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DOCTOR OF PHILOSOPHY

Transfer Pricing in the Oil Industry
Improving Tax Anti-Avoidance Regimes in the Gulf Of Guinea

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TRANSFER PRICING IN THE OIL INDUSTRY:

IMPROVING TAX ANTI-
AVOIDANCE REGIMES IN THE
GULF OF GUINEA

Z.A. Nyah

PhD in Energy, Petroleum and Mineral Law and Policy

Dedication

To Fidelia and the Nyahs

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Abbreviations

ADR	Alternative Disputes Resolution
ALP	Arm's Length Prices
ALR	Arm's Length Range
ALS	Arm's Length Standard
APA	Advance Pricing Agreement
API	American Petroleum Institute
APT	Additional Profits Tax
ATAF	African Tax Administration Forum
BBL	Barrels
BOE	Barrels of Oil Equivalent
BRICS	Brazil, Russia, India, China and South Africa
CEMAC	Economic and Monetary Community of Central African States
CFC	Controlled Foreign Companies
CM&C	Central Management and Control
CPC	Cameroon Petroleum Code
DD&A	Depreciation, Depletion and Amortization
DD&R	Deter, Detect & Redress/Remedy
DGI	Direction General des Impôts (Directorate General of Taxation)
DVNI	Division of National and International Tax Examinations (France)
E&P	Exploration and Production
ECT	Energy Charter Treaty
EITI	Extractives Industry Transparency Initiative
EMTR	Effective Marginal Tax Rate
FDI	Foreign Direct Investment
FIRS	Nigeria's Federal Inland Revenue Service
FTA	French Tax Administration (Authorities)
GDP	Gross Domestic Product
GoG	Gulf of Guinea
HRIC	Higher Rates of Proportional Income Tax
IOC	International Oil Company

IRS	Internal Revenue Service (USA)
JITSIC	Joint International Tax Shelter Information Centre
KRA	Kenyan Revenue Authority
LGTA	Light General Tax Audit Approach
LNG	Liquefied Natural Gas
LTU	Large Taxpayers Unit (or Department)
MAC	Moscow Arbitration Court
MAP	Mutual Agreement Procedure
MAS	Model Avoidance Scheme
MNE	Multinational Enterprise (s)
NOC	National Oil Company
O&G	Oil and Gas
OECD	Organization for Economic Cooperation and Development
OFCs	Offshore Financial Centers
OHADA	Organization for the Harmonization of Business Law in Africa
OPEC	Organization of Petroleum Exporting Countries
OSP	Official Sales Price
PATA	Pacific Association of Tax Administrators
PPTA	Petroleum Profit Tax Act (Nigeria)
PSC	Production Sharing Contract
PWYP	Publish What You Pay
R/T	Royalty Tax
R&D	Research and Development
RFTC	Russian Federation Tax Code
TCF	Trillion Cubic Feet of gas
TP	Transfer Prices (or Pricing)
TPM	Transfer Price Manipulation
TTPAA	Tight Transfer Pricing Audits Approach
UT	Unitary Taxation (or Formulary Apportionment)
WTI	West Texas Intermediate
ZATOs	Closed Administrative Territorial Formations

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Naturally, I assume responsibility for any errors or omissions that might exist in the work.

Declaration

This doctoral thesis is written by Zebong Asaah, Nyah under the supervision of Dr. Abba Kolo of the Centre for Energy, Petroleum and Mineral Law and Policy of the University of Dundee, in partial fulfillment of the requirements for the degree Doctor of Philosophy in Energy, Petroleum and Mineral Law and Policy. The author, unless otherwise stated, has consulted the references cited in the thesis and declares that the work has not been previously accepted for a higher degree.

Date

Candidate sign.....

Abstract

The research is based on the international tax concept of transfer pricing and specifically examines it as a mechanism used abusively by international oil companies (IOCs) to dodge taxes. Transfer price manipulation (TPM) has recently emerged as an issue of concern to stakeholders in the oil industry due to the fairly extensive scope of operations and assets that are controlled by IOCs and the economic recession of 2008 that widely caused a decline in corporate profits. Over time, the effect has been reinforced reliance by multinational enterprises (MNEs) on aggressive tax planning schemes to optimize after tax profits and the adoption of countervailing measures by governments to protect their domestic tax bases from undue erosion. Notwithstanding that IOCs pay large amounts in taxes to governments around the world the atmosphere has been particularly tense with critics accusing them of being notorious abusers of international tax rate differentials. In reaction to this perceived threat, many resource rich countries seeking to mobilize badly needed but increasingly scarce fiscal revenues have over the years allocated considerable resources to developing anti-avoidance regimes capable of *detering*, *detecting* and *remedying* aggressive tax avoidance schemes. This raises three important concerns, namely: (i) the extent of involvement of IOCs in TPM, (ii) the effectiveness of present anti-avoidance regimes in the Gulf of Guinea in terms of tackling abusive practices, and (iii) measures that can be taken to improve effectiveness of these regimes. It is against this backdrop that anti-avoidance regimes in two OECD (US, France) and two GoG (Cameroon, Nigeria) countries are analyzed. Using qualitative analysis as basis for the study it is argued that defects in the engineering and administration of anti-avoidance regimes in the GoG could create an incentive or facilitate recourse by IOCs to complex TPM schemes designed to avoid taxes. The range of techniques used to achieve this outcome is examined and defects in the design and implementation of existing GoG tax anti-avoidance regimes are identified. Finally, in order to improve the effectiveness of these regimes the study recommends domestic and international measures to be taken to diminish existing lacunae and mitigate recourse by IOCs to TPM schemes.

GENERAL INTRODUCTION

The international taxation discipline has significantly grown in importance in recent years, a trend explained by two main factors. Firstly, multinational enterprises (MNEs) have been developing ingenious ways to minimize their exposure to taxation risks around the world. Of these, transfer pricing (TP) is the greatest single challenge to effective tax gathering facing most governments.¹ Secondly, states are developing and testing innovative ways to improve the effectiveness of domestic and international taxation regimes as they seek to tackle challenges arising from overlapping tax jurisdictions. That is, MNEs aim to beat taxation regimes, while governments aim to reinforce them.

Krasner defines international regimes as "sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations."² Eden relies on this definition to note the existence of an international tax regime within which is nested an international transfer-pricing regime built on the *arm's-length standard*.³ This sub-regime focuses on challenges that arise from MNEs using intrafirm TP in the context of cross-border trade. MNEs are indeed perceived widely to abuse TP such that governments have tended to overlook its legitimate business uses and focused more on treating it as a mechanism adopted by multinationals to dodge taxes and to increase their global after-tax profits.⁴ It can be used to shift profits between two or more jurisdictions with tax rate differentials, requiring that states adopt effective anti-avoidance rules to *deter, detect* and *redress* abusive TP.⁵

Transfer price manipulation (TPM) is widespread across major international industries like finance, manufacturing and pharmaceutical, which have been considerably covered in the literature.⁶ However, not much has been written on the subject in the oil industry notwithstanding the scope of

¹ Ernst & Young, *Global Transfer Pricing Surveys*, p.5 September 2006; On more recent concerns expressed by the

OECD and G20 leaders, see: Houlder, V., *Taxation: Unsafe offshore*, Financial Times (FT), January 13, 2013; Houlder, S., *Structural Causes and Regime Consequences: Regimes as Intervening Variables*, in *International Regimes*, edited by Stephen Krasner. Ithaca N.Y.: Cornell Univ. Press (1983). This definition applies to domestic regimes as well.

³ Eden, L., *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America*, p.103 (1998)

⁴ Burke, J., *Re-thinking First Principles of Transfer Pricing Rules*, 30 Va. Tax Rev. (2011) 613

⁵ Greenaway, T., *International Tax Arbitrage: A Frozen Debate Thaws*, *Tax Notes International*, January 25, 2010]

⁶ Eden (1998), supra note 3 at pp.320-352; see also FT, *Tax wars: Looking at STARS*, September 25, 2011, ("In a two part investigation, the Financial Times and ProPublica examine how banks and companies have used the tax system to their own advantage"), available at: <http://www.ft.com>; Pearson, T., *Proposed International Legal Reforms for Reducing Transfer Pricing Manipulation of Intellectual Property*, 40 N.Y.U. J. Int'l L. & Pol. (2008) 541.

economic operations and assets controlled by international oil companies (IOC).⁷ This is hard to explain without undertaking proper analysis but suffice to indicate that the highly unique treatment and complex fiscal systems reserved for hydrocarbons is a reason for the *status quo*. Further, since benchmark prices for hydrocarbons are available on open markets this raises legitimate questions in the minds of critics on the relevance of pursuing research in this area. From this perspective TP is not seen as a problem, creating in effect three major preoccupations. The first is determining whether IOCs actually manipulate transfer prices. If they do, the second questions the effectiveness of existing anti-avoidance regimes in tackling the practice. And, where these regimes are found to be defective, the third explores what measures to adopt going forward to render them effective.

With these concerns in mind, we select and analyze TP anti-avoidance regimes adopted by net-producing and net-consuming countries. For reasons explained in chapters 1.2 and 2.2, two OECD and two Gulf of Guinea (GoG) countries are retained for this purpose. It is argued that a defective anti-avoidance regime is likely to incentivize and facilitate recourse by IOCs to complex TP schemes. Noting that the select regimes have policy and statutory differences that serve as bases for comparing their effectiveness, the work examines the range of techniques used and identifies lacunae in existing TP regimes. It also provides a repertoire of options that countries looking to develop more effective regimes can draw from. With these in mind the study explores ways to improve existing GoG anti-avoidance regimes by diminishing lacunae and mitigating the recourse by IOCs to abusive TP schemes. Since most GoG hydrocarbon-producing countries operate in somewhat similar context and face similar challenges as many of their counterparts on the continent, it is expected that results of the study would prove useful across Africa [and possibly beyond]. However, this study does not provide a one-size-fits all solution to the problem and states relying on solutions proposed in this work have to adapt them to their specific circumstances.

The thesis is structured in three parts and eight interrelated chapters. PART I comprises three chapters relating to the background, conceptual and analytical frameworks, and oil taxation. Chapter 1 presents the background and typology of research variously discussing the problem area, questions, objectives, justification and methodology. The chapter also presents some limitations to the study and useful caveats to consider when critiquing data analyses and findings of the research.

⁷ For example, of the over 400 pages book by Daniel et al on petroleum taxation, only 4 pages were devoted to TP issues. See P. Mullins, *International Tax Issues for the Resources Sector*, in P. Daniels, M. Keen & C. McPherson (Eds.) *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (Routledge, 2010) pp.378, 388-391. Among the few exceptions, see, Deloitte, *Transfer Pricing in Oil & Gas Sector*, *International Tax Review*, Dec. 2012; Deloitte, *Spotlight on LNG: Transfer Pricing challenges in the Industry*, *Global Oil & Gas Tax Newsletter*, Nov. 2012

In chapter 2, focus is on examining the conceptual and analytical frameworks in relation to which arguments in the thesis are developed. Broadly, the concept of transfer pricing is discussed, the construct of *effectiveness* is examined, and a qualitative framework for judging the effectiveness of existing TP regimes in the GoG is developed. For its part chapter 3 examines oil markets, prices, petroleum fiscal instruments and tax regimes. Considering that the research focuses on IOCs and their possible use of TPM to avoid taxes, it proved essential to include a chapter presenting baseline information on both trading and fiscal arrangements specific to the oil industry. It is hoped that this would enhance understanding of issues raised in the substantive chapters (4, 5, 6) of the study.

PART II of the thesis covers two main issues. Firstly, chapter 4 explores publicly available evidence in a bid to determine whether IOCs actually or could minimize liability to tax by manipulating transfer prices in spite of existing TP anti-avoidance regimes. The practice is examined as an issue of global concern, and one that is gaining increased traction in the GoG. Indeed, any successful deployment of these schemes *a priori* suggests the existence of possible defects in actual anti-avoidance regimes. This supposition, however apparent, is ascertainable only if one analyzes this contention properly. As prelude to making such analyses, chapter 5 presents an overview of the given-regime-state of TP anti-avoidance regimes in four select countries: the US, France, Nigeria and Cameroon. Chapter 6 analyzes the effectiveness of these regimes in terms of deterring, detecting and remedying TPM from the *bi-dimensional* perspectives of their engineering and administration. As will be seen in the thesis, these chapters reveal important lacunae that need to be addressed. With this objective in mind, TP anti-avoidance regimes in the US and France are jointly used as benchmarks with important lessons that could be drawn on by other countries (including those in the GoG) to inform possible reforms and upgrades to existing tax anti-avoidance regimes.

The study is concluded in PART III that contains two chapters. The first explores and recommends solutions to TPM that are of a domestic nature and the second proposes international measures to complement domestic efforts. In chapter 7, the propitiousness of having GoG countries maintain the arm's-length standard over unitary taxation is examined. The chapter also examines whether it makes strategic sense to pursue a light approach over one that is tight in regulating TPM, and what measures can be taken to reinforce the effectiveness of domestic TP regimes in line with the regulatory approach chosen. Chapter 8 for its part argues the need to create an international Transfer Pricing Support Facility to assist African governments in their effort to find effective ways to deter, detect and remedy aggressive international tax avoidance schemes like TPM.

PART I

TYOLOGY OF RESEARCH AND THE TAXATION OF OIL COMPANIES

CHAPTER 1

BACKGROUND AND TYPOLOGY OF RESEARCH

Taxation remains a highly sensitive and complex subject presenting avenues for conflict between taxing authorities and taxpayers. Besides, the discipline has often developed its own logic that sometimes differ from what obtains in many other legal disciplines. It is therefore no surprise that non-experts perceive discussions on taxation as bordering on the edge of eccentricity and attempts at understanding tax related issues continue to be quite challenging to many. Take for example the definition of 'tax' itself. It is defined in the US case of *Phillips Petroleum Co. v. Commissioner*,⁸ as "an involuntary charge imposed by legislative authority for public purposes." This definition can be construed widely to include a variety of fiscal receipts that would ordinarily not qualify as taxes. Typical examples include the national insurance contribution (NIC) and payments by users of public services such as healthcare that are rightly public receipts but do not technically amount to taxes. It is for this reason that the caveat "...for which nothing is received in return" is often added to the classic definition of tax.⁹ Taxes are also not used solely to raise revenue for public purposes. Other important uses include its role in the redistribution of wealth and as an instrument of macroeconomic management to discourage the consumption of harmful goods like tobacco and alcohol.¹⁰ Regardless of the purpose for its imposition, taxpayers are often confronted by two choices when it comes to the issue of settling taxes. That is, whether to disburse the amounts of money claimed by the fisc in taxes or to resist doing so. While it is presumptuous to question the commitment of taxpayers in contributing their *fair* share in taxes, this dilemma suggests that in matters of taxation the interest of governments and taxpayers seldom align. Few areas of taxation, if any, truly exemplify this contention more intensely than the taxation of multinational enterprises.

In this opening chapter therefore, the background and typology of the study is discussed in six main sections. Firstly, the potential for conflict in the field of taxation is examined concerning notably the issue of cross-border intrafirm transfers that easily results in the manipulation of transfer prices (1.1). This is closely followed by a presentation of the research problem that largely focuses on fears by governments of extractives rich countries that IOCs could, if not already using TPM to erode

⁸ 104 TC 256 at 294-295 (1995)

⁹ James, S. & Nobles, C., *The Economics of Taxation*, Chapter 2 –'introduction to Part 1' pp.2-15 (1992)

¹⁰ Shipwright, A. & Keeling, E., *Revenue Law*, p. 9 (1997)

domestic tax bases. This raises serious concern regarding the effectiveness of existing TP anti-avoidance regimes in deterring, detecting and remedying abuse (1.2). Next, three research questions are identified, two of which are incidental offshoots of the principal one (1.3). As indicated earlier in the introductory section critics are likely to question the relevance of pursuing research on TPM in the oil industry, in response to which the objectives and justification of the research are presented (1.4). The research methodology is discussed in section 1.5 and major limitations encountered during the study are presented in section 1.6.

1.1 Potential for Conflict in International Taxation

Multinationals have grown into highly influential players in the global economy. They have become not only attractive targets of taxation, but importantly stand as the category of taxpayers presenting the most technical and practical challenges to governments aiming to tax in an effective manner transactions taking place within their borders. This is so because while governments seek to optimize tax yield, MNEs for their part seek to optimize global after-tax profits for the benefit of shareholders. Inherent in this rapport is the potential for conflict of a dual nature, namely *domestic* and/or *inter-jurisdictional*. Firstly, there is risk of conflict between governments and MNEs that often culminate in accusations and counteraccusations of tax avoidance and over taxation. TPM is used in this thesis to illustrate the point. Secondly, since the imposition and collection of tax is an important attribute of sovereignty, there is risk of conflict between the MNE's home and host governments considering that they each seek to tax transactions taking place within their borders or under their tax laws. For example the US is one such country that adopts a unitary tax system for its residents and citizens often leading to jurisdictional overlap and sometimes double taxation. In theory this outcome is enabled by the fact that a country's exercise of powers to impose taxes is unbounded both under international and most domestic laws. In *Madden v. Kentucky*¹¹ for example, the US Supreme Court opined that, "...in taxation, even more than in other fields, legislatures possess the greatest freedom in classification." Equally, it is unlikely under the 'Revenue Rule' that courts in one country would assist in the enforcement of another's tax laws: *Government of India v. Taylor*.¹²

¹¹ 309 US 83, 88 (1940), quoted in *Regan v. Taxation With Representation*, 461 US 540, 547 (1997)

¹² [1955] AC 491

In practice though, the potential for conflict (domestic or inter-jurisdictional) is checked by a couple of factors. Firstly, the power to tax is limited by enforcement and collection difficulties, and the countervailing interest of other governments.¹³ Further, the imposition of tax is legal only if authorized by statute: *A-G v. Wilts United Dairies Limited*.¹⁴ This principle of legality limit's but does not eliminate the risk of conflict. Nonetheless, it is incorporated in many constitutions around the world¹⁵ and can be traced back to Article 4 of the UK Bill of Rights (1688) that provides: "...levying money for or to the use of the Crowne by pretense of prerogative without grant of Parlyament for longer time or in other manner than the same is or shall be granted illegal."¹⁶ Notwithstanding that domestic tax laws have since evolved along statutory lines to reduce areas of possible conflict between stakeholders by essentially clarifying applicable rules, it is worth noting that the risk of conflict still exists. Likewise, the international tax regime relies on sovereign governments incorporating into domestic statutes acceptable global standards. This is not always evident. Therefore, 'architecting, engineering and administering'¹⁷ tax systems that eliminate the potential for conflict in domestic and international taxation continues to prove incredibly complex. It is every draftsman's dilemma.

The Draftsman's Dilemma: Design Lacunae

The draftsman's task is a *circulus inextricabilis* in which he must factor into his design of a good tax system key canons of taxation,¹⁸ that is, create rules intended to bring within its letters some and not other type of earnings, on some and not other forms of transactions, in some and not other industries, and for some and not other legal persons. The result is detailed and unavoidably complex provisions that are often ambiguous or obscure. This in-turn creates avenues for avoidance, threatening the very tenets on which the 'good' system was built in the first place.¹⁹ Although the complexity of tasks assigned the draftsman merit our sympathy, a combination of the needs to provide certainty to businesses and the fact that governments have unbounded powers to tax, traditionally make courts less sympathetic to the use of ambiguous phrases like 'benefitting from' or

¹³ Arnold, Brian, *The taxation of controlled foreign corporations: an international comparison*, p.1 Canadian Tax Paper N^o. 78 Toronto; Canadian Tax Foundation

¹⁴ [1921] 37 TLR 884

¹⁵ For example: 16th Amendment to US Constitution, and Article 34 in France Constitution.

¹⁶ Clarendon's, *History of the Great Rebellion and The Case of Ship Money* 3 St. Tr. 725 (1637)

¹⁷ Shoup, C., "*Melding Architecture and Engineering: A Personal Retrospective on Designing Tax Systems*" in *Retrospectives on Public Finance*, pp. 19-30 (1991). In Shoup's view good rules involve the correct blend of choices on which taxes to impose, the substantive issues of each tax, and practical implementation.

¹⁸ Equity, neutrality, certainty and efficiency

¹⁹ Shipwright (1997), *supra* note 10 at p.11

'connected therewith' in tax statute: *Commissioners of Customs & Excise v. Top Ten*.²⁰ Statute must clearly tax the subject and not simply intend to, else the fisc risk seeing reasonable back-tax claims reversed by the courts in line with the maxim 'there is no equity in a taxing statute'. However unfair this might be, Lord Simon of Glaisdale opines in *Ransom v. Higgs* that to rule otherwise would be "to substitute the rule of caprice for that of law".²¹ Thus, the draftsman's challenge is not only to *create a 'good' tax system* that gathers revenue in line with canons of taxation, but equally *keeping it 'good'* through effective anti-avoidance safeguards. Otherwise, effort is wasted and the system so diligently designed is rendered unfair, if the taxing statute contains inherent flaws that operate against effective deterrence, detection and remediation of abusive practices. In effect tax avoidance schemes are only effective to the extent that the architecture, engineering and administration of a country's tax anti-avoidance regime is defective.²² This thinking is important to bear in mind when exploring approaches and measures to adopt in strengthening domestic and international tax anti-avoidance regimes.

The Concept of Tax Avoidance

Liability to a tax charge is *prima facie* a matter of law not morality, and whether or not the abuse of tax laws is established depends on the interpretation one makes of a taxing statute. Since tax is a creature of statute, it is questioned whether courts should strictly apply the charge without inferring "equity in the taxing statute", or rather take a more proactive interpretational approach to serve as guardians of "fair contribution".²³ If so, how are judges to reconcile conflicting views on what types of tax planning arrangements amount to legitimate or illegitimate minimization of tax? Indeed, one person's perception of certain commercial arrangements as legitimately intended to *mitigate tax*, might to another be deemed as artificial or outright fraudulent and intended solely to *avoid* or *evade* taxes. Experts variously describe the spectrum of taxpayer behavior aimed at minimizing tax as *mitigation*, *avoidance* and *evasion*. However, these concepts are often confused and their meanings

²⁰ [1969] 3 All ER 39

²¹ [1974] 3 All ER 949: This emphasizes importance of the principle of legality in the area of taxation. Nonetheless, the courts are moving away from this strict interpretation: see *Ramsay (WT) Ltd v. IRC* [1981] STC 174, *IRC v. Burmah Oil* [1982] STC 30. In *Whitney v. IRC* [1926] AC 37, at p. 52, Lord Dunedin rather took the view that tax laws are meant to be workable and courts should secure that objective, unless some crucial omission makes that unattainable. This has developed into what is now called the 'new approach'

²² See Chapter 2.2 for discussions of effectiveness analysis

²³ Shipwright (1997), *supra* note 10 at p.70

interchanged given that it is difficult to establish bright line distinctions between them.²⁴

Tax Evasion or Tax Fraud

Evasion is the illegal non-payment of a lawful tax. It is a most objectionable form of noncompliance as it involves the taxpayer setting up transactions in a manner that oversteps the mark and enters into the realm of criminal conduct (e.g. fraud, dissimulation) in a drive to reduce its tax liability. As is the case with any other crime there is intentional knowledge (*mens rea*) and the actual or attempted performance of wrongdoing (*actus reus*). Classic examples include *deliberately* failing or omitting to put an item into a tax return or claiming deductions to which a taxpayer knows it is not entitled. In both cases evasion is established if there is absence of an honest belief that a person is not liable to a tax, and not merely due to negligent conduct. As concerns TPM, the *Yukos Case* in Russia is an example where promoters of such schemes were convicted of criminal conduct, ordered to pay back-taxes and jailed for tax fraud.²⁵ However, courts seldom decide TPM cases along the lines of evasion. The evidence suggests that while tax authorities often allege fraud when initiating TP suits, many of these disputes are settled with very little or no follow-through on fraud charges. Examples of such cases could be found in the US,²⁶ Canada²⁷ and the UK.²⁸ This suggests an inclination in many countries to treat TPM as avoidance, reserving charges of evasion only to extreme cases where criminal conduct and practice are deemed to have taken place.

Tax Avoidance: Acceptable and Unacceptable avoidance

Avoidance, unlike evasion, is legal. Miller and Oats describe it as working within the law or exploiting the same to minimize tax liability by arranging one's affairs -prior to a tax liability arising- to attract less tax than would otherwise be paid.²⁹ While avoidance is broadly regarded as legal, a distinction is often made between forms of the practice that are *acceptable* and others that are not. In

²⁴ The distinction between tax avoidance and tax evasion is sometimes thin or blurred; Gammie, M., *Moral taxation, immoral avoidance - what role for the law?* BTR (2013) 577; Viegas, R., *Evasive Measures? The ever-blurring line between tax avoidance and tax evasion*, Journal of Int'l. Banking & Finance Law, September 2013, PP. 510-511; ("Legally, there is a clear difference between evasion and avoidance... The reality, however, is more complicated.") Palan, R. et al., *Tax Havens: How Globalization Really Works* 10 (2010), quoted by *Jasmine M Fisher, Fairer Shores: Tax Havens, Tax Avoidance, and Corporate Social Responsibility*, 94 Boston Univ. L. Rev. (2014) 337, at fn. 10

²⁵ Other examples include a US\$ 200 millions settlement between Russian Tax Authorities and oil major Lukoil in back-taxes for 2000-2001; and US\$1 billion tax claim against TNK-BP Oil Company for 2001.

²⁶ *J. Benjamin Johnson v. Shell Oil Co.*

²⁷ *Redpath Industries Ltd., et al. v. The Queen* 84 DTC 6349

²⁸ *IRC v. Burmah Oil Co. Ltd* [1982] STC 30; [1981] STC 174

²⁹ Miller, A. & Oats, L., *Principles of International Taxation*, p.12 (2009); Avi-Yonah, R., Sartori, N. and Marian, O., *Global Perspectives on Income Taxation Law*, Chap. 7 (OUP, 2011)

principle one should not find it hard to distinguish between acceptable and unacceptable avoidance. In practice though, the line between both types of avoidance is blurred.

Acceptable avoidance (or tax mitigation) is commonly used in the literature to express the legitimate and entirely rational behavior by taxpayers to take lawful and advisable steps to reduce tax costs. It has been argued by the UK courts that if a taxpayer so arranges itself and business affairs in a manner that lawfully limits the Inland Revenues likelihood of “dipping the largest possible shovel into his stores”, this was *acceptable* as it is under no “obligation, moral or other” not to do so: *Ayrshire Pullman Motor Services v. IRC*.³⁰ Lord Templeman notes in the Privy Council decision in *Challenge Corporation* that a “taxpayer has always been free to mitigate his liability to tax”. Lord Tompkin also argues “everyman is entitled if he can to order his affairs so as that the tax attaching under the appropriate acts is less than it otherwise would be”. As noted by the House of Lords in *Willoughby*, the hallmark of mitigation is taking advantage of a fiscally attractive option afforded taxpayers by the legislation and genuinely suffering the economic consequences intended by parliament to be suffered by those taking advantage of the option. Courts around the world are clarifying their approach to distinguishing mitigation from avoidance, basing it largely on “the choice doctrine”. If a taxpayer while structuring its commercial transactions is faced with two lawful alternatives, one resulting in a high amount of tax and another in less tax being paid, it would be wrong to infer that it has engaged in unacceptable avoidance of tax simply because it chooses to settle for the most tax efficient option. It is legitimate to expect a rational actor to select the most favorable option and outcome.

Unacceptable forms of avoidance, simply referred to in the literature as tax avoidance, are mainly determined using the “purpose test”. The structuring of commercial transactions amounts to unacceptable avoidance if a taxpayer’s dominant purpose is to reduce or eliminate its tax liability. As Lord Templeman states in *Commissioner of Inland Revenue (New Zealand) v. Challenge Corporation Ltd.*,³¹ a transaction is deemed unacceptable for tax computation purposes if ‘income tax is avoided and a tax advantage derived from an arrangement when the taxpayer reduces his liability to tax without involving himself in the loss or expenditure which entitles him to that reduction’. A taxpayer engages in unacceptable avoidance if its financial position remains unchanged except for the cost involved in devising and implementing the scheme. Unacceptable avoidance carry’s with it the connotation of an unfair and artificial -but otherwise lawful- arrangement of business affairs with the

³⁰ [1929] 14 TC 754

³¹ [1986] STC 548 at p. 554

primary aim of reducing ones liability to tax. A taxpayer who so arranges its business affairs to reduce its tax liability, and whose financial position remains unchanged except for the cost employed to devise and implement the scheme, is reasonably said to have avoided tax unacceptably. In *Ensign Tankers v. Stokes*,³² Lord Goff of Chieveley said avoidance is unacceptable if it resulted from “a creation of artificial structures by which, as though by the wave of a magic wand, the taxpayer conjures out of the air a loss, a gain or expenditure, or whatever it may be, which otherwise would have never existed.” Unacceptable avoidance is therefore complying with the *letters of the law* but *not its spirit*, and the result of many factors including amongst others tax aversion, high-unjustified taxes and lack of civility amongst the tax paying public. Examples of unacceptable avoidance schemes include treaty shopping, gold plating, double dips and transfer price manipulation (TPM) the last of which is the focus of the present study notably with respect to the GoG oil industry.

MNEs, IOCs and TPM: An Introduction to the Concepts

The influence of multinationals in the global economy has increased significantly over the years.³³ MNEs are highly integrated businesses comprising two or more companies, operating in two or more countries and placed under a common center of control. In principle, they uniquely blend vertical and/or horizontal cross-border integrated units presenting the advantages that they can draw from a common pool of resources and share the common goals of earning profits and growing their share of markets.³⁴ However, they present certain important challenges to governments. Firstly, governments only have jurisdictional competence whereas MNEs enjoy a global reach due to their presence in many countries around the world. Secondly, activities pursued by their affiliates are under some form of control by the parent. If centralized, as the case is with many such companies, then the head office can directly influence decisions on investment, production, sales, trade or *pricing*. Thirdly, they aim to optimize global after-tax profits. Sometimes, this entails allocating resources and taxable bases (income, expenses, overheads) between participating jurisdictions in a manner that clashes with home and host country tax and other economic policies.³⁵

³² [1992] STC 226 at p.244

³³ The 1993 World Investment Report, p.13 UNCTAD (1993) as far back as 1993, estimated that at least 35,000 parent companies controlled some 170,000 foreign affiliates around the world. Given that international trade has grown and many companies are expanding their operations abroad, these numbers would have significantly increased today.

³⁴ Eden (1998), *supra* note 3 at p.13

³⁵ WIR (1993), *supra* note 28. On the highly Integrated nature of IOCs and their tendency to engage in TPM, see: Glenn P. Jenkins and Brian D. Wright, *Taxation of Income of Multinational Corporations: The case of the United States Petroleum Industry*, 57 *The Review of Economics and Statistics* (1975) pp. 1-11; Thomas A. Gresik, *The Taxing Task of Taxing Transnationals*, 39(3) *Journal of Economic Literature* (2001) 800-838

Indeed, IOCs are good examples of multinationals that operate and are present through controlled affiliates and subsidiaries in all corners of the world. For purposes of the study, IOCs are multinationals that habitually explore, produce, transport, refine and market hydrocarbons including for example ExxonMobil, Royal Dutch Shell, ConocoPhillips, Total SA, ChevronTexaco and BP.³⁶ IOCs are classified as majors or independents. *Majors* customarily engage in all five listed stages of the industry value chain and are highly integrated enterprises sharing in the common goal of optimizing group after-tax profits.³⁷ *Independents* for their part operate on a much smaller scale and are engaged in one or more but not all stages of the industry value chain. In both cases, some form of control (decentralized or centralized) is exercised by the parent on its affiliates including, issuing directives on intragroup transfers. Prices charged for intrafirm operations are referred to as transfer prices. It is *controlled* if set by the head office, or *market-based* if negotiated independently by a group's business units. **Transfer pricing** can be used for legitimate and illegitimate purposes. As a *legitimate* practice, it serves to reduce transactional costs,³⁸ determine profitability of individual divisions, measure performance of individual units, and motivate corporate managers.³⁹ However, it is not the legitimate but illegitimate uses of TP that is discussed in this study. As an *illegitimate* practice, IOCs can manipulate transfer prices to report higher taxable profits in countries where taxes are lower in effect boosting their post-tax earnings. Implementation of such schemes in the hydrocarbons industry is troubling to tax authorities around the world considering the industry's highly integrated structure and huge volumes of complex intrafirm transfers carried out annually.⁴⁰

This predisposition is reinforced by allegations that IOCs exploit both integrated structures and ineffective anti-avoidance regimes to game jurisdictions of tax revenues.⁴¹ Most of these schemes take linear or circular forms and consist of shifting income from high to low tax countries, and/or shifting costs from low to high tax countries on tangible, intangible or service transactions.⁴² Today the issue of TPM is topical and can be traced to the 2008 financial crisis that resulted in

³⁶ Smith, E. et al (Eds.) *International Petroleum Transactions*, p.24 (1993).

³⁷ For example recent mergers between Exxon and Mobil (ExxonMobil); Total and Elf (TotalFinaElf now Total SA); Conoco and Phillips (ConocoPhillips); Chevron and Texaco (ChevronTexaco, now Chevron)

³⁸ Emmanuel, C. & Mehafdi, M., *Transfer Pricing*, p. 24 (1994); John JA Burke, *Re-thinking First Principles of Transfer Pricing Rules*, 30 Va. Tax Rev. (2011) 613

³⁹ Mostly in management accounting: see Abdallah (1989), Tang (1993). This issue is developed further in Chapter 2.1

⁴⁰ Eden (1998), *supra* note 3 at p.6

⁴¹ Examples include *Exxon Corp. & Affiliates v. IRC* [1993] T.C. Memo.1993-616 (USA); and *Irving Oil Limited v. The Queen (Appeal)* Carswell Nat 281[1988] 1 C.T.C. 263, 16 (Canada)

⁴² The technical meaning given to the concepts of 'Low' and 'high' in this study can be found in Section 1.2 below. For discussions on how these schemes work, see Chapter 4.1.3.1 {*infra*}

reduced profit margins for some industries, exerting enormous pressure on managers to improve after-tax performance. The crisis also squeezed most government budgets and intensified the need to mobilize badly needed but increasingly scarce fiscal revenues. It refocused the attention of governments to abusive TPM schemes and the need to challenge them. In fact “the likelihood of being challenged by tax authorities on... transfer-pricing [practices]” is a major risk acknowledged by multinationals.⁴³ The extent to which governments are effective in doing so remains open to debate. For example, in spite of accumulating years of experience and allocating huge resources to efforts aimed at tackling the problem, governments of developed countries continue to face immense difficulties. Besides cross-border operations are vast such that even the smartest tax officials can inadvertently let abuses slide through their scrutiny undetected. This is further rendered possible by the fact that most governments insist on businesses using the *arm’s-length standard* to determine TPs.⁴⁴ Given that developed countries continue to face these challenges in spite of taking fairly comprehensive steps to tackle TPM, one can surmise the depth of problems facing developing ones that are only now introducing TP regimes.

Options for Tackling TPM: Judicial and Statutory Anti-avoidance

Assuming that one can tell what forms of business arrangements amount to tax avoidance⁴⁵ it is important that governments adopt anti-avoidance mechanisms that are capable of tackling such schemes effectively. Two major techniques that have been developed in this regard are *judicial* and *statutory* anti-avoidance. *Judicial anti-avoidance* has been widely used by courts in common-law countries to mostly tackle schemes that are countered in general terms in the statute. Examples of judicial doctrines that have been developed to counter avoidance schemes include: shams (*WT Ramsay v IRC*), substance over form, step transaction doctrine (*Helvering v Gregory*), business purpose test (*Furniss v Dawson*), and object and spirit (*Stuart Investment Ltd. v R*).⁴⁶

Alternatively, the legislature in a country could adopt *statutory anti-avoidance rules* that

⁴³ Henderson Global Investors, *Tax, Risk and Corporate Governance*, p. 4, (2005a); On the issue of tax avoidance being high on the political agenda of many governments: see FT, *Competitive behaviour should not stray into protectionism*, September 30, 2014; FT, *EU’s Amazon probe steps up pressure over tax deals*, Oct. 7, 2014, available at: <http://www.ft.com/cms/s/0/d03cce8e-488f-11e4-ad19-00144feab7de.html#ixzz3FYpu6Mol>; *Tax avoidance by multinational companies*, A Report by the UK Parliament Public Accounts Select Committee, available at: www.parliament.uk/business/publications; Wilmshurst, P., *UK Transfer Pricing and the Tax Avoidance Debate*, 65 *Tax Executive* (2013) 33; Jasmine M Fisher (2014), *supra* note 26

⁴⁴ ALS privileges transactional analysis and this poses serious practical challenges e.g. there are hardly any common criteria or rules available for determining ALP on services and brands

⁴⁵ As seen earlier, the difference between acceptable avoidance (mitigation) and unacceptable avoidance can be dodgy.

⁴⁶ Shipwright (1997), *supra* note 10 at p.72

generally or specifically counter business arrangements deemed to be unacceptable avoidance. In principle, some countries adopt general anti-avoidance “provisions requiring that any transaction the paramount object of which is the avoidance of tax should be void for that purpose though valid for all other purposes.”⁴⁷ In this case, the *judicial doctrines* mentioned earlier would be useful in determining transactions that amount to tax avoidance and those that do not. This technique has the advantage that it eliminates the drafting difficulty of foreseeing all avenues of avoidance, of keeping tax rules simple, or of creating road maps and outlets for new avoidance schemes. However, general rules are not ideal in dealing with all types of avoidance schemes. For certain forms of objectionable schemes it is needed that the law clarifies via detailed and *specific anti-avoidance* rules, business transactions that would amount to tax avoidance if they are to be effectively tackled. Examples of such schemes include: thin capitalization, loss reliefs and group reliefs, re-investment relief, offshore funds, leasing, distributions and the transfer of assets/profits abroad that is examined in this thesis.

There is, it seems, consensus that the appropriate technique for tackling TPM is statutory anti-avoidance. It is nonetheless debatable if statutory anti-avoidance rules adopted for this purpose should take the specific or general forms. Recent trends show a certain level of inclination towards adopting specific rules,⁴⁸ a technique hereinafter adopted as basis of our analysis.

1.2 The Main Research Problem

The research broadly centers around the need to attract inward FDI into the GoG oil sector and fears by these countries that IOCs could, amongst others, dodge domestic taxes by engaging in TPM.⁴⁹ The TPM problem seen from this perspective presents two main challenges to GoG oil producing countries like Nigeria and Cameroon. Firstly, there are indications that IOCs engage in TPM schemes: Professor Hudson’s claim that oil companies use transfer prices to avoid taxes,⁵⁰ and questions as to the *exclusive business purpose* of the 2005 Royal Dutch Shell M&A deal.⁵¹ Likewise,

⁴⁷ Lord Simon of Glaisdale in *Ransom v Higgs* [1974]

⁴⁸ See Kenyan and Canadian court cases

⁴⁹ It is important to note that *natural resource taxation regimes* differ from the *common taxation regime*. Its fiscal structure is unique and while some of the rules applied to common tax regimes are valid for resource taxation, highly specialized skills are required to analyze income & cost issues for purposes of resource taxation.

⁵⁰ Wall Street economist Prof. Michael Hudson claims “...Esso and other oil majors were able to “game” the world’s tax systems by selling their crude oil at so low a price to their tanker companies as to leave little income for Saudi Arabia, Venezuela or other oil producing countries...” in Counter Punch (2004)

⁵¹ Tax Gap Reporting Team, *Shell*, The Guardian, 3rd February 2009 at <http://www.guardian.co.uk/business/2009/feb/03/3> [Last visited: February 9, 2011] in which it is claimed Shell UK’s merger with Shell Netherlands creates a situation in which

one can also surmise from *U.S. ex rel. Johnson et al. v. Shell Oil Co., et al.*,⁵² *Yukos*⁵³ and research publications,⁵⁴ relevant evidence that the problem affects extractives and other major international industries.⁵⁵ While the extent to which GoG governments are justified in viewing these accusations as founded remains unclear, there is little doubt that this has to be taken seriously since many of these countries rely heavily on oil revenues to finance broader economic growth. The second problem concerns the effectiveness of anti-avoidance regimes adopted to tackle TPM. A review of existing regimes shows that different approaches can be adopted to tackle TPM, and adoption of a defective approach in the GoG would pose huge problems for these countries.

The Importance of Oil in GoG Countries

The oil sector is very important in terms of its economic contribution to many producing and consuming countries around the world.⁵⁶ Oil production represents a sizable portion of GDP, export earnings, and is a vital source of state revenues that is needed to drive socio-economic growth in many countries in sub-Saharan Africa.⁵⁷ In the Central African sub-region for example notably in Equatorial Guinea, Gabon and Chad, oil revenues have extensively contributed to the funding of economic development. Cameroon's economy is relatively diversified although the contribution of oil remains substantial. In terms of production capacity, the combined output of Central Africa is low

"Shell is now simultaneously a British public company, tax-resident in Amsterdam, whose brands are Swiss"; See *Yukos Case* for in-depth understanding of these mechanisms

⁵² ED TX No. 9:96 CV66 (E.D. Tex. Lufkin Division)

⁵³ Komisar, L., *Yukos Kingpin on Trial*, Corporate Watch, May10, 2005. <http://www.corpwatch.org/article.php?id=12236> [Last visited: April 3, 2008]. *Yukos v. Russia*, (Application no. 14902/04), Judgment of the ECHR, 20 September 2011; contrast with *RosInvestco v. Russia*, SCC Arbitration V (079/2005) award of 12 September 2010, and *Yukos v. Russia* (PCA Case No. AA 27) award of 18 July 2014

⁵⁴ Global Witness, *Extracting Transparency: The Need for an International Financial Reporting Standard for the Extractive Industries*, London, Global Witness (2005); Further examples of allegations of TPM by some MNCs operating in these countries and beyond are discussed in James L. Smith, *Issues in Extractive Resource Taxation: A Review of Research Methods and Models*, IMF Working Paper WP/12/287, 2012 at PP. 3-4; Fuest, C. and Riedel, N., *Tax Evasion and Tax Avoidance: The Role of International Profit Shifting*, in Peter Reuter (Ed.), *Draining Development? Controlling Illicit Funds from Developing Countries* (The World Bank, 2012) Chaps. 3 & 4; Graft Bleeding Africa of many Billions: Report, A Report by the The Africa Progress Panel, 2013, available at: www.africaprogresspanel.org; Edward Kofi Osei, *Transfer Pricing in Comparative Perspective and the Need for Reforms in Ghana*, 19 *Transnat'l L. & Contemp. Probs.* (2011) 599; Tax avoidance by multinational companies, A Report by the UK Parliament Public Accounts Select Committee, available at: www.parliament.uk/business/publications; Tax in Developing Countries: Increasing Resources for Development Written evidence submitted to the UK Parliamentary Select Committee by Christian Aid in February 2012, available at: <http://www.publications.parliament.uk/pa/cm201012/cmselect/cmintdev/writev/1821/tax19.htm>

⁵⁵ A good example is the brewery industry. See ActionAid Report, *Calling Time: Why SABMiller Should Stop Dodging Taxes in Africa*, (2010) http://www.actionaid.org.uk/102017/tax_justice_campaign.html [Last visited: Feb. 11, 2011]; On TPM by UK company in the Zambian sugar industry, see: Sweet nothings: the human cost of a British sugar giant avoiding taxes in southern Africa, A Report by the ActionAid (2012).

⁵⁶ Saudi Arabia, Iran, Qatar, Indonesia, Nigeria, Angola and like the USA, UK, France and Germany respectively

⁵⁷ As per CIA World Factbook, agriculture represents 19.8% of Camerouns, 56% of C.A.R's, and 51% of Chad's GDP

compared to other GoG producers like Nigeria and Angola. In Table 1, the total daily crude oil production of all six CEMAC countries⁵⁸ and the Democratic Republic of Congo stood at 1,076,400 bbl./day in 2009 with trends indicating that output has been declining in Gabon and Chad, stagnating in Equatorial Guinea and increasing in Cameroon.⁵⁹ In that same year, Nigeria produced 2,211,420 bbl./day representing about twice the combined output of all the other seven countries. Likewise, It also held 37.2 billion barrels in estimated reserves compared to a combined total of 6.6 billion barrels held by the seven other countries. A common feature of these countries is their heavy reliance on oil revenues to support broader economic growth. In the following subsections we look at the importance of oil in the CEMAC and Nigerian economies.

Table 1-1: Daily Oil Production Statistics in Central Africa, Nigeria and Angola (2009)

Country	Start of production	Oil production in barrels/day (2009)	Reserves in billion barrels (2009)
Equatorial Guinea	1991	346,020	1.1
DRC	1975	22,000	0.2
Gabon	1957	241,810	2.0
Cameroon	1978	77,230	0.2
Republic of Congo	1957	274,340	1.6
Chad	2003	115,000	1.5
CAR		0	0
By comparison			
Nigeria	1958	2,211,420	37.2
Angola	1958	1,820,000	9.5

Sources: US Energy Information Administration, Country Analysis Briefs (www.eia.gov/countries) and own compilation.

i The barrel is the usual unit of oil quantities, with one barrel corresponding to 158.98 litres.

Oil is the lifeline of *Equatorial Guinea's* (EG) economic growth, with total proven oil reserves in the country estimated at some 1.1 billion barrels. After production peaked at 376,000 bbl./day in 2005 liquid outputs declined to 346,020 bbl./day in 2009 and 320,000 bbl./day in 2011 according to EIA data. Much of EG's crude oil was exported to markets in North America with the US alone taking 70,000 bbl./day. Other importers include Spain, Italy, Canada and China. The country earned € 4.8 billions in revenues from oil in 2008 representing more than 90% of total state revenues, and an estimated 98% of export earnings.⁶⁰ It is important to note that international players like Noble Energy, ExxonMobil, Ocean Energy Hess, Tullow and Marathon dominate the country's oil sector.

⁵⁸ CEMAC comprises Chad, Cameroon, Gabon, Central African Republic, Republic of Congo, and Equatorial Guinea.

⁵⁹ While the thesis is not on gas, it is worth noting that countries in the sub-region hold sizable reserves of associated and dry gas. Cameroon and Equatorial Guinea respectively hold gas reserves estimated at 4.7 and 4.4 TCF. The latter is the only exporter of LNG in CEMAC and the third largest producer of gas in sub-Saharan Africa after Nigeria, Angola.

⁶⁰ <http://www.imf.org/external/country/GNQ/index.htm> [Last visited: April 13, 2014]

The *Republic of Gabon* has been a major oil producer in Africa, historically exporting its Rabi Light and Mandji Blend crudes to the US (60%, now declined to 15% since 2000's), India (14%), Europe (12%) and Indonesia (11%).⁶¹ Oil production has also declined with the country moving from the 3rd largest producer of oil in sub-Saharan Africa to occupying 6th place. Indeed, after production peaked at 370,000 bbl./day in 1997 output has since declined by roughly 1/3rd to 244,000 bbl./day in 2012. In spite of this oil continues to contribute significantly to Gabon's economy, representing 87% of export earnings and 50% of GDP in 2010.⁶² IOCs, with the exception of Gabon's national oil company that is sole domestic player,⁶³ vastly dominate the country's upstream oil sector including Total, Shell, Perenco, Addax (Europe); ExxonMobil, Vaalco Energy (US); and Sinopec. (China).

Oil is an important source of income to the *Republic of Cameroon*. Although production peaked at 180,000 bbl./day in 1988 and later declined to 63,000 bbl./day in 2012, output is likely to increase as discoveries in the Bolongo and Dissoni Blocks come on-stream. In spite of annual output staying relatively modest, the country still receives huge incomes from the sale of crudes to US and EU off-takers. In 2012 for example, the National Hydrocarbons Company (SNH) that manages Cameroon's upstream interest transferred roughly US\$ 1.54 billions to the state treasury. This does not include direct tax payments by IOCs to the taxation directorate. Cameroon also earns transit fees for hosting a segment of the Chad-Cameroon pipeline that delivers Chadian crude for export to the deep-sea port of Kribi.⁶⁴ Broadly, oil contributes about 28% of state revenues and 60% of Cameroon's export earnings. With the exception of SNH as the only significant domestic actor operating in the sector, IOCs like Perenco and Addax dominate the country's upstream petroleum landscape.

The *Republic of Chad* only started producing oil in 2003 but has since emerged as an important player in the oil industry in sub-Saharan Africa. However, daily production has declined from 119,000 bbl./day in 2009 to 115,000 bbl./day in 2011,⁶⁵ a trend likely to be reversed upwards as newly discovered fields in the country's Southern Region come on-stream to add 30,000 - 60,000 bbl./day. Much of Chad's crude is exported to the US (83.2%), China (6.8%), and France (5.6%).

⁶¹ EIA estimates based on analysis of APEX tanker data (Lloyd's Maritime Intelligence Unit)

⁶² <http://www.eia.gov/countries/cab.cfm?fips=GB> [Last visited: April 8, 2014]; Other sources suggest different figures

⁶³ See: <http://gabonoil.com/en/our-assets/production>. The Gabon Oil Company was created in 2011 by Decree N°1017/PR/MMPH of August 24, and now administers state participation in fields across Gabon including: Hylia (operated by Total Gabon), Bende & Totou (Shell), Renboue (Addax), Olowi (CNRI) and 24 other fields operated by Perenco

⁶⁴ Cossé, S., *Strengthening Transparency in the Oil Sector in Cameroon: Why Does It Matter?* p.8 IMF Policy Discussion Paper (March 2006)

⁶⁵ <http://www.eia.gov/cfapps/ipdbproject/iedindex3.cfm?tid=5&pid=53&aid=1&cid=r6,&syid=2007&eyid=2011&unit=TBPD> [Last visited March 30, 2014].

Broadly oil represents 50% of its GDP, 93% of exports earnings and roughly 79% of state revenues.⁶⁶ As with other producing countries examined above, IOCs largely dominate the country's upstream oil sector including US incorporated ExxonMobil and Chevron, Malaysia's PETRONAS and China's CNPC. There are hardly any major domestic players in Chad's upstream oil sector at the moment.

The *Federal Republic of Nigeria* is Africa's largest single producer of oil. The country's output has on average increased from 2.211 million bbl./day in 2009 to 2.553 million in 2011,⁶⁷ and is poised to continue increasing as new fields come on-stream. As with other GoG countries the sector is dominated by subsidiaries of EU or US incorporated IOCs including ConocoPhillips, ExxonMobil, Total, ENI, Addax Petroleum, Royal Dutch Shell and Chevron. However, there is greater presence of domestic players in Nigeria than in any of the CEMAC countries with salient examples including NNPC,⁶⁸ Oando and Zenon. As concerns exports, much of Nigeria's oil is sold to the US (33%), India (12%) and Brazil (8%).⁶⁹ However, a portion is refined in Nigeria to supplement products imported for domestic consumption. The government earned about US\$ 143.5 Billions in revenues between 2009-2011 from its oil sector accounting for 90% of export earnings and 70% of State revenues.⁷⁰

From the above one observes certain parallels between these GoG oil-producing countries including the: (1) established dominance of IOCs, (2) likelihood that the existing status quo will last for a long time, (3) prospect that much of these crudes will continue to be traded with related parties creating risks of TPM, and (4) the effort by host countries to optimally tax the sector. These factors together comprise the elements needed to 'game' GoG countries of tax revenues. One could as such argue that the current structure of the oil industry in the GoG has the potential to influence the calculi of governments and IOCs as far as taxation is concerned (see 4.2.2.2).

Diversity of Approaches used in Tackling TPM

In matters of international tax avoidance one inevitably comes across the concepts of 'low' and 'high' tax countries. 'Low tax countries' or 'tax havens' as they are sometimes referred to offer very generous tax advantages as a means of gaining an edge over other governments in the

⁶⁶ By the close of 2011, Chad's cumulative earnings from the project since it began in 2003 amounted to US\$ 8.4 Billions.

⁶⁷ EIA, *Supra* note 53

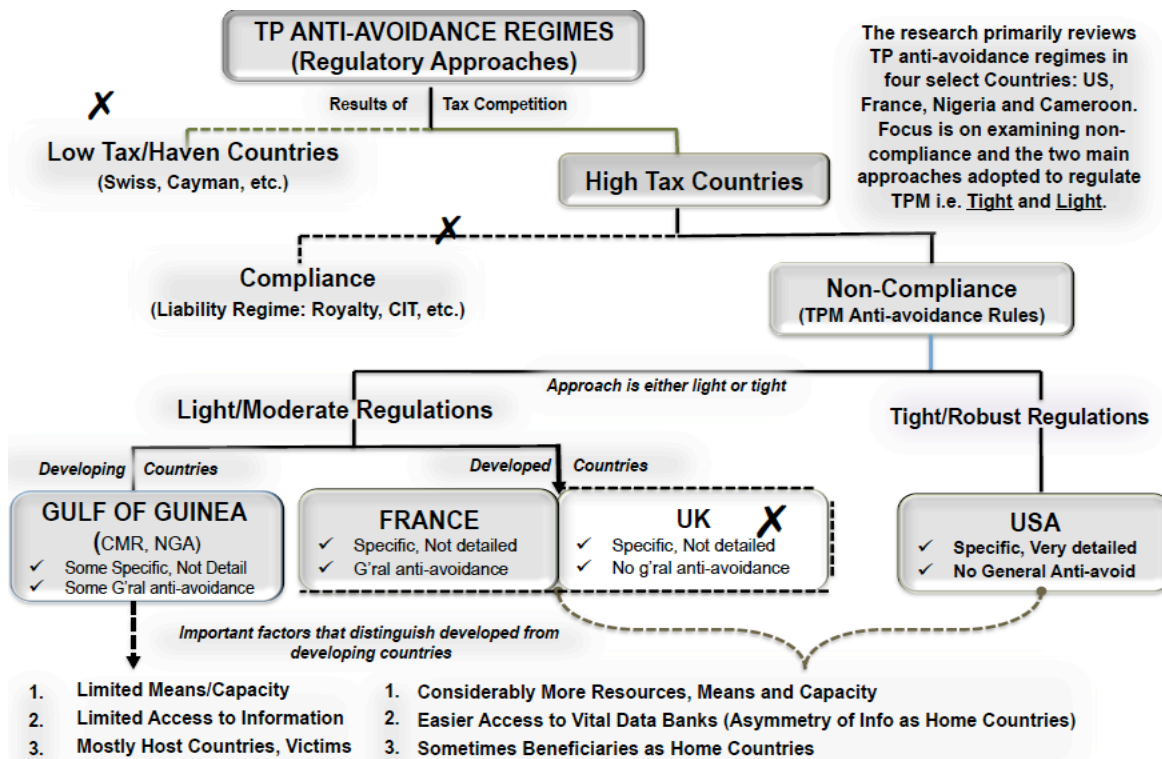
⁶⁸ NNPC is the national oil company that manages the country's interest in all operating contracts concluded with sector operators notably Joint Ventures (JV) or Production Sharing (PSC's).

⁶⁹ Global Trade Atlas, APEX (Lloyds), and U.S. Energy Information Administration

⁷⁰ Onyekawa, N., *Nigeria's EITI Financial Flows Reconciliation Report: 2009 – 2011 Oil & Gas Audit (2012)*. Sources of income include the sale of Equity O&G, royalty, signature bonuses, concession rentals and gas flaring penalties, PAYE, Petroleum Profits Tax, Company Tax and VAT. Much of these revenues came from the sale of Bonny Light and Qua Iboe. See Rowling, R., *Brent Pipeline Resumes Flows; Nigeria Bonny Crude Price Stable (2013)*

competition for scarce international financial and capital flows.⁷¹ The long established reluctance of havens to tighten business regulations makes them attractive hosts for persons engaged in, or transactions designed to avoid high taxes in other countries. Examples include the Isle of Man, Switzerland and Mauritius. The approach adopted by ‘**high tax countries**’ to regulate businesses is quite different. While high tax countries sometimes incorporate low tax elements into their taxing frameworks,⁷² they are traditionally resolute in their adoption of comprehensive rules to tax persons or transactions, have occasionally broadened tax bases and rates, or adopted appropriate legal frameworks to counter abusive tax practices. Examples of countries that fall under this category include developed ones like the US and France,⁷³ and developing ones like Cameroon and Nigeria.

Figure 1-1: Snapshot of Existing Approaches to Tackling TPM



⁷¹ Prem Sikka notes that while these countries account for only about 1.2% of world population, about half of all world trade, 26% of assets and 31% of net-profits of US MNE's are located in these Offshore Financial Centre's; Also see, FT, *Competitive behaviour should not stray into protectionism*, September 30, 2014; FT, *EU's Amazon probe steps up pressure over tax deals*, October 7, 2014, available at: <http://www.ft.com/cms/s/0/d03cce8e-488f-11e4-ad19-00144feab7de.html#ixzz3FYpu6MoJ> [Last visited December 15, 2014]

⁷² For example the exemption of foreign source income from domestic taxes (*France*), taxing foreign source incomes only when remitted to parent (*USA*), or exempting the same if deemed as active business income (*Canada*);

⁷³ Both the US and France have *adequate* financial and administrative capacity/*means* to fight TPM. For purposes of our present analyses and proposals France has the advantage of operating a well-tested **general anti-avoidance rule**. It is also worth noting that the *means* and *capacity* of Cameroon and Nigeria to fight TPM is to an extent *limited*.

As shown in figure 1-1 [supra] the research focuses on **noncompliance with TP rules** in 'high tax' jurisdictions. Two main approaches used to design **anti-avoidance** frameworks intended to tackle TPM are notably examined. That is, the specific anti-avoidance (so-called **tight**) approach on the one hand, and the general (so-called **light**) approach on the other.

In principle, opinion in 'high tax countries' remains divided on whether TPM is best tackled by adopting **light** anti-avoidance provisions or by adopting **tight** ones. Indeed, the classification of a **TP anti-avoidance regime** as **light** or **tight** is not easy to make given that these regimes comprise the two main categories of tax law namely **substantive** and **procedural** rules, and the approach used in designing each of them might sometimes differ. For example, one might argue in some cases that both categories of a country's TP anti-avoidance rules and its accompanying regulations are light; or vice versa. In others, the argument might be that the substantive component is light while its procedural component tight, or vice versa. These possibilities make it necessary to clarify our use of the terms tight and light in this research. That is, are the terms 'lightness' or 'tightness' used to describe only the substantive or procedural aspects of select TP anti-avoidance regimes? Or, are they used to describe both categories of the regime jointly? A good starting point for this analysis would be to clarify the difference between these two categories of the law.

The distinction between both categories is not easy and clear-cut especially in cases where the legislature opts to keep them in a single law.⁷⁴ The distinction is evident if separate laws are adopted to deal with rules pertaining to each category.⁷⁵ **Substantive law** essentially defines and regulates the substance of rights, obligations and liabilities of parties under law. In the context of this study, this relates to the Arms length standard (ALS) and certain aspects of compliance regimes. **Procedural law** for its part is the aggregate of rules that prescribe practices, procedures or the legal machinery by which substantive rights and duties are administered, enforced or maintained. It also covers the forms of redress for abuses to substantive rights and methods of obtaining them. In matters of tax law, this comprises aspects of compliance, audits, penalties and tax appeals.

Firstly, the substantive and/or procedural rules of a TP anti-avoidance regime might be described as **light** if the general approach is adopted in their design. That is, if general anti-avoidance is chosen as basis for engineering the regime. While these regimes typically have TP anti-avoidance provisions built into them, *they are broadly worded and the detail that goes into defining TPM, the*

⁷⁴ In France and Cameroons for example, both substantive and adjectival components are contained in the tax code

⁷⁵ In the UK, substantive issues pertaining to TP is contained in 739-746 Income and corporation Taxes Act [1988], whereas the procedures and administration issues are handled in the Taxes Management Act [1970].

*ALS and related rules is non-specific (substantive category).*⁷⁶ The same is true for rules that are adopted to manage **compliance obligations, audits, penalties and appeals procedure (adjectival category)**. This approach ensures that taxpayers are not burdened with heavy-handed rules in the process of safeguarding that they contribute *fairly* to the public purse. In France for example, the Tax Code defines TPM and ALS in rather general terms.⁷⁷ As such, the substantive category of France's TP anti-avoidance regime is light. Likewise, there are very limited procedures included in France's code to address TP documentation, reporting, audits, penalties or appeals; since the country broadly deals with TPM schemes no differently than it does other tax avoidance schemes. Cameroon adopts a similar approach. Therefore, it is observed that the adjectival category of both France's and Cameroon's TP regimes are moderately designed in line with the **light approach** for engineering laws and regulations to tackle TPM. Whether this approach is effective in the context of both countries, especially Cameroon is a question open to debate.

Alternatively, the substantive and adjectival categories of a country's TP regime might be designed following the **tight** approach. These are countries that have essentially decided to build specific TP anti-avoidance rules into their laws and regulations. That is, the *wording used and the degree of detail that goes into defining rules meant to determine TPM and ALS (substantive category) is comprehensively specific*. Likewise, the adjectival category is deemed to be tight if robust rules and procedures are adopted to govern **compliance obligations, audits, penalties and appeals** of TP abuses in quite specific terms. In the US for example, it is not obvious that the tight approach is adopted in the design of substantive rules, given that the primary TP provision (s.482) may not be seen as defining TPM in quite specific terms. In spite of the **accompanying regulation** to s.482 (**Reg. 1.482**) adopting clear definitions of TPM and the methods to be used in ascertaining the ALS, a comparison of US and OECD rules on this issue are quite similar. Excepting a few and quite specific issues,⁷⁸ it can be argued that the substantive category of the US's TP regime is light. This can be contrasted with the adjectival category of the same regime, where procedures that are heavily specific to TPM are adopted to ensure compliance with documentation and reporting obligations, audits and penalties, and for pursuing tax appeals. One could therefore broadly describe the US's TP regime as tight, although this mainly applies to its adjectival category.

⁷⁶ See Chapters 4 and 5 for more detailed discussion of this issue

⁷⁷ Although the OECD Transfer pricing guideline is a useful complement to domestic French law

⁷⁸ Take for example the US's adoption of the tightly construed "best method" rule, whereas France adopts the "any method" rule which as seen later in Chapter 6 is lighter.

Selecting a Suitable Approach for Tackling TPM in the GoG

Ascertaining TPM is not always obvious and the approach that is selected to engineer a country's anti-avoidance regime is a determinant factor in facilitating detection and remediation of the practice. Sometimes an identical set of facts and transactional outcomes could amount to TPM if applied to a country's law, and not to laws in another country. Therefore, different levels of success are likely to be achieved by adopting different approaches to tackling TPM in contexts that sometimes differ. This raises genuine questions as to the suitability and effectiveness of adopting the tight approach as a preferred policy response to TPM instead of the light one, and vice versa. This preoccupation is especially relevant to governments in the GoG for two main reasons. Firstly, in the developed world (notably the OECD) where a decision to adopt either approach is likely to be influenced by the consideration that many host countries seeking to prevent TPM are in some respects themselves home country beneficiaries of its fallouts, the pertinence of recommending one approach over the other might not be as urgent. This context differs from GoG countries that are overbearingly host⁷⁹ and hardly ever home countries. Therefore, while the light approach might prove effective in countries that are both victims and (to a limited extent) beneficiaries of TPM, it might not be so in countries that are often victims and hardly beneficiaries of TPM.

Secondly, effective monitoring depends on the ability of the fisc to access information on related and unrelated party transfers on a cross-border basis. From this standpoint, the bulk of assets and MNE operations go through, are located or reported in *home* countries thus giving them a relative advantage as far as accessing this information is concerned. Coupled with an established history of possessing the resources and capacity needed to monitor group activities effectively, it is only fair to argue that developed countries can plausibly adopt light approaches. This is not true of GoG countries that lack the capacity to, have limited access to information and are arguably only now just starting to tackle the practice. With these differences in mind, one muses over the effectiveness of GoG countries adopting a light approach in designing TP anti-avoidance regimes. Indeed in developing countries where TPM is a problem and efforts are ongoing to tackle it, critics have overtly questioned the strategic usefulness of copying and sticking to the light approach (mostly OECD) instead of adopting the tight alternative offered by the US.⁸⁰ This brings us to the research questions.

⁷⁹ GoG countries are mostly recipients of FDI through permanent establishments (subsidiaries, branches, affiliates, etc.); in fact very few companies in these countries, if any, have the muscle to go international as concerns the petroleum sector

⁸⁰ Action Aid (2011), *supra* note 55 at p.6

1.3 Research Questions

In light of the research problem examined above, the present section outlines three questions that the thesis aims to answer. Considering that the work focuses on the effectiveness of TP anti-avoidance regimes in tackling abuses within the GoG, this is reflected in the *main* research question:

1. To what extent, if any, are anti-avoidance regimes within the Gulf of Guinea designed to effectively tackle transfer price manipulation by IOCs?

Two *incidental* research questions arise from this main preoccupation. Firstly, it is important to explore and present evidence that IOCs can, or in fact manipulate transfer prices. Secondly, if findings on the main question show current anti-avoidance regimes in the GoG to be defective, then there arises a need to propose an alternative approach to and combination of rules capable of rendering the system effective. Both incidental preoccupations are reflected in the second (2nd) and third (3rd) research questions:

2. To what extent, if any, do international oil companies manipulate transfer prices? And,
3. What lessons, if any, can governments in the Gulf of Guinea learn from other jurisdictions?

The objectives of, and justifications for undertaking this project are discussed in the next section.

1.4 Objectives and Justification

1.4.1 Main Objectives

A central aim of the discipline of international taxation is to *fairly*⁸¹ allocate taxes generated by multinationals amongst participating countries.⁸² Another aim is to balance the needs to raise tax revenues with that of creating an enabling environment to attract FDI. These are two broad objectives of the research. However, its specific goals are to:

1. **Explore and present available evidence of TPM** within the international petroleum industry, and to highlight fiscal implications of the practice on select hydrocarbons rich GoG countries;
Gap filling

⁸¹ In line with principles of (1) inter-nation & international taxpayer equity, and (2) international neutrality; see Chapter 2.2.2 [infra] for detailed discussion of these concepts

⁸² Miller & Oats (2009), *supra* note 29 at p.18

2. **Undertake a comparative analysis of the effectiveness of select anti-avoidance regimes** in tackling TPM by IOCs. That is, select GoG regimes are analyzed against systems operated by select OECD countries; *Gap filling*, and
3. If existing GoG anti-avoidance regimes are judged defective, **to recommend an alternative approach to and composition of anti-avoidance rules** designed to adequately respond to the problem in light of GoG circumstances; *Policy and regulatory upgrade*

Gap Filling Objective

A few researchers (mainly economists) have investigated TPM in the petroleum industry, sometimes sourcing and analyzing same sets of data but reaching different conclusions on the issue. During the 1980s and '90s some of these empirical-based studies concluded that IOCs manipulated both commodity (crude, products) and financial (management fees, dividend, royalty) transfer prices, albeit on a negligible scale. In the USA for example, Bernard and Weiner in a 1990 study examining evidence of TPM in the US petroleum Industry⁸³ concluded that over the years 1973-84: (1) mispricing's on actual crude transactions declined;⁸⁴ (2) longer credit repayment days most likely resulted in credit manipulation –*thin capitalization*, (3) transport costs were significantly manipulated;⁸⁵ and (4) the non-credibility of extra foreign taxes over the normal US income tax charge reduced the influence of foreign income taxes on TPM.⁸⁶ In conclusion, the authors took the view that little TPM occurred during the period either because the US IRS *effectively enforced transfer pricing anti-avoidance regulations* or IOCs used other tax avoidance methods to minimize their tax liability. In Canada however, opinion on the subject varied between R.J Bertrand on one hand, and Rugman and McIlveen on the other. While R.J. Bertrand concluded that IOCs used TPM to overcharge Canadian consumers for inter-affiliate imports between the years 1958-1973, Rugman and McIlveen in 1985 challenged Bertrand's findings and accused him of making selective use of available data.⁸⁷ After correcting for errors and recalculating they concluded no evidence had been found to enable the conclusion that IOCs had used TPM to minimize taxes in Canada. In 1992, Bernard and Weiner revisited debates between Bertrand and Rugman and surprisingly found after

⁸³ Bernard, J-T. & Weiner, J., *Multinational Enterprises, Transfer Pricing and Taxes: Evidence from the US Petroleum Industry*, p.124 (1989)

⁸⁴ Increased spot market trade is one reason given to explain the decline of TPM in the O&G industry

⁸⁵ This point is emphasized by Prof. Hudson and discussed further in Chapter 4.2.1.1

⁸⁶ The US uses *residence-based taxation* as opposed to *source-based taxation* used by France, Netherland

⁸⁷ Rugman, A. & McIlveen, J., *Multinational Oil Limited*, Journal of Management Case Studies 1:108-18 (1985)

accounting for variables that affiliates had instead charged transfer prices that were averagely lower than 3rd party prices. This was completely at variance with Bertrand's findings and they concluded that 'not only was he (Bertrand) wrong, he had it backwards'.

Findings of these studies cast doubt over the accuracy of claims that TPM is rife in the oil industry.⁸⁸ Eden advises against taking these claims too seriously as incentives for and the practice of TPM may have considerably declined over the years. She basis her view on three main factors, namely the: (i) liberalization of fiscal policies -*harmonization of tax rates, reduction of tariffs, free trade areas, and reduction of cross-boarder restrictions*; (ii) liberalization of FDI policies -*repatriation of funds*; and (iii) tightening of tax and tariff regulations -*stricter TP regulations, firmer compliance rules, and new penalties which increase TPM costs*. While Bernard and Weiner and Lorraine thinly opine that the US transfer pricing regime is proving *effective*, not all experts on the subject share this perspective. Grubert, for example, contends that a considerable amount of tax haven income still escapes current U.S. tax.⁸⁹ He observes that even the U.S. CFC rules that are probably the most restrictive of those of the major industrialized countries does not go far enough, which view is corroborated by case law (see chapter 4 for discussions on this issue) suggesting countries are losing billions of dollars to TPM in the oil industry. Therefore, on both the first (*if IOCs manipulate transfer prices*) and second (*effectiveness of anti-avoidance regimes in tackling TPM*) issues, debates remain inconclusive even in countries where data is readily accessible and action has indeed been taken.

Although academics have vastly covered the subject in other industries, it is obvious in light of available literature that it remains sparsely explored as far as hydrocarbons is concerned in spite of the industry's importance to economies around the world. Furthermore, there is an obvious gap in the literature presenting evidence of and discussing TPM by IOCs operating in the GoG. Lastly, there has been substantively speaking no in-depth study undertaken to assess the effectiveness of fairly recent, if any, anti-avoidance measures adopted within the GoG to tackle the issue. A combination therefore, of the facts that such a study is not done on the GoG and that effectiveness of the design of TP anti-avoidance regimes is judged through the lenses of '*deterrence*' and '*rule of law*' (notably in detecting, remedying abuse) afford uniqueness and originality to the research.

⁸⁸ Eden (1998), *supra* note 3 at pp. 331-340

⁸⁹ Grubert, H., *Tax Planning by Companies and Tax Competition by Governments: Is There Evidence of Changes in Behavior?* pp. 113 – 142 (2000)

Policy and Regulatory Upgrade Objective

The GoG is has been attracting billions of US\$ in investment into E&P, transportation and refining activities as evidence grows of the regions rich hydrocarbon resources.⁹⁰ Considering that states in the region are key beneficiaries of these capital inflows it is crucial that governments find a right balance between taxing and safeguarding the interest of IOCs. Finding this balance is important as it has the potential to sustain or impede inbound foreign direct investments (FDI). In this respect, there is need to constantly upgrade policy and regulations to changing market/industry dynamics in order to ensure that they respond adequately to investor needs. This constant action is needed with respect to both compliance and noncompliance components of tax regimes. It should be noted that the focus of this study is on upgrades to noncompliance aspects of these regimes, notably TPM. There are preliminary grounds as explained in preceding paragraphs to suggest that TP anti-avoidance regimes within the GoG require both policy and regulatory upgrades. Notwithstanding that the industry remains a top revenue earner for GoG governments and presents huge risk of possible tax losses to TPM, a review of the literature suggests that little academic research has been done on *upgrading regimes* in this region. This project aims to drive the agenda on this highly needed upgrade. There is a polemic though. If the upgrade results in tighter anti-avoidance regimes being proposed, critics are likely to argue its very purpose defeated since tighter systems can and sometimes impede FDI. The merits of this argument can be countered on two main grounds: (1) tax anti-avoidance rules are primarily designed to prevent noncompliance with tax obligations and very rarely, if well designed, create any significant extra costs to compliant taxpayers; and (2) if tighter anti-avoidance rules result in reduced FDI, then it can be assumed that the economics of these investment projects are predicated on tax avoidance, which itself reinforces the need to upgrade not only anti-avoidance rules but also reform compliance ones in order to boost FDI.

1.4.2 Justification of the Research

As indicated earlier some critics might question the relevance of undertaking research in this area since IOCs are less likely to abuse transfer prices compared to other companies. This is so because crude is often regarded as homogenous and the degree of obscurity hitherto embedded in *depletion contracts* has been considerably lost to the visibility that *spot-markets* offer. Benchmark

⁹⁰ WIR (1993), supra note 35 at pp.32 & 33. Also US\$ 4.2 billions, *Chad-Cameroon Petroleum Development and Pipeline Project* that remains the largest single private investment in sub-Saharan Africa

prices for crude oil are now easily obtained from these markets rendering the manipulation of intrafirm prices difficult. This perception is founded and cannot be ignored. However, this research does not mostly agree with it since there is some evidence that assumptions underlying this view are flawed. For example, crude exists in different grades (*sweet, sour*) and qualities (*API° gravity, sulfur*) and downstream petroleum products are also highly heterogeneous. Besides it is not only crude prices that can be manipulated but costs as well. Further, it is important to note that resource taxation significantly differs from tax systems applied to most other industries. It is built on the economic rent theory⁹¹ and extractive fiscal systems are specifically designed to capture most –if not all- windfall profits earned by resource firms. It is not uncommon in this context to impose high levels of non profit-based taxes that might be regarded in all other industries as downright excessive and untenable. There is therefore risk of TPM being used in the oil industry, which if viewed from the perspective of reward to IOCs (profits) and governments (taxes), makes even the slightest risk of TPM important to investigate. The research is thus justified by the following factors:

1. IOCs pay several US\$ billions in taxes to governments and how they use transfer prices cannot be ignored. In the US for example, O&G have historically generated between one and two-thirds of taxable income from abroad, benefitting about the same fraction of foreign credits, and is from a tax perspective about as large as all other industries put together.⁹² In 2007, estimates of other tax revenues in Equatorial Guinea accounted for only 1.4% of GDP, while oil revenues rose in excess of XAF 2,000 billions representing about 42.7% of the countries GDP.⁹³ Whether or not IOCs use TPM to avoid taxes is of importance to governments, and so is the effectiveness of anti-avoidance measures put in place to tackle abuse. Gains in improved tax yield to governments can be enormous.
2. IOCs still have incentive to manipulate transfer prices: Owens Jeffrey (head of fiscal affairs OECD) named three perceptible reasons why multinationals still have incentive to manipulate transfer prices. Firstly, the urge to move cash to other countries without paying withholding taxes, and also improve financial reports to shareholders in countries with unconsolidated reporting

⁹¹ It is the “excess of total revenue derived from some activity over the sum of the supply prices of all capital, labor and other inputs” Garnaut, R. & Ross, A., *Taxation of Mineral Rents*, p.27 (1983); For more discussions on resource rent theory, see Boadway & Keen, in Daniel, et al. (2010), supra note 7 at p.13; Also discussed elaborately in Chapter 3.2.1.1 of the thesis

⁹² Bernard & Weiner (1989), supra note 83 at p.2

⁹³ Equatorial Guinea, 2010, <http://www.africaneconomicoutlook.org/en/countries/central-africa/equatorial-guinea/> [Last visited: March 23, 2011]; Further details on the importance of O&G to GoG economies are considered in Chapter 4

- systems. Secondly, un-harmonized tax rates mean profit shifting will still produce benefits due to rate differentials. Lastly, the existence of tax havens underpins the importance of TPM in allocating income and avoiding taxes. If one links these factors to a heavily taxed oil industry riddled with complex fiscal structures designed to keep out of the pockets of IOC's as much revenue as possible (without affecting project economics), the temptation on the part of IOCs to earn a little more in saved tax cost cannot be underestimated.
3. High volumes of intrafirm transfers within the O&G industry and recent volatilities in oil prices: Tax-wise, O&G are unique and undoubtedly the most important commodities traded internationally. Its importance resonates in terms of volumes and values traded. As noted by the OECD Observer,⁹⁴ over 60% of oil industry transactions take place on intra-firm basis. This is quite substantial and coupled with high volatilities in oil prices is likely to create an enabling environment for TPM. Hence, even the slightest marginal increase or decrease in TPM has far-reaching implications for governments (tax yield) and IOCs (improved return).
 4. Many IOC's trade with affiliates incorporated in tax havens (Switzerland, Cayman): MNE's pay diverse taxes at various rates to governments worldwide. This ranked 2nd of 20 concerns expressed by 98 multinationals surveyed by Tang in 1990.⁹⁵ As a result many IOCs that want to limit their global exposure to taxes have adopted the technique of incorporating affiliates in havens. In 1994 for example, Hines and Rice⁹⁶ found that by 1982, 143 US incorporated oil companies owned 2,475 subsidiaries/affiliates worldwide, 18.2% of which were based in tax havens. Considering that transactions occur between IOCs and their havens based affiliates, it is important to study these relationships and how well states have risen to this challenge.
 5. There is tentative evidence that some IOCs use TPM to avoid taxes: In spite of the fact that IOCs are major contributors of fiscal revenues to governments around the globe, many still regard them as notorious abusers of international tax rate differentials. How governments respond to the problem and the effectiveness of their response are important issues to explore.

⁹⁴ OECD Observer, April 2002

⁹⁵ Tang, *Transfer Pricing in the 1990's: Tax and Management Perspectives*, (1993)

⁹⁶ Hines, J.R. & Rice, E.M., *Fiscal Paradise: Foreign Tax Havens and American Business*, QJE109 (1): 149-182 (1994)

6. Finally, factors including the recent economic crisis, growing *tax gap*, and the need for tax administrations to cooperate on tax avoidance issues justify the study.⁹⁷ The current business climate is constrained, trading profits in many industries have dropped, and many companies are bust. As the ‘tax gap’ widens⁹⁸ there are concerns that tax revenues may further decline if multinationals unchecked, resort to dodging taxes as a means of galvanizing after-tax profits. There is need for tax authorities worldwide to improve collaboration in the areas of information exchange, harmonization of tax rates, etc. By examining the effectiveness of TP anti-avoidance regimes the present research provides further insight into the problem and supports efforts aimed at encouraging greater cooperation between tax authorities.

Research findings would be of interest to fiscal policymakers, tax authorities, professionals, oil companies and possibly economists. It is hoped that the results would inform governments of the effectiveness of existing anti-avoidance regimes and identify such areas requiring upgrades as take steps to fight cross-border tax abuse. It is especially intended to identify loopholes and to cause governments of oil producing countries in the GoG *-seeking to update or build new anti-avoidance regimes-* to assess existing approaches to regulating TPM. In line with the objectives stated earlier, expectation is that research findings would contribute to ongoing efforts to tackle abuse of intra-firm transfer prices. The methodology chosen to achieve this goal is discussed in the next section.

1.5 Methodology: Comparative Qualitative Analysis

Both quantitative and qualitative methodologies have been used in the literature to discuss TPM since the subject is interdisciplinary and of demonstrable interest to economics, management and legal scholars. There is, as such, an inclination on the part of researchers that examine TP to incorporate interdisciplinary considerations into their analysis. As far as this study is concerned however, it should be noted that it is essentially grounded in the law discipline and is intended to make a contribution to law and policy, and not other academic disciplines like economics, accounting or management. Therefore, only information that is needed to assist us understand the subject better are drawn from these disciplines as basis for enhancing our project objectives stated in 1.4.1.

⁹⁷ This is elaborated in Chapter 8. Also see Ernst & Young, *2009 Global Transfer Pricing Surveys*, p.6 Sep. 2009 [http://www.ey.com/Publication/vwLUAssets/2009_EY_Global_transfer_pricing_survey/\\$FILE/Ernst%20%20Young%2009%20Global%20transfer%20pricing%20survey.pdf](http://www.ey.com/Publication/vwLUAssets/2009_EY_Global_transfer_pricing_survey/$FILE/Ernst%20%20Young%2009%20Global%20transfer%20pricing%20survey.pdf) [Last visited: Jan. 28, 2011]

⁹⁸ USA: US\$ 345 billions 2005; UK £42 billions 2010

This perspective also considerably informs the use of **qualitative comparative analysis** as the methodology in this research, which is amongst other reasons, clearly suitable for this type of research. The methodology allows us to navigate easily between TP anti-avoidance regimes in all four select countries, two of which are OECD (*US, France*) and two GoG (*Cameroon, Nigeria*).⁹⁹ If appropriately applied it easily reveals both similarities and differences, or strengths and weaknesses of the select regimes.¹⁰⁰ In assessing the effectiveness of TP anti-avoidance regimes within the framework of this study we rely simultaneously on a *hypothetical case design* (chapter 4.1) and *ex post facto evidences* (chapter 4.2). Much of the information used for this purpose is obtained from primary and secondary sources on the OECD, US, France, Cameroon and Nigeria. International tax instruments, statutes, expert opinions, textbooks, scholarly articles, the internet and case law data¹⁰¹ were gathered for use in the research. Landmark court cases on TPM in the US, France, Russia and Kenya shall be analyzed with the aim of determining whether, these anti-tax avoidance regimes are effective in tackling abuse. Aspects of this research, albeit limited, entail interviewing lead tax auditors to the oil industry working for tax services in the GoG. This is important because while there is public information indicating that tax authorities in the US and France have challenged TP practices of IOCs, there is broadly speaking little evidence of tax authorities in the GoG doing so.

As we move to examine in the chapters that follow the effectiveness of GoG anti-avoidance regimes, it is important to note that three methods are used in the process. Firstly, we extract from the available literature and case law some classic forms of TP manipulation often used by IOCs to avoid taxes. This information is used to design a Model Avoidance Scheme (MAS) comprising *income* and *cost* shifting elements. Next, we examine the effectiveness of existing anti-avoidance regimes occasionally applying the MAS or other examples to standard oil transactions and opining on the effectiveness of existing anti-avoidance regimes in terms of their ability to facilitate efforts by tax authorities to detect and remedy TP abuse. This approach is adopted because deterrence, whilst ideal, does not always work such that enforcement through effective detection and remediation are crucial to the regimes overall effectiveness. Lastly, we use these findings to make a determination of the actual or likely effectiveness of existing anti-avoidance regime designs.¹⁰² Empirical evidence gathered from primary and secondary sources is used to support qualitative arguments in the thesis.

⁹⁹ Reasons for choosing these countries are discussed in Chapters 1.3 and 2.2.1

¹⁰⁰ See, Avi-Yonah, et al. (2011), *supra* note 29 at Chap. 1: on relevance of comparative tax methodology

¹⁰¹ For example the OECD Transfer Pricing Guidelines and Model Tax Treaty

¹⁰² See Chapter 2 for discussions on how performance is judged

For practical reasons the study adopts both the **text-by-text** (segregated) and **point-by-point** (integrated) approaches for qualitative comparative analysis.¹⁰³ Some key attributes of select anti-avoidance regimes are first treated as standalone components of the work. This is later reinforced by an integrated cross-country analysis to identify the strengths and weaknesses of anti-avoidance choices in each select system compared to others notably in the GoG. Lessons drawn from these systems are carried into the final two chapters of the study and used as basis of domestic and international recommendations that can be adopted by governments seeking to improve the effectiveness of TP anti-avoidance regimes in hydrocarbons rich GoG countries.

1.6 Limitations of the Research

After examining the objectives, scope, questions and methodology it is noted in conclusion to this chapter that three key limitations to the study can be identified. Firstly, concerns over the confidentiality of actual terms stipulated in petroleum contracts make access to oil industry documents highly restrictive. Likewise, companies largely treat transactions or information resulting from the execution of these contracts as highly sensitive commercial data. This standard predisposition of the industry explains the dearth in publicly available information on specifics of intrafirm transactions. It also explains a noticeable reluctance on the part of IOCs to discuss or disclose such information that is needed to make precise determinations of the actual extent of their deployment of TPM. Data currently released to the public by the industry very rarely, if at all, details information on prices used for each intrafirm transaction. Rather, data is aggregated making it hard to tell what volume of the companies overall trade took place on an intragroup basis and what prices were applied to each transaction. Considering the level of confidentiality that is maintained in natural resource contracts and the practice of mostly aggregating data released to the public, it did not prove possible to access and analyze primary data on the exact extent of the manipulation of transfer prices by IOCs in the GoG. This limitation largely accounts for the decision to rely extensively on secondary data sources and to use qualitative analysis in formulating an appropriate response to the second research question. Notwithstanding the apparent straightforwardness of this methodology it was still observed interestingly that as at the time of research, very little public data, information or evidence of TPM in the GoG had been put out in the public space.

¹⁰³ Walk, K., *How to Write a Comparative Analysis*, Writing Center at Harvard University (1998) <http://www.fas.harvard.edu/~wricntr/documents/CompAnalysis.html> [Last visited: November, 2010]

Secondly, while tax regimes in different countries operate similar tax rates they might differ in terms of the rules used to ascertain taxable basis. Significant differences could thus exist as regards the scope of liability notwithstanding similarity in tax rates. Therefore, recommendations made as a result of analyzing one, do not necessarily apply to another. In light of this, extreme care needs to be taken in comparative studies -as *the present*- not to compare tax systems blindly. An approach would be to broadly examine all rules likely to distinguish one select regime from another, which is of course arguably impracticable given the very limited scope of this work. Another approach is to identify as basis for the analyses some system attributes that potentially impact the effectiveness of TP regimes. This latter approach is adopted in the present study in view of which *four* main *attributes* have been retained. Lastly, tax regimes¹⁰⁴ around the world are constantly evolving as governments take progressive steps to render them more effective.¹⁰⁵ It is therefore hard to judge the effectiveness of TP regimes within such an ill-defined and potentially dynamic context, thus creating internal validity concerns that are likely to affect the relevance of research findings. For example, subsequent to starting the study, Nigeria and Ghana have since adopted TP regulations indicating a possible shift in policy towards tightening their anti-avoidance regimes. This development, mid way into the research, is welcome and serves to reinforce some of the views expressed in the thesis.

All three limitations have been taken into account in the design of this research¹⁰⁶ in ways it is hoped do not affect the validity or relevance of our findings. As the study aims to recommend wide-ranging and long-term improvements to TP policy and enforcement issues in sub-Saharan Africa, it is expected that the effectiveness of actual regimes would increase in the GoG as these countries move to upgrade laws, regulations and the administration of their anti-avoidance regimes. Therefore, rather than affect the present research findings in any significant way, reforms that are currently being implemented or introduced by some of the select countries serve to reinforce the practical relevance of this study. It also reinforces the need to rapidly push through these reforms in order to tackle TPM in a timely and most effective manner.

¹⁰⁴ Including laws, regulations, administrations, etc.

¹⁰⁵ Avi-Yonah et al (2011), *supra* note 29

¹⁰⁶ See, Section 1.2 *supra*, and Chapter 2 *infra*

CHAPTER 2

CONCEPTUAL AND ANALYTICAL FRAMEWORKS

The research goes beyond the discourse on taxes that IOCs pay to examine rules adopted by governments to prevent avoidance of these taxes. The level of progress registered on this issue varies substantially between developed and developing countries. Indeed, some anti-avoidance regimes have been *effective* in deterring or detecting and remedying TPM while others have been less so. The suggestion that one regime effectively tackles TPM and that another does not is subjective since perceptions on what amounts to effectiveness could vary between analysts. This raises two main preoccupations. The *first* concerns the concepts of transfer price manipulation and effectiveness of TP regimes. This for example covers questions like: what is transfer pricing? What are the competing perspectives on the issue? And, how does it differ from TPM? Questions linked to the construct of effectiveness include: what is effectiveness? How is it measured? If one applies the construct to TPM and legal analysis, how is it to be judged? And what outcomes could be deemed to amount to effective anti-avoidance? Or, is effectiveness subjective and therefore the researcher's responsibility to set criteria for judging it? Addressing questions like these should help clarify the concepts of TPM and effectiveness both of which are frequently used in this research (2.1).

The *second* section for its part develops an *analytical framework* to be used in judging the effectiveness of TP anti avoidance regimes (2.2). With the help of a diagram and explanatory text, the analytical framework used in the thesis is presented. The section discusses and retains as basis for the current research two developed (France, US) and two developing (Nigeria, Cameroon) countries that each present unique characteristics useful to our analysis.¹⁰⁷ These regimes comprise four key attributes namely the *arm's-length standard*, *compliance requirement*, *adversarial (audits, penalties) procedures and appeals*. The inter-relational arrangement of these attributes to the four baseline canons of taxation (*equity, efficiency, neutrality, certainty*) and select performance criteria (*deterrence, detection, remediation*) constitute the regime's **architecture**. These concepts that make-up the architecture are analyzed in judging the effectiveness of **engineering** and **administrative frameworks** of TP regimes. Concluding remarks to the chapter are presented in Section 2.3.

¹⁰⁷ The reasons for selecting these countries are discussed in Section 2.2.1 on the classification of system attributes.

2.1 The Concepts of Transfer Pricing and Effective Anti-Avoidance

This is divided into two subsections. The first examines the concept of transfer pricing as used in the study. Given that this is a study in taxation law we have for practical reasons limited our analysis of the concept to two main perspectives, that is, management accountancy and international taxation. While there is an abundance of literature discussing both perspectives on the subject, focus seems to be increasingly placed on the manipulation of transfer prices (2.1.1). Likewise, views on how to assess or judge effectiveness could vary depending on whether one analyzes the construct from the perspective of an economist, a legal expert or other angle. The study therefore delineates the construct of effectiveness as it is meant to be understood hereinafter, clarifying in the process which of two analytical processes (qualitative or quantitative) the thesis adopts as basis for judging the effectiveness of TP regimes in select countries (2.1.2)

2.1.1 The Concept of Transfer Price Manipulation

Transfer pricing is important in both management accounting and taxation disciplines. These constitute the two main perspectives on the subject. Considering that the transfer price used for intragroup transactions ultimately determines the distribution of incomes reported across segments of a firm, the issue is vital to companies and governments for different reasons. To management accountants, intragroup pricings have a resource allocation function and are used to measure performance of divisional managers in terms of profits generated by business segments they run. From this angle, TP is considered a legitimate practice with concrete benefits for integrated businesses. However, since there is growing concern amongst tax authorities that MNEs sometimes alter their tax liabilities by manipulating TPs, governments tend to hold a rather skeptical view on the subject. In principle, companies adopt either of two main bookkeeping approaches when reporting transfer prices, that is, decoupling and unified approaches. In some corporations, the approach is to keep two sets of books. The one used for internal performance assessments and profit measurement, and another that is used for tax reporting purposes. Decoupling is expensive to maintain, and easily results in disputes with tax authorities. The preferred approach has been to keep a single set of accounts for both management and tax reporting purposes.¹⁰⁸ In these cases risk of tax disputes is

¹⁰⁸ E&Y, *Transfer Pricing Global Survey* (2003)

reduced provided the TP used complies with recommended standards for reporting intragroup transfers. Nevertheless trends show that MNEs are increasingly turning to decoupling.¹⁰⁹ In this subsection we note that taxes are major costs to firms, which cost can and are increasingly being avoided by companies seeking to improve after-tax profits. TP offers such an opportunity, sometimes facilitated by tax havens (B). First, we discuss the role of TP in the management of firms and the concept of economic globalization that make TP relevant in international taxation (A).

A. Management Accountancy Perspective

TP as an Instrument of Intrafirm Management

Many of the world's largest companies rank transfer pricing amongst the most pressing challenges they face. Firms notably charge TP for: (1) supplies by parent to subsidiaries –*capital, technology, managerial skills*; (2) payments by subsidiaries to parent –*interests, royalties, license fees*; and (3) supplies and receipts between all related parties. Often there are interlocking networks of related firms working together to counteract competition in an imperfect market setting. How well they fare against competition depends on levels of control exercised by the parent company and the extent to which flexibility is allowed subsidiaries to make their own business decisions. If an MNE opts for a decentralized structure this often results in the creation of responsibility centers (profits, costs, investment) that are subject to performance appraisals including on intrafirm transactions.

In principle, managers only assign notional accounting numbers to intrafirm transactions including standard or actual costs, divisional profits, and return on investments. In this context the role of management accounting is to assign transfer prices for all transfers between responsibility centers. Such a price is deemed *controlled* if set by headquarters and implemented by segments of the firm, and/or *market* if negotiated independently by units under market conditions applicable to unrelated parties in the sector. From this perspective, transfer prices are used to evaluate goods and services exchanged between profit and cost centers, and are charged by one division of a large firm to another for products or services supplied to such other. One should note that: (i) seldom are these transactions treated as cash flows as they are mainly accounting entries; (ii) The TP is costs for the receiving division and income for the supplying division; and (iii) counter entries are often used to eliminate overstated TP on these transactions in firms where good accounting practices prevail.

¹⁰⁹ Springsteel, I., *Separate But Unequal*. CFO Magazine, (August, 1999)

Therefore, TP is treated in management accountancy literature as having two key functions: (1) motivating managers, and (2) facilitating performance monitoring.

Firstly, it helps in the coordination of production, sale, and pricing decisions of different divisions thus making managers aware of the value placed by other segments of the group on goods and services supplied or used by their divisions. Secondly, the TP permits the company to generate separate profit figures for each division enhancing the basis on which to separately evaluate the performance of each division. This also has the advantage that MNEs deploy TP strategically to ensure proper allocation of revenues and costs within the organization in a manner that uses scarce resources efficiently. In this role, it serves as a monitoring tool that assists decision makers and enablers to evaluate performance of integrated divisions within the MNE. Therefore, by setting appropriate TPs a firm can motivate managers of divisions or subsidiaries of a group to operate efficiently. Transfer prices are also used for transactions between segments of integrated domestic firms. However, it is mostly renowned for its cross-border implications and easily understood when examined within the context of economic globalization (B).

Economic Globalization as the Enabling Factor

Over the past half century there has been a major shift of government policies and efforts towards globalization of the world economy, resulting in greater international trade. Increasing trends to use TP is a logical consequence of the globalization process whereby MNEs, driven by profits, move to incorporate subsidiaries and establish alliances with affiliates around the world. By dismantling barriers to trade and developing a variety of internal and external linkages between different economies, globalization has accelerated capital mobility between countries. Marx and Engels succinctly observed that capital, in perpetuity needs an “expanding market for its products; [and] chases the bourgeoisie over the whole surface of the globe. It must nestle everywhere, settle everywhere and establish connections everywhere.”¹¹⁰ Oil is an example of a truly global industry in which companies are engaged in the business of exploring, extracting, transporting and also marketing petroleum all over the world. Moreover, decisions taken in one part of the world to finance, produce and tax petroleum, inevitably has rippled effects for consumers and producers in others. Thus, ‘globalization’ facilitates the flow of oil across borders and shapes the policy and strategic choices of major industry stakeholders like IOCs, governments and civil society.

¹¹⁰ Marx, K. & Engels, F., The Communist Manifesto (Introduction by David McLellan), p.6 (1998)

Conversely, globalization has opened windows of opportunities for companies to: (1) easily relocate operations to more desirable offshore jurisdictions and (2) transfer profits to countries with more favorable tax regulations. It has freed multinational companies (including IOCs) from the confines of territorial space and has simultaneously opened governments to risks of capital flight and international tax avoidance. Companies can now easily create permanent establishments including subsidiaries, affiliates and joint ventures around the globe. For example, before Yukos' collapse it had affiliates in Russia, Switzerland, Gibraltar, Panama and the Isle of Man;¹¹¹ Likewise ExxonMobil and Chevron own subsidiaries and affiliates in the UK, Germany, Netherlands, Asia, Africa and Latin America.¹¹² This global reach permits companies to take advantage of tax rate differentials and/or avenues to game tax jurisdictions against each other. This is the lens through which the discipline of international taxation approaches the concept of transfer pricing (B).

B. International Tax Perspective -*Transfer Price Manipulation*

Mechanism for Reducing Tax Cost

The primary goal of MNEs is to increase shareholder value by maximizing profits.¹¹³ In the current business climate where competition is rife, profit optimization is often achieved by keeping costs at reasonably low levels whilst seeking to increase revenues. In this context payments for specific economic benefits, like taxes, are viewed as costs that could and where possible should be mitigated. Not surprisingly, firms are increasingly making use of financial engineering techniques to keep such costs low. While this is not necessarily the consensus within the business community the extent of its importance is illustrated by comments of leading accounting firm's like Ernst & Young. E&Y say 'tax is a cost of doing business so, naturally, a good manager will try to manage this cost and the risks associated with it.'¹¹⁴ This might entail, amongst others, actively seeking ways to arrange a corporations business affairs to attract the least tax possible. Deloitte & Touche advise that it is desirable to start managing tax costs early in order to take full benefit of tax holidays to "shift a supportable level of profit to...reduce the multinational group's worldwide tax cost."¹¹⁵ Tax accounts for a sizeable portion of overall corporate costs in oil,¹¹⁶ and reducing it could substantially improve

¹¹¹ Komisar (2005), supra note 53

¹¹² *Exxon Corp. & Affiliates v. IRC* [1993] T.C. Memo. 1993-616

¹¹³ Kennedy, A., *The End of Share Holder Value: Corporations at the Cross-Roads*, (2000)

¹¹⁴ Irish Times, 7th May 2004

¹¹⁵ Deloitte & Touche, *Global Transfer Pricing: Arms-Length Standard*, (2007)

¹¹⁶ ExxonMobil declared in their 2012 Financial Statement to have paid US\$ 31.045 Billions in Income and other Taxes

after-tax profits. As discussed in Chapter 3 the net-basis used to compute resource taxes like Royalty,¹¹⁷ CIT, Cost and Profit oils are determined by taking into account costs and/or income engaged during the company's operations.¹¹⁸ Tax basis are thus tied to pricing of both 'cost' and 'income' on transactions that take place on the spot or futures markets, or as agreed between related parties under non-market conditions.

Let us take for example royalty to illustrate this point. It is either *unit* (on the physical quantity produced)¹¹⁹ or *ad-valorem* (by reference to the value of mineral produced) based. Mispricing concerns will not arise over unit based royalty since it is charged as US\$/ton, US\$/barrel or an equivalent measure. However, in cases where royalty is value-based both pricing of production and the exact point of valuation are important. In practice a rate is applied to a base (actual or expected sale **value**) to obtain the royalty charge. If the price component were misstated by error or design the royalty base will be undervalued or overvalued with governments and IOCs standing to make or lose money as a result. As concerns CIT, both 'costs' and 'incomes' are relevant. In a typical Royalty-Tax system, gross revenues minus royalty equals net-revenues. Cost (Opex, Capex) is deducted from net-revenues to get taxable income. As concerns PSCs the '*cost oil*' mechanism permits contractors to recover Capex and Opex to an agreed limit (for example 40%) to obtain the '*profit oil*' component. The contractor's share of profit oil is then taxed.¹²⁰ Thus, successful attempts at mispricing operations profoundly affect the taxable base on petroleum transactions. In view of recent increases in oil prices and efforts by host states to optimize tax revenues on oil operations, it can be said that companies no longer take the prospect of increased tax cost lightly. Efforts are being made via avoidance schemes to keep tax costs low with *tax havens* playing an important role in easing this process (B).

The Role of Tax Havens in Facilitating TPM

What is a tax haven? And, what criteria might qualify one jurisdiction and not another as a tax haven? These are important questions that puzzle many who come into first contact with the subject. Tax havens may be "loosely defined to include any country having a low or zero rate of tax on all or certain categories of income, and offering a certain level of banking or commercial secrecy..." for its

¹¹⁷ In many countries, royalty is charged on the gross revenues earned from sale of hydrocarbons or other minerals. In order to reduce its regressive effects, exceptions exist where certain costs are deducted for computing royalties

¹¹⁸ See Chapter 3.2.2.1 for discussion on royalties

¹¹⁹ Kemp, A., *Economic Considerations in the Taxation of Petroleum*, in Khan, K. (ed.) Petroleum Resources and Development, Economic, Legal and Policy Issues for Developing Countries, pp. 121-145 (1987)

¹²⁰ Johnston, D., International Petroleum Fiscal Systems and Production Sharing Contracts, pp.30 & 40-42 (1994)

users.¹²¹ Key characteristics of havens include: low or nil tax on some or all types of income and capital, absence of exchange controls, provision of offshore banking facilities, good communication facilities, clear opportunities for offshore tax planning, availability of professional advisers and financial/commercial secrecy. Havens can be classified into four main categories: (1) production havens -Ireland, (2) base or secrecy havens -Mauritius, Cayman Islands, (3) treaty havens - Netherlands, and (4) concession havens being countries offering particular tax incentives -UK, US, Netherland. In principle all forms of havens pose challenges to tax authorities. However, functions performed by production and secrecy havens pose the most challenge to authorities, that is, *produce* goods and services, *shift* tax claims amongst jurisdictions, and also *hide* tax claims from governments.¹²² MNE's exploit these functions differently and at different times.

As governments tighten tax rules on these issues (US, UK, France), IOCs have tended to move their operations to tax shelters in order to mitigate the effect of tighter rules on corporate profitability. For instance KPMG concluded following a 2006 poll of top executives of 120 MNEs that 62% of respondents planned to move assets and operations to havens, while 14% had already moved some of their operations to low tax jurisdictions.¹²³ Havens are gaining prominence as cornerstones of the globalization process and are now estimated to account for over half of total world trade in spite of the fact that they represent only 3% of global GDP.¹²⁴ They hold US\$ 11.5 trillions in assets but represent only about 1.2% of the world's population. These staggering figures are explained by the fact that havens impose light regulations and low or no tax obligations on firm's setting-up structures and booking transactions for tax avoidance purposes.¹²⁵

Many leading corporations around the world lodge at least some of their operations in tax havens. By 2007, 83 of 100 large US corporations owned subsidiaries in havens with at least one identified as controlling 427 such subsidiaries in low tax jurisdictions.¹²⁶ In the US Enron was reported to control 900 subsidiaries in Barbados, Cayman Islands, Turks and Caicos, and Mauritius.¹²⁷ German firms are said to own approximately 12,600 subsidiaries in Switzerland, Liechtenstein and

¹²¹ Gordon Report prepared for US Treasury in 1981

¹²² Kurdle, R.T., *The Campaign Against Tax Havens: Will it last? Will it work?* 9 Stan JLB & Fin (2003-2004)

¹²³ Miller & Oats (2009), supra note 29 at p.255

¹²⁴ Christensen, J. et al., *Tax Avoidance, Tax Competition and Globalization: Making Tax Justice a Focus for Global Activism*, p. 67 in Penttinen, J. et al., (eds.), *More Taxes: Promoting Strategies for Global Taxation*, (2005)

¹²⁵ Mitchell, et al., *No Accounting for Tax Havens*, (2002)

¹²⁶ Large US Corporations and Federal Contractors with subsidiaries in jurisdictions listed as tax havens or financial privacy jurisdictions, GAO-09-157 December 2008, at <http://www.gao.gov/new.items/d09157.pdf>

¹²⁷ Prem, S., *Tax Gap: Shifting Profits Across Borders*, The Guardian UK, February 12, 2009, <http://www.guardian.co.uk/commentisfree/2009/feb/11/taxavoidance-tax> [Last visited: August 13, 2013].

Luxemburg, which are all tax havens. There is a strong presupposition that tax avoidance is often a prime consideration in the creation of these subsidiaries lending credence to claims that governments are losing huge amounts in taxes to these practices. It is estimated that European governments lost about £100 billions in taxes to schemes involving offshore financial centers in the 2000s.¹²⁸

Tax havens mainly serve as financial transit/storage hubs for large numbers of international transactions currently passing through them. This would normally not constitute a problem except that the reasons for which IOCs and other MNEs transit or lodge operations in these havens have been widely regarded as less than noble, contravening ideals of a 'good' tax system set by Adam Smith in his seminal work *The Wealth of Nations*.¹²⁹ From this perspective, havens are a key component of a wider puzzle designed to facilitate global tax avoidance via use of schemes like double dipping, treaty shopping and transfer pricing. Although it is not obligatory that firms use tax havens in the design and implementation of avoidance schemes, it is known that the high levels of secrecy and lack of proper regulation by havens guarantee optimal results. Thus havens provide an enabling environment in which TPM schemes easily materialize with minimum or no risk of detection or proper monitoring by tax authorities. Famous examples of jurisdictions classified as havens by the OECD, NBER and US District Courts include: Anguilla, Antigua and Barbuda, Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Cyprus, Dominica, Gibraltar, Isle of Man, Lichtenstein, Malta, Mauritius, Switzerland, Netherland Antilles and Panama.¹³⁰ Examples of the role played by some of these jurisdictions in facilitating TPM are discussed later in 4.2.

2.1.2 The Construct of Effectiveness of Laws

Effectiveness is defined as '...producing the result that is wanted or intended; or producing the expected result.'¹³¹ Often this entails qualitatively and/or quantitatively measuring actual outcomes and making reasoned judgments on whether that which is measured/judged meets or is likely to meet intended outcomes. In this section the construct of effectiveness and preference for using qualitative analysis in judging effectiveness of tax laws is discussed.

¹²⁸ Financial Mail of November 25, 2001

¹²⁹ See *Infra*, Chapter 2.2.1 for in-depth discussions on the tenets of a good tax system

¹³⁰ Miller & Oats (2009), *supra* note 29 at p.270

¹³¹ Wehmeier, S., (Ed.) *Oxford Advanced Learner's Dictionary of Current English*, p.371 (2000)

A. The Construct of Effectiveness

The ability to measure or judge, it is argued, has greatly contributed to the growth of our civilization.¹³² In the social science disciplines some form of assessment of the effectiveness of existing systems is required in order to inform necessary improvements. Therefore, the researcher has to decide in *light of the type of study undertaken*, which of two (*qualitative* or *quantitative*) methodologies to adopt in assessing effectiveness. Most social science disciplines study events, processes and certain complex occurrences that are difficult to understand, let alone quantitatively measure.¹³³ For example, laws/regulations are often used to shape the environment in which actors operate as a means of influencing behavioral outcomes. Assessing their effectiveness provides a meaningful link between the strategy adopted and its actual or likely outcome.¹³⁴ Assessing the outcomes of deliberate policy choices provides policymakers with the information needed to make informed decisions on whether to stay or change course.¹³⁵ In the social sciences, researchers have traditionally preferred using the qualitative methodology to do so although this might be changing.

Increasingly some social scientists are using quantitative (notably formularized) models in their research. This is notably true of research in the area of TP, which is often associated with the economics or business accounting disciplines; and economists are progressively tending to express their research in terms of formularized models instead of the traditional empirical methods hitherto used in the discipline. In the economics literature emphasis is placed on establishing an *optimal transfer price* (OTP), which could mean determining the most efficient and beneficial price to the business. Often, this is at odds with tax laws given that the OTP is, for tax computation purposes, not necessarily the acceptable pricing standard. Rather, governments require MNEs to use the *arms-length price* that is technically rarely ever the optimal transfer price. Therefore, if the views of economists on the subject are to go past academic and policy discourse, it is crucial that lawmakers accommodate and materialize them in the actual taxing statute. Indeed, while tax rules are sensitive to and rely on concepts and practices drawn from other disciplines to ascertain tax liability it remains *prima facie* a matter of law, not accountancy,¹³⁶ mathematics or formularized economics. In *Aberdeen*

¹³² Sydenham, P., *Relationship between Measurements, Knowledge and Advancement*, Measurement, Vol.34, pp. 3-16, 2003 at p.3

¹³³ Geisler, E., *The Metrics of Science and Technology*, p.35 (2000)

¹³⁴ Melnyk, S., et al. *Metrics and Performance Measurement in Operations Management: Dealing with the Metrics Maze*, Journal of Operations Management, Vol.22, pp. 209-217, 2004, at p.209

¹³⁵ Gartner, S., *Strategic Assessment in War*, p.1 (1997)

¹³⁶ *Britannia Airways Ltd. v. Johnson* [1994] STC 763

Construction Group Ltd v. IRC,¹³⁷ Lord Wilberforce reinforced this view by noting that: “The capital gains tax is a tax upon gains: it is not a tax upon arithmetical differences.” Hence, what amounts to tax and how it is to be determined is primarily the purview of law.

If one shares this perspective (economists are likely not to), it is understandable why the adoption of formularized models in judging effectiveness of laws has proven controversial and often criticized for its lack of practicality.¹³⁸ Law as a discipline is heavy on practice, such that attempts to judge legal outcomes by adopting mathematical constants and variables is to say the least simplistic. The wordings of the law must be profoundly analyzed together with facts of a case (or related conjectures), a predisposition that favors qualitative instead of formularized methods as far as judging laws is concerned. It is argued that research on the effectiveness of laws should be approached from this perspective. Chief Justice Spigelman AC emphasizes this logic by noting that:¹³⁹

“Not everything that counts can be counted. Some matters can only be judged -that is to say they can only be assessed in a **qualitative way**... In some spheres of government decision-making the things that can be measured are the important things. In other spheres the things that are important are simply not measurable. The law is at the latter end of the spectrum.”

Embedded in this thinking is the distinction between effectiveness and efficiency. The distinction is important to make as both concepts present different insights into a given system. *Effectiveness* deals with how well a system is likely to, or actually tracks against its purpose; whereas *efficiency* describes how well the system utilizes available resources to do so.¹⁴⁰ The latter is only a criterion, amongst others, that can be used in determining the former. Spigelman C.J., further argues that while current justice systems might not be the most efficient means to resolve disputes, governments have deliberately chosen ‘inefficient ways of decision-making in the law in order to protect rights and freedoms.’¹⁴¹ That is, inefficient systems of disputes resolution have been chosen to make rights and freedoms effective. One could as such conclude that *quantitative* analysis typically used in the physical sciences has significant limitations when applied to legal research.

¹³⁷ [1978] 127 at p.131

¹³⁸ Eden (1993), *supra* note 3 at p. xii preface

¹³⁹ In Annual Conference of the Australian Institute of Jud Admin entitled “Measuring Court Performance” on 16 Sep 2006.

¹⁴⁰ Sink, D., *Productivity Management: Planning*, p.42 (1985); see 2.1.3 for meaning of efficiency as used in taxation

¹⁴¹ Spigelman C.J., *Economic Rationalism and The Law*, Judicial Officers’ Bulletin, Vol. 13 N^o 2 of Mar. 2001

B. Methodology for Judging Effectiveness of TP Regimes

Research on the effectiveness of systems is carried out in clearly defined context and outcomes should be understood in their proper context. Given that legislative environments can be very dynamic, a challenge that often arises is how to hold static contexts in which legal research is being done. Further, these systems are quite broad such that it is impracticable to attempt to assess every aspect of a select system. It is more feasible to identify key aspects of the system that are useful to the research and to then focus one's attention on analyzing sets of interlocking attributes drawn from provisions of the law that pertain to the system. For a study designed to judge the extent of effectiveness of a legal system and to propose appropriate improvements to it, this approach ensures that research findings are the direct result of analyzing relevant system structures and processes. As noted earlier, preference in legal research has been to use the qualitative methodology in analyzing and objectively informing views on the effectiveness of TP anti-avoidance regimes.

As used in this study therefore, **effectiveness is the perceptible gap between the actual-regime-state and the ideal-regime-state.**¹⁴² That is, the extent to which actual TP regimes in select GoG countries are, or likely to fare against an ideal TP regime from the trio-dimensional perspectives of their architecture, engineering and administration.

2.2 Analytical Framework of the Research

After undertaking a preliminary review of TP regimes in a range of countries (Table 2-1 *infra*), three important components were observed to exist in existing frameworks. Firstly, they adopt principles, norms, rules and procedures that can be grouped into a set of four attributes that are central to analyses on the effectiveness of TP regimes. These are the *arm's-length standard*, *compliance*, *adversarial* and *appeal* attributes.¹⁴³ Secondly, architects of these regimes align tax anti-avoidance objectives to those of the broader tax system by weaving into the fabric of these attributes the baseline canons of taxation of *equity*, *efficiency*, *neutrality* and *certainty*.¹⁴⁴ And thirdly, it is

¹⁴² Bullock, R., *Theory of Effectiveness Measurement* (2006), who develops this approach elaborately but from a quantitative perspective

¹⁴³ Broadly speaking, tax regimes comprise four functions namely tax compliance, audits, appeals and collection. In this thesis, we concentrate on the first three and sparingly touch on the issue of tax collection in Chapter 6.

¹⁴⁴ Although tax regimes comprise both compliance and noncompliance rules, it is common to think of them in terms of the former only, ignoring the fact that both are constituents of a tax regime. Both play an equally important role in ensuring a system's overall effectiveness. These rules should effectively tackle noncompliance and ensure that the broader economic goals of a country are safeguarded through anti-avoidance. Hence, anti-avoidance regimes should be assigned

observed that these anti-avoidance attributes have as main objectives to deter, detect and remedy TPM. Bearing in mind all three, the yardstick used to judge the effectiveness of regimes is the ability of *actual regime attributes* to deter otherwise non-compliant actors from engaging in TPM, or to facilitate the detection and remediation of abuses compared with *ideal regime attributes*.¹⁴⁵ While it is easy to determine *actual regime attributes* in select countries, it is a challenge to ascertain what the *ideal regime attribute* is given that contexts in which regimes are implemented differ and the approach (light or tight) adopted in each country's design is indeed shaped by its reality. However, a review of select regimes reveal certain elements that should be incorporated into an ideal TP regime, which elements are harnessed into an analytical framework used in the study to judge effectiveness of TP regimes in the GoG from the perspectives of their architecture, engineering and administration.

Table 2-1: Transfer Pricing Anti-avoidance Regimes

HIGH TAX	COUNTRIES	ARMS-LENGTH	THIN CAP	AUDITS/ PENALTIES/ APPEALS	COMPLIANCE	TREATIES
TIGHT	USA	s. 482 ¹⁴⁶	s.163 (J) ¹⁴⁷	Yes	\$6662 (E)	60+
LIGHT (DEV'D)	FRANCE	Art. 57	Art. 212/	/L.64	L.13 B	100+
LIGHT	CAMEROON	Art. 19 Bis/L.19 B	--/	L.9, 33 & 33 Bis./L.95/L.115	--/	4
(DEVELOPING)	CHAD		--/	--/	--/	1
	Eq. GUINEA	No	Yes	Yes	No	1
	GABON	Art. 12	No	Yes	--/	5
	NIGERIA	s.9, 15 & 23	--/	Yes	--/	10
LOW TAX	COUNTRIES	ARMS-LENGTH	THIN CAP	AUDITS/ PENALTIES/ APPEALS	COMPLIANCE	TREATIES
TAX HAVEN OR OFC'S	ISLE OF MAN	No	No	No	No	9+
	SWITZERLAND	ALP	Yes	No		80+

Compiled from 2010 Deloitte Tax Guides (<http://www.deloitte.com/taxguides>)

While there are technical differences between architecture and engineering, it is worth noting that these are not clear-cut since both concepts sometimes overlap.¹⁴⁸ In this study **architecture** signifies the art of *designing TP systems* with a focus on *functionality*, where design is the general arrangement of different components of the system.¹⁴⁹ **Engineering** for its part focuses on providing the technical details needed to construct or realize the design. That is, architects *initiate* the project by

unique objectives that translate into and are obligatorily aligned to the country's broader tax objectives. For discussions on how tax laws are shaped by the broader economic policy objectives, see Silvant, *Improving Tax Compliance*, in Bird, R. & M. de Jantscher (eds.) *Improving Tax Administration in Developing Countries*, p. 274 (1992)

¹⁴⁵ Sproles, N., *Identifying Success Through Measures*, PHALANX, Vol. 30, No. 4, pp. 16-31, (Dec. 1997) at p.16 highlights this approach

¹⁴⁶ Stripping of Corporation Tax Base through transfer pricing

¹⁴⁷ Earnings stripping on intergroup loans, was added to US Income Tax Act by the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239) of 1989 to prevent stripping of withholding taxes via DTT

¹⁴⁸ See definition of architecture in Concise Oxford English Dictionary, p.68 11th Edition, Oxford University Press, 2008.

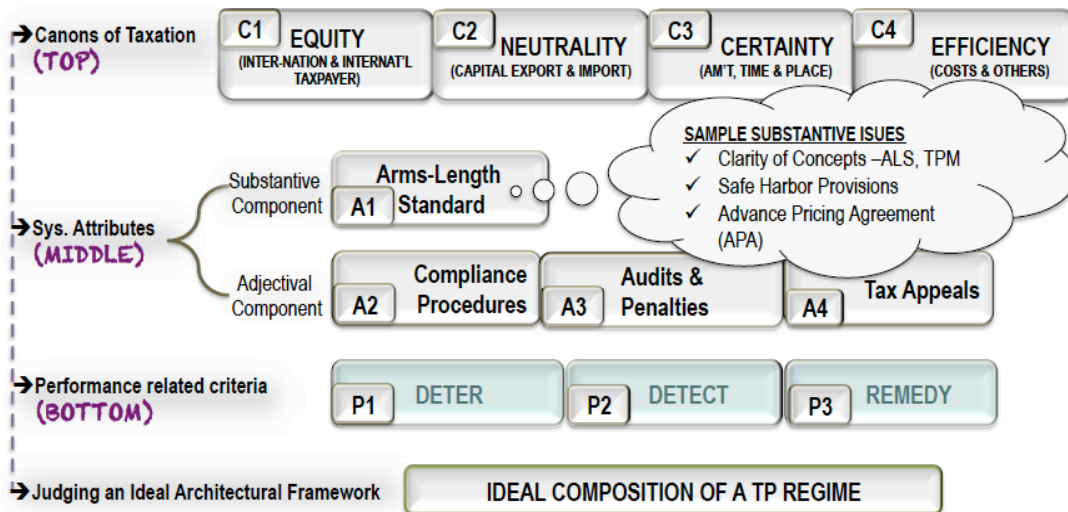
¹⁴⁹ Also, see definitions of design in Wehmeier, S. & Ashby, M., (Eds.) *Oxford Advanced Learners Dictionary of Current English*, p. 315, 6th Edition Oxford University Press 2001

drafting it, while engineers *populate* the design with details needed to operationalize the same. Therefore, system architects hand over their design comprising both the *components and proposed arrangement thereof* to system engineers whose task it is to materialize the same using the country’s policy approach (light or tight) as basis for doing so. A rule of thumb in distinguishing between both perspectives is to view *architecture* as focusing on the ‘**what**’, and *engineering* on the ‘**how**’. That is, architecture signifies the *composition* (including *arrangement*) of concepts that makeup the regime (2.2.1); while **engineering** builds on this architectural framework by actually detailing anti-avoidance rules that are precisely chosen to tackle TPM using either the light or tight policy *approaches* (2.2.2).

2.2.1 Ideal ARCHITECTURE –Composition and Arrangement

Tax anti-avoidance regimes aim broadly to deter or detect and remedy noncompliance. Architecting an ideal TP regime to achieve these objectives largely depends on the **composition** of **concepts** that are included into the regime and the interconnected arrangement of these concepts in a manner that effectively tackles TPM. An ideal architecture of TP anti-avoidance regimes should comprise three layers of concepts. The first or **top layer** focuses on legislatures using widely agreed baseline canons of taxation in the design of TP regimes namely equity, neutrality, efficiency and certainty. The second or **middle layer** consists of attributes (tools) available to governments for use by the fisc in tackling TPM notably ALS, compliance, adversarial and appeals. And, a third or **bottom layer** that deals with key performance objectives of the regime notably deterrence, detection and remediation. Any ideal architectural framework of a TP regime would comprise these concepts.

Figure 2-1: Ideal Composition of TP Regimes



A. Composition of an Ideal TP Regime

A.1 The Top Layer of Concepts: Baseline Canons of Taxation

The architect in designing an ideal regime needs to recognize that anti-avoidance rules are part of the broader system that is meant to complement compliance rules. It would be recalled that Adam Smith in *The Wealth of Nations*¹⁵⁰ expounded four canons of a good tax system, which have recently been expanded to take account of the international context in which MNEs now operate. *Therefore, in architecting an ideal 'tax system' there is need to ensure that its anti-avoidance component is underpinned by these baseline principles of taxation.* That is, anti-avoidance attributes should be aligned to Smith's canons of taxation. The importance of factoring these canons into the architecture cannot be ignored given that in designing an ideal anti-avoidance regime, architects seek to maintain or restore the tax system's equity,¹⁵¹ neutrality,¹⁵² efficiency and certainty.

Canon 1: Equity -Inter-nation Equity & International Taxpayer Equity

Smith argued that taxes be paid in proportion to incomes to enable governments cover public expenses. This initial understanding of the canon of equity and based on proportionality, has since evolved in two main ways. (1) To proportionality (horizontal) is added progressivity (vertical). *Horizontal equity* requires those in like circumstances to be treated alike, that is, those with similar income levels should be taxed in equal measure. *Vertical equity* for its part requires those placed on different income brackets to support the tax burden differently. (2) The second main evolution of equity is linked to increased international trade and the need for countries to 'fairly' share resulting tax revenues. As per this extension, inter-nation equity requires cross-border tax revenues to be shared fairly amongst countries competing for the default right to tax on a source or residence basis, the tax base and methods of relief for taxpayers in the event of double taxation. Further, international taxpayer equity requires domestic tax systems to guarantee both horizontal and vertical equity for all

¹⁵⁰ Adam Smith, *Causes of the Wealth of Nations*, The Pennsylvania State University (2005)

¹⁵¹ Another example that can be observed is that of equity. MNE's operate in same markets as domestic firms and if a tax system's anti-avoidance component is designed such that it fails to tackle TPM effectively; the ensuing accrual of undue tax advantages to foreign companies creates a non-competitive and imperfect market environment that is disadvantageous to domestic firms. This outcome in the design defeats the axiom of equity where well-designed anti-avoidance rules are needed to restore *equity*.

¹⁵² Kaplow, L., *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, NBER Working Paper 5391, Cambridge (1995);

taxpayers resident in the same tax jurisdiction regardless of the country of origin of its owners.¹⁵³ Since *pretax returns* for both foreign and domestic incomes are alike, so should *post-tax returns* be. From an anti-avoidance standpoint, adopting this principle is important because if domestic firms are effectively taxed while MNEs operating in the same markets as they do are allowed to dodge taxes via TPM, this undoubtedly undermines *system equity* and Smith's view of a good tax system.¹⁵⁴

Canon 2: Neutrality -Capital Export and Capital Import Neutrality

Neutrality is also a canon of taxation. A neutral system is one designed to limit the likelihood of tax considerations influencing the choices of economic operators. An ideal system should eliminate 'distortionary substitutional effects' by permitting economic agents to operate without preoccupying themselves with issues of taxation until after profits are earned. That is, pre-tax decisions on the corporate form, location of tax base, debt-to-equity ratio or pricing policies, should stay unchanged post-tax.¹⁵⁵ Musgrave has broadened the canon of neutrality to now include the international context of business interactions between two or more tax systems. Under the first, *Capital Export Neutrality* (CEN), the investor's decision to make domestic or foreign investments is not to be influenced tax related considerations. That is, post-tax outcomes or returns should remain balanced on two or more investments with identical pretax returns. Neutrality is harmed if tax considerations play a key role in persuading the investor to export its capital to one country and not another. Under the second, *Capital Import Neutrality* (CIN), taxes should not be charged on investment on the basis of its origin or ownership. Investors should be treated equally by receiving the same post-tax return for same pretax investments regardless of whether they are domestic or foreign. The idea is to create a system that neither encourages nor discourages decisions by persons on whether to invest at home or abroad, work at home or abroad, or even to consume domestic as opposed to foreign goods.¹⁵⁶

Canon 3: Certainty -Inter-nation Tax Certainty

An ideal regime is designed to achieve an environment of utmost *certainty* for taxpayers, notably with respect to domestic tax laws and their implementation. The taxpayer's scope of liability and procedures for computing, filing, payment, audit, penalty, appeal and recovery should be clearly

¹⁵³ Musgrave, P., *The Taxation of Foreign Investment Income: An Economic Analysis*, p.281 (1963); All resident legal persons should be treated alike. Does equity apply to domestic firms only or does it include foreign firms as well? If the latter applies, do not home countries stand to benefit more since they can tax an entity's global measure of income?

¹⁵⁴ Shipwright (1997), *supra* note 10 at pp.10-12

¹⁵⁵ Eden (1998), *supra* note 3 at p.74

¹⁵⁶ Musgrave (1998), *supra* note 153 at p.280. Without some form of **global coordination of national tax systems**, a truly global tax system that is neutral remains imaginary and whether states will cede sovereignty in tax matters to such coordination is quite another question. This possibility is developed in Chapter 8

defined in the law. This encourages 'tax morality' and makes tax evasion or avoidance detectable and punishable. If taxpayers know what needs to be paid, when it must be paid and where payments should be made this diminishes risks of arbitrarily taxation by authorities. From this angle, it is essential that system architects maintain *inter-nation tax certainty* adopting two dimensions to this issue. Firstly, multinationals operate businesses in many countries around the world and knowing with certainty what tax rules apply in each and which country exercises primary and/or residual jurisdiction to tax its operations facilitates the ability to take vital investment decisions. Secondly, an aspect of this principle that has definitively crept its way into most natural resource agreements is *fiscal and regulatory stabilization clauses*. Since resource projects are capital intensive and span for periods often exceeding twenty years, there is a constant worry amongst resource companies that once investment is made, host countries could alter project economics by changing tax rules. These uncertainties have caused IOCs/investors to insist that oil rich countries include in resource contracts stabilization clauses that would freeze issues of fiscal liabilities throughout the duration of a project.

Canon 4: Efficiency -International Tax System Efficiency

Lastly, an ideal regime is designed to be *efficient*, that is, '...take[s] out and keep[s] out of the pockets of people as little as possible, over and above what it brings into the public treasury.'¹⁵⁷ There are four ways in which a tax system is inefficient. That is, if: (i) pre-collection administrative costs outweigh post-collection yield, (ii) business is obstructed, (iii) it does not make unsuccessful attempts to avoid taxes inefficient to avoiders, and (iv) audits leave an odious effect on perceptions of economic agents. Internationally, the tax regime's efficiency takes either of two forms, *namely inter-nation efficiency and international taxpayer efficiency*. As concerns the first, governments spend enormous resources to define policy, implement or enforce diverse tax laws that subject MNEs to extensive filing requirements in as many states as they operate. The lack of collaboration between all these countries mean they collectively spend more resources than is otherwise needed to collect taxes from MNEs. Likewise, the cost of compliance is quite high for MNEs that must conform to tax obligations in all these countries and are as a result bound to use the services of tax planners and compliance experts to minimize global exposure to these risks. From an anti-avoidance standpoint, the regime is ideal if designed to create inefficiencies for noncompliant taxpayers by ensuring that costs of avoiding liability effectively outweigh all potential benefits of doing so.

¹⁵⁷ Smith (2005), supra note 150

A.2 The Middle Layer of Concepts: Attributes of the Regime

Attributes of an ideal anti-avoidance regime should contain a set of rules that preempt TPM and another that responds to cases of the practice. In this sub-heading, we only discuss the thinking/philosophy underpinning our selection of **four attributes**, some of which are substantive and others procedural. Questions on the engineering of these attributes are discussed in section 2.2.2 [infra].

Preemption Component: ALS (Safe Harbors, APA's) and Compliance

Firstly, TP rules should be designed to **preempt** the possibility that legitimate compliance choices might be misconstrued as avoidance. It therefore achieves compliance by adopting **clear** rules to guide and facilitate taxpayer compliance, the non-respect of which is avoidance. This includes the creation of special protocols and mechanisms via which parties can agree on acceptable practices.¹⁵⁸ A skewed definition of concepts or design of rules creates ambiguities in the TP regime. Preemption seeks to eliminate these ambiguities as a means of reducing costly disputes between the fisc and taxpayers that might occur as a result. An example is the adoption of rules that clearly defines practices which amount to TPM including rules for sourcing data, selecting methods, and internalizing protocols for economic and functional analysis relevant for the ascertainment and implementation of ALS.¹⁵⁹ In order to avoid accidentally netting compliant practices, or erroneously excluding those that should be ordinarily netted, regime architects need to *clarify* all relevant *concepts* as a prerequisite for effective compliance to the regime. Technically, the operationalization of everything else including the role of attributes in achieving performance objectives depend on it.

Given that TP is not an exact science, the ideal regime preempts undue quarrels between the fisc and MNEs by incorporating **safe harbors** into its architecture. If transfer prices fall within a predetermined arm's length range, this eliminates the need for adjustments. It is a useful measure by which all stakeholders can decide upfront which intrafirm pricing policies to adopt or avoid. Likewise, architects of ideal TP regimes could enhance compliance by adopting **Advance Pricing Agreements (APA)**. APAs are very useful in averting unnecessary TP disputes in that it presents authorities and taxpayers an opportunity to negotiate and agree applicable transfer prices and the extent of documentation reporting or disclosures to be complied with. It reduces the cost and time otherwise spent in resolving disputes that are likely to arise further down the implementation chain and

¹⁵⁸ Preemption is different from **deterrence**. While both result in taxpayers complying with their obligations, this is achieved from different angles. Deterrence seeks to achieve compliance via the threat of sanctions designed to dissuade rational taxpayers from choosing noncompliance.

¹⁵⁹ See chapters 5.2.2.2 for more in-depth discussions on this issue

strengthens compliance within a cooperative and non-adversarial framework. APAs can be efficient in contexts where data is scarce and the ability to handle complex TP adjustments is weak.

Response Component: Audits and Penalties, and Appeals

Ideal TP anti-avoidance regimes incorporate attributes designed to **respond** to genuine cases of noncompliance. ‘Response attributes’ as these can be referred to comprise a package of noncompliance rules built into anti-avoidance regimes to enable the fisc react to schemes designed to avoid taxes. Response attributes, therefore, are the main repository of **tools** that are relevant in detecting and remedying TPM. Ideally, architects would carefully select and incorporate into the regime audit protocols and remedies that are needed to effectively tackle TPM. And lastly, architects of an ideal anti-avoidance regime would also incorporate varying types of dispute resolution mechanisms open to unsatisfied taxpayers seeking redress. However, it is worth noting that the details and exact composition of dispute mechanisms differ between countries.

A.3 The Bottom Layer of Concepts: Performance-related Criteria

Amongst others, Professor Walker argues that the law is best designed if it seeks to (1) prevent, not punish, and (2) only penalizes behavior that causes harm.¹⁶⁰ The first objective refers to a predisposition of the legislature to deter noncompliance, and the second to a need to detect and remedy abuses once enforcement kicks in. Ideally therefore, the TP anti-avoidance regime should aim to achieve three main performance objectives, namely deter, detect and remedy abuse (DD&R).

Performance 1: Deter Tax Avoidance

The first criterion selected for our analyses has been developed into an elaborate theory commonly used in the disciplines of criminology, road safety, taxation and international relations.¹⁶¹ Deterrence ideally strengthens compliance in two main ways.¹⁶² The *first* is *intimidation* by which noncompliance costs are designed to outweigh all the potential benefits of tax avoidance thus making compliance more attractive to rational actors. Secondly, *enforcement* also contributes given that the implementation of sanctions than the mere threat of it would force rational taxpayers to comply.¹⁶³

¹⁶⁰ Walker, N., *Punishment, Danger, & Stigma: The Morality of Criminal Justice*, (1980)

¹⁶¹ Hosoya, C., *Miscalculations in Deterrence Policy: Japanese-US Relations, 1938-1941*, JoPR 5, No.2 (1968), 97-115;

¹⁶² Two other, but less relevant, ways in which effective deterrence contributes to compliance are through **education** (knowledge of and belief in the sanctity of sanctions leads to compliance) and **reinforcement** (sanctions over time cause actors to comply with the law by pure force of habit)

¹⁶³ Elliott, B., *Deterrence Theory Revisited*, (2003) <http://www.rsconference.com/pdf/RS030055.pdf?check=1> [Last visited: Mar 3, 2011]. Deterrence is either specific or general. The former relies on an abusers’ past experiences with punishment

There is an underlying assumption in this context that potential abusers are rational actors who make rational choices. As such if potential abusers perceive the consequences of noncompliance to outweigh its potential benefits, they are unlikely to abuse the system if acting rationally.¹⁶⁴ For this to happen risks associated with noncompliance should be made so great and sanctions severe so that potential noncomplying rational actors would instead choose to comply. From this standpoint, it has a preventative effect and the decision not to abuse on account of fear or the perception of sanctions as severe, swift and certain is its deterrent effect.¹⁶⁵ A person is deterred from offending by sanctions “if, *and only if*, he refrains [or is likely to refrain] from that act because he fears the implementation of the sanctions, *and, for no other reason.*”¹⁶⁶ Causality should exist between the decision to comply and the *fear* of sanctions for not doing so. Therefore, if a person is likely to or complies on account of moral scruples, ostracism or disapproval by society, this is not deterrence as no intimidation by way of sanction is brought to bear on him to do so.¹⁶⁷

However, a regime whose architecture adopts deterrence as the sole goal is bound to be defective given that the theory has inherent limitations. The exact role of deterrence is unclear¹⁶⁸ and its realization depends on effective enforcement systems. It is worth noting that some economic actors are irrational (risk-prone, tax averse, impulsive, compulsive) so that deterrence is irrelevant to their circumstances.¹⁶⁹ And, even rational actors can make different rational choices over the same issue¹⁷⁰ if they become unrealistically optimistic about the outcome of engaging in avoidance, act on the basis of realistic risk-taking, or even act in defiance.¹⁷¹ An ideal TP regime should be designed to **deter noncompliance**. However, given its limitations deterrence cannot fully cause compliance of

to deter, while the latter appeals to the imagination of those that are yet to come into first contact with sanctions to dissuade noncompliance.

¹⁶⁴ Beyleveld, D., *Identifying, Explaining and Predicting Deterrence*, *The British Journal of Criminology*, 19, 3 July, p.205-224 (1979)

¹⁶⁵ Elliott (2011), *supra* note 163 at p.8; Aaron, H. & Slemrod J. (eds.) *The Crisis in Tax Administration*, Chap. 8 (2004)

¹⁶⁶ Beyleveld (1979), *supra* note 164 at p.207

¹⁶⁷ Elliott (2011), *supra* note 163 at p.2. In this respect, one must not confuse deterrent measures with such others primarily designed to boost compliance. The former aims to cause compliance by *threat of repercussions*, while the other uses incentives to achieve this. Some taxpayers accept and simply proceed to make good their tax obligations (*voluntary compliance*) without intimidation.

¹⁶⁸ Fattah, E., *Deterrence: A Review of the Literature*, p.48, Law Reform Commission, Canada (1976)

¹⁶⁹ Elliott (2011), *supra* note 163 at p.4; Lebow, R., & Stein, J., *Rational Deterrence Theory: I think, Therefore I Deter*, p.208 *World Politics*, Vol. 41, No.2 (Jan., 1989), pp. 208-224

¹⁷⁰ Zagere, F., *The Dynamics of Deterrence*, p.1-7 (1987)

¹⁷¹ For example, some people are *tax-averse* so that risks of detection and related sanctions are not sufficient to deter tax avoidance especially when sanctions can be avoided or its implementation is seen as uncertain. If tax-averse citizens succeed to abuse the system this amounts to *undeterred noncompliance*.

taxpayers with their tax obligations. When it fails, and it often does in tax matters, an ideal regime shifts the focus of tax authorities to enforcing compliance.

Performances 2 and 3: Detect and Remedy Tax Avoidance

The architecture is ideal if it creates, on basis of the *rule of law*, the necessary framework that allows tax authorities to enforce compliance by *detecting* and *remedying* prejudices caused to the public purse. It is important that architects incorporate both criteria in their design of response components to the regime since courts might take the ‘thin’ interpretational view that taxpayers are “entitled to rely on the rules and answers to which those rules give rise” and may not be stopped from enjoying any benefits stumbled upon in the course of their legitimate business dealings, even if those results are obviously unanticipated, unintended or downright undesirable.¹⁷² This reinforces the view by Scalia that ‘it is the law that governs, not the intent of the lawgiver’.¹⁷³ The outcome of a literary interpretation of tax rules is valid since to do otherwise would be to subvert the rule of law.¹⁷⁴ This ‘thin’ perspective may not be ideal given that it restricts the extent to which doctrines developed under the general anti-avoidance approach can be used in the detection and eventual remediation of TPM. Whilst maintaining restraint on arbitrary power,¹⁷⁵ a ‘thicker’ interpretation of anti-avoidance rules is to treat them as descriptive and normative, and designed to ensure impartial enforcement of legal norms including cases in which even unintended mischief is observed.¹⁷⁶ There is a sense that *morality* (ethical values) is *institutionalized* as per this view of the doctrine such that the governed and their government are willing and able to be regulated by the law.¹⁷⁷ Detection and remediation should be guided by the constructs of justice and fairness; and in turn support them by posing as *ideal prisms* via which positive law is to be viewed. This view is balanced in its requirement of normative clarity in the enactment of laws, whilst regarding as vital the need for ethical considerations in their enforcement. In such cases, enforcement of the law is accepted by taxpayers not merely out of compulsion but because they are perceived as fair and just.

¹⁷² Hariton, D., *Sorting Out the Tangle of Economic Substance*, 52 Tax Law 235, 237 (1999)

¹⁷³ Scalia, A., *A Matter of Interpretation: Federal Courts and the Law*, p.17 (1997)

¹⁷⁴ This ‘thin’ conception of the *rule of law* raises questions as to its different from the *rule by law* and *law and order*. Or, is there no difference between these two so that the implementation of positive law even if it results in mischief parliament could not have intended still amounts to the rule of law?

¹⁷⁵ WJP, *Rule of Law Index 2010*, p.13-14, <http://www.worldjusticeproject.org/about/> [Last visited: March 21, 2011]

¹⁷⁶ Lord Moulton, *Law and Manners*, p.1 The Atlantic Monthly (July 1924). Lord Moulton in this article classified human action in three domains –positive law, ethics (obedience of the unenforceable) and free choice. His idea of ‘*obedience to the unenforceable*’ domain of manners is similar to the thick conception of the rule of law, but differs in that under the latter ethical considerations are reflected in the procedures and substance of positive law.

¹⁷⁷ Robert S. Summers, *The Principles of the Rule of Law*, 74 NOTRE DAME L. REV. 1691 (1999).

Ideally, a regime that is architected to achieve the detection and remediation objectives would be underpinned by validity and acceptance of the actions of enforcers. Governments, their officials and persons acting as their agents should be accountable under the law (i); which laws are clear, publicized, stable, fair and protect fundamental rights (ii); process to enact, administer and enforce these laws is fair, accessible and efficient (iii); and access to justice is provided by competent, independent and ethical actors with adequate logistics (iv).¹⁷⁸ Enforcers of TP regimes should leave potential offenders with no doubt that they will be detected and sanctioned.¹⁷⁹ Ideally, wide-ranging and clearly prescribed procedures are needed for audits and to restore *fairness* to the system by returning to the public purse that which the taxpayer unduly keeps out and a little extra for the trouble of having to recall it. Indeed, empirical studies¹⁸⁰ and theoretical modeling¹⁸¹ show that detection plays an important role in preventing noncompliance. On one hand, a regime is ideal if robust powers are given to detect TPM and impose related sanctions. On the other, it is ideal for such powers to be constrained by the right of unsatisfied taxpayers to contest tax recalls in independent and impartial tribunals/instances. Therefore, the architecture of an anti-avoidance regime is ideal if it permits authorities to detect and remedy abuse in strict keeping with the rule of law.

B. Ideal Arrangement of Anti-avoidance Components

Besides determining the anti-avoidance regime's composition, the architecture is only ideal if concepts are arranged as a matrix of logical interactions designed to tackle abuse. As seen in chapter 1.3 [supra], the thesis focuses on analyzing the effectiveness of tax anti-avoidance regimes in the GoG with respect to TPM. In an ideal system, the logical arrangement of the first, second and third layers of concepts are naturally based on this overriding goal. The architect's task is to classify these concepts into horizontal sets of similar criteria or attributes, to vertically superpose these sets of criteria, and to then use them as basis to analyze interactions that exist between these components of the system, that is, vis-à-vis components found within other layers of the architecture. At this stage it is irrelevant whether the architect adopts the *specific or general policy* approach in its design of the regime. Rather, focus is on the matrix of how regime components interact as reflected in Fig 2.2.

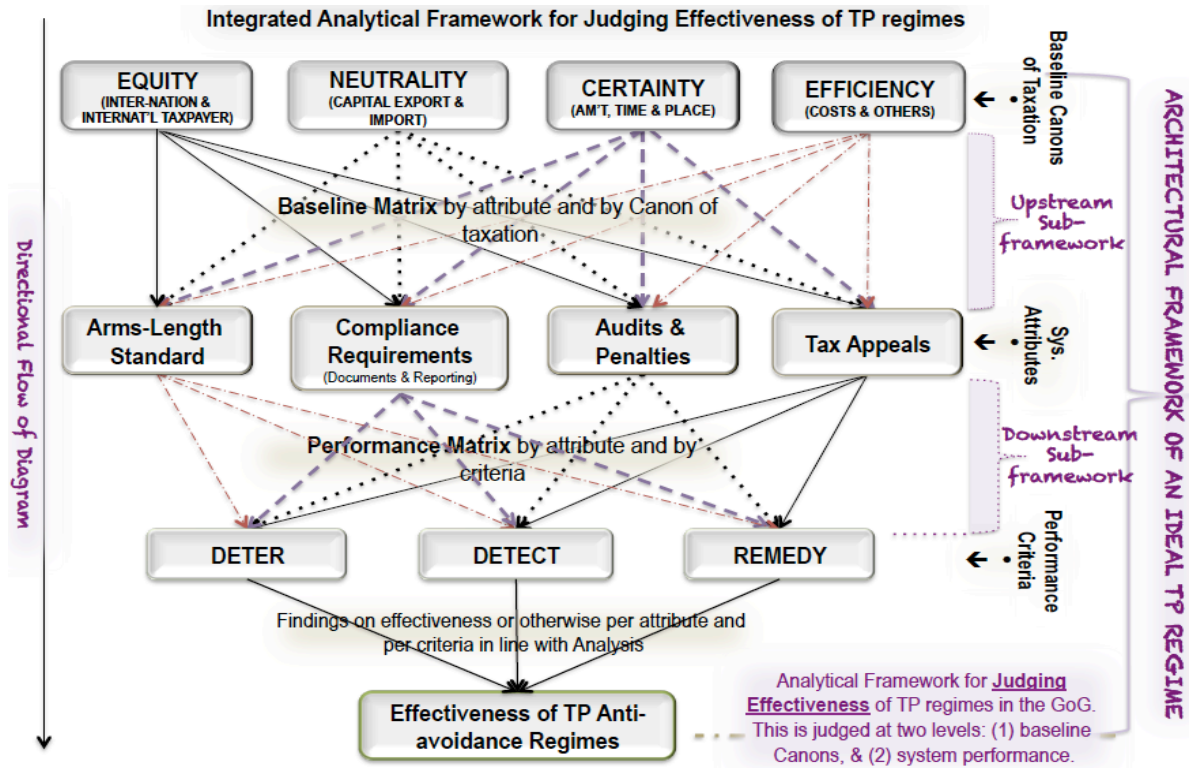
¹⁷⁸ WJP (2011), supra note 175 at pp.13-14. The four elements comprise the working definition used by the World Justice Project for indexing adherence to the rule of law doctrine.

¹⁷⁹ South, D., *General Deterrence and Behavior Change: A Comment on the Australian Psychological Society Position Paper on Punishment and Behavior Change*, Australian Psychologists, 33, 76-80 (1998)

¹⁸⁰ Andreoni, J. et al., *Tax Compliance*, 36 J. ECON. LITERATURE, 818, 841-43 (1998)

¹⁸¹ Allingham, G. & Sandmo, A., *Income Tax Evasion: A Theoretical Analysis*, J. Public Econ. 1972, 1 (3/4) pp.323-38

Figure 2-2: Architectural (also analytical) Framework of the Research



The architectural framework presented above comprises a matrix of interactions between diverse concepts that are grouped together into three layers of concepts discussed above, namely baseline axioms of taxation (*top*), system attributes (*middle*), and performance criteria (*bottom*). The first or **upstream sub-framework** comprises the interval of interactions between the top layer/ baseline canons of taxation (*equity, neutrality, certainty, efficiency*) on the one hand, and the middle layer/system attributes on the other (*ALS, Compliance, adversarial, appeals*). This interval serves to judge whether attributes of the anti-avoidance regime are designed in conformity with baseline principles of the broader tax system. Therefore, the upstream interval focuses on analyzing relationships between canons of taxation and system attributes within a *first sub-framework* that is described as the **baseline design matrix**. This can be illustrated using audits and penalties. If for example TP audits are successful in identifying only a portion of mispriced transactions or that the penalties do not adequately punish noncompliant taxpayers, the canon of equity is defeated since taxable income earned by some taxpayers go untaxed whereas competitors are.

The second or **downstream sub-framework**, as seen in figure 2.2, concerns the **interval** of relationships between the middle layer of concepts/system attributes on one hand, and the bottom layer/performance criteria (*deter, detect, remedy*) on the other. Therefore, the second interval focuses

analyses on how well architects of the regime design system attributes to deter TPM or facilitate effective detection and remediation of the scheme within a *second sub-framework* that is described as the **performance matrix**. Sticking with the example above, if TP audits are not capable of identifying cases with mispriced transactions or penalties do not adequately punish noncompliant taxpayers, the performance objectives of detection or remediation are not effectively achieved and the regime cannot be described as effective.

Both sub-frameworks are important in ascertaining the effectiveness of TP anti-avoidance regimes, albeit from different angles. Under the first sub-framework, it is possible to tell if architects conform attributes of the anti-avoidance regime to the baseline principles of the broader tax regime. Under the second sub-framework, it is possible to judge whether the architect's design actually achieves envisaged performance outcomes. In principle once all pieces of the top, middle and bottom layers of concepts are incorporated and arranged in the manner described above, the regime's architecture is deemed effective. It is observed that the designs of existing TP regimes in all four select countries (US, France, Nigeria, Cameroon) follow this architectural framework. Hence, it is worth noting that in analyzing TP regimes in the GoG, very little space or time is given to determining their effectiveness from an architectural standpoint. Rather the focus is on determining effectiveness of these regimes from the perspectives of their **engineering** and **administration**. The architectural framework elaborated above [Figure 2-2] also presents an ideal framework for analyzing tax anti-avoidance regimes. *It is as such adopted in the study as the analytical framework for judging the effectiveness of select regimes from both the perspectives of their engineering and administration.*

2.2.2 Ideal **ENGINEERING** and **ADMINISTRATION** of Regime Attributes

From the engineering and administration standpoints, attributes (middle layer of concepts) are core to the TP regime given that performance on both the top and bottom layers is a reflection of how well engineered and administered they are. Attributes of an ideal regime as noted earlier include; (i) definition TPM and ALS, (ii) documentation and reporting rules, (iii) adversary procedures related to audits and sanctions, and (iv.) dispute resolution/appeal mechanisms.¹⁸² The main difficulty is that any of two main approaches (light or tight)¹⁸³ in engineering and administering TP anti-avoidance regimes can be adopted. The US for example, adopts 'tight' and specific procedures to tackle the TP

¹⁸² NB. These are not criteria for judging effectiveness but attributes retained for our analyses. Specific criteria used to judge effectiveness are discussed in Sections 2.2.2 (*Effective design*) and 2.2.3 (*Effective performance*) below.

¹⁸³ See Chapter 1.2 for discussions on the what amounts to the tight and light approaches

issue,¹⁸⁴ whereas France has typically adopted 'light' ones. France's approach differs from the US's in that TP is mainly treated no differently from other avoidance schemes.¹⁸⁵

In the Gulf of Guinea, most TP regimes are 'light' with indications that some countries might be gearing to 'tighten' them.¹⁸⁶ While the study aims to judge effectiveness of TP rules in the GoG, this region spans from West through Central Africa¹⁸⁷ making it impracticable to aim to analyze anti-avoidance regimes in all of these countries. Therefore, out of *five* randomly reviewed oil producers in the GoG -**Cameroon**, *Gabon*, *Equatorial Guinea*, *Chad* and **Nigeria**- it is observed that TP regimes in two case countries present certain useful similarities and differences representative of the *status quo* in most others in the region. The first four are CEMAC members united in their approach to taxation and extensively influenced by the French tax system¹⁸⁸ as illustrated using the following three examples. Firstly, there is striking similarity in the wordings of Articles 57 of the FTC (*France*),¹⁸⁹ 12 of the GTC (*Gabon*) and 19 of the CTC (*Cameroon*),¹⁹⁰ all relating to the indirect transfer of profits abroad. Secondly, the methods of determining taxable profits for corporate income tax purposes in these countries are remarkably similar.¹⁹¹ Thirdly, by operating weak or no comprehensive TP regulations countries in the CEMAC are making rather slow progress in their regulation of TPM. Due to similarities in these systems it can be argued that results gotten from analyzing one regime are relevant to, and present similar opportunities for reforming others. Cameroon is retained as case country for the present analysis since it is presently implementing some useful tax reforms in the area of anti-avoidance compared to others in CEMAC. Nigeria for its part is retained for two main reasons, its oil potential and its adoption of a different tax system from those operated by CEMAC countries.

Two main questions can be asked when investigating this issue. Firstly, what details should go into engineering and administering attributes of the TP regime? Secondly, are existing regimes in

¹⁸⁴ Eden (1998), *supra* note 3 at p.384

¹⁸⁵ Ernst & Young (2003), *supra* note 108 at p.106

¹⁸⁶ See Chapter 5.2.2.1 for evidence of this notably with respect to Nigeria

¹⁸⁷ Ondo, D., *Emergence of the Gulf of Guinea in the Global Economy: Prospects and Challenges*, p.3 IMF WP/05/235 (2005) at <http://www.imf.org/external/pubs/ft/wp/2005/wp05235.pdf> [last visited: March 23, 2011]

¹⁸⁸ The approach adopted by CEMAC countries vis-à-vis the Corporate Income Tax can be traced back to Chapter III of Act 3/72-UDEAC-153 of 22 December 1972 instituting the said tax and modified by Directive N°. 02/01/EEAC050-CM06 of 3rd August 2001. As per these rules, irregular transfer of taxable profits out of the CEMAC is not allowed and Tax Authorities can adjust taxable basis in such cases. The Directives identify specific types of irregular transfers including mispricing of purchases or sales, overcharging royalties or interest rates, or excessive payments for services rendered.

¹⁸⁹ Notably the French Tax Code

¹⁹⁰ *Cameroon General Tax Code*, p.23 (2009). Practical rules for implementing the ALS were only introduced in 2007

¹⁹¹ In Cameroon for example, Art. 6 of the CTC provides that the taxable profit is a '*net-profit*' defined as the 'results of all transactions ...including, in particular, the transfer of any assets in the course of or on the completion of trading' plus '*net-assets*'. This is the position in both France and Gabon as evidenced in Articles 38 and 8 of their respective tax laws.

the GoG engineered and administered to take into account these details? In this section, the focus is to analyzing the first question only. Key analyses on the second question are handled for chapter 6.1.

Attribute 1: Arm's-Length Standard (ALS)

Identifying the applicable TP standard is an important starting point for any analysis. There are broadly speaking two concepts used to handle intrafirm transfer pricings, namely the separate entity (*arms-length*) and unitary (*formulary apportionment*) concepts.¹⁹² Under influences of Article 9 of the OECD Model Tax Convention¹⁹³ and Section 482 of the US Inland Revenue Code¹⁹⁴ ALS is now widely regarded as the acceptable standard for determining intrafirm transfer prices. From an engineering standpoint for example, it has been adopted in Article 57 of FTC (France), and Sections 15 of PPTA (Nigeria) and 19 of CTC (Cameroon). As per the standard, prices used for intrafirm transfers should reflect those charged by independent or unrelated parties engaged in similar transactions. If tax authorities find evidence that companies do not use market prices for intrafirm transfers they can move to adjust and tax profits accruing from controlled transactions.¹⁹⁵ This attribute is very important since it is *de jure* point-of-reference for what amounts or doesn't amount to TPM. Technically it is key in determining the overall effectiveness of a regime as it identifies and defines the scope of the problem. If it fails to provide a comprehensive definition, this lapse unavoidably creates implementation difficulties at the levels of documentation, disclosures, audits, penalties and appeals.¹⁹⁶ In any event the applicable standard (ALS, UT) would be carefully selected by system engineers in a country to effectively protect domestic tax revenues.

Attribute 2: Compliance Requirements: TP Documentation and Reporting

In principle our select countries all adopt the self-assessment system by which taxpayers file with the tax administration returns that detail or aggregate information used to ascertain taxable incomes and gains.¹⁹⁷ According to this system the *fisc* accepts returns that are filed and collects taxes arising from the taxpayers declarations while preserving the right to audit these accounts. In theory, documentation and reporting should be engineered to cause taxpayers or third parties to *voluntarily* provide tax authorities with exhaustive information needed to enable them gather taxes,

¹⁹² Developed in Chapters 4.1.2 and 7.1 of the thesis

¹⁹³ OECD Guidelines (2009), *supra* note 77 at p.93

¹⁹⁴ 1986, (26 USC)

¹⁹⁵ OECD Guidelines (2009), *supra* note 77 at pp.25 & 27

¹⁹⁶ Eden (1993), *supra* note 3 at pp.254-278

¹⁹⁷ Shipwright (1993), *supra* note 10 at p.34

and to detect and remedy abuse easily. Notwithstanding that filing is required in tax regimes worldwide, it is the extent to which lawmakers perceive and use it to prevent avoidance that varies between countries. In some jurisdictions taxpayers are required to *keep record* of, and *report* all intrafirm transactions on the sale and purchase of tangibles and intangibles, payments for and receipts of services, rents and royalties, loans and borrowings and interest payments, in an annual information return.¹⁹⁸ In others, taxpayers are only required to keep and make these documents available to tax authorities upon receiving a *formal request*.¹⁹⁹ In yet others, the duty is imposed on promoters of schemes to *disclose* the details of services performed for clients to tax authorities if these are likely to result in tax avoidance.²⁰⁰ A good example is the UK's Tax Avoidance Disclosure rules introduced in the 2004 Finance Act. Considering that information is key in efforts to effectively monitor taxpayers, the duty to report eases access to vital data and reduces areas of obscurity that usually surround MNE activities. It saves time, costs and helps tax officials to better focus their investigations. However, it has certain shortcomings notably the criticism that it unduly invades taxpayer privacy and imposes extra compliance burdens.²⁰¹ As far as the **ALS**, documentation and reporting are concerned the trend shows that the responsibility for **administering** routine declarations of taxpayers is mainly assigned to compliance units within large tax offices (LTO). Examples include *TP dedicated* or *generic* management units of LTO in Nigeria and Cameroon respectively.

Attribute 3: Adversarial Procedures: TP-Related Audits And Penalties

Tax audits serve to validate the veracity of documentation and reports filed by taxpayers. If the system engineer fails to develop a framework for effective tax audits this creates an enabling environment for MNEs to engage in aggressive short/long-term tax planning.²⁰² When engineering ideal tax audit frameworks, system engineers need to incorporate amongst others rules relating to the statute of limitation and the burden of proof.²⁰³ If deficiencies are identified then the taxpayer, depending on the country, is charged interests and penalties for tax recalls. The engineering of audit

¹⁹⁸ Cotton Q., *US Expands Reporting Requirements and Adds Record-keeping Requirements for Canadian-owned Corporations, and Expands Penalties for Noncompliance*, p. 445, CTJ 38 (2) (1990); pp.444-56

¹⁹⁹ For example s. 6038 (A, C) Internal Revenue Code; s. 982 Tax Equity and Fiscal Responsibility Act (TEFRA) 1980

²⁰⁰ Including banks, accountants, investment firms, tax advisers and lawyers; Bond, S. *et al.*, Tax Avoidance, <http://www.ifs.org.uk/budgets/gb2006/06chap10.pdf> [Last visited: Mar 27, 2011]

²⁰¹ Cockfield, A., *Protecting Taxpayer Privacy Rights Under Enhanced Cross-Border Tax Information Exchange: Toward a Multilateral Tax-Payer Bill of Rights*, in 42 U.B.C. Law Rev. (2010) 419; Also Mahalingham in 20 Int'l Tax Rev. (2009) p.51

²⁰² Daniel *et al.* (2010), *supra* note 7 at p.350

²⁰³ Likewise, the 'burden of proof' is essential in matters of appeal and the party on whose shoulder it rests faces a huge challenge. In principle, the *onus* in most countries rests on tax authorities to prove avoidance. Some countries exceptionally revert this onus if tax authorities have reason to suspect taxpayers of TPM.

and penalty rules can be tight or light. In the US for example, audits and penalties (**s.6662**) are tightly engineered specifically for TP. In France the approach is light with TP only becoming an issue to be investigated if tax examiners during a scheduled audit have cause to believe that the taxpayer has illicitly transferred profits abroad (**Art.L13 B**) and for which only generic TP penalties or interests apply for TPM related deficiencies. Both audits and penalties are therefore important attributes to take into account in our analyses as they hugely contribute to detection, remediation and possibly deterrence of TPM. Notwithstanding its importance, this attribute has shortcomings including the strain it places on taxpayers during the process and risks that examiners may overstep ill-defined powers to unreasonably harm taxpayers.²⁰⁴ It is worth pointing out that the **administration** of attribute 2 is mostly assigned to management units that are charged with tax examinations.

Attribute 4: Tax Appeals (The Right to Dispute Determinations by Tax Authorities)

The right to appeal is one of many that make up the rule of law doctrine. Unsatisfied taxpayers must be given the right to appeal back tax claims and penalties. Standard mechanisms for resolving tax disputes include administrative appeals, arbitration, judicial appeals and competent authority. In many countries tax appeals begin with taxpayers filing a claim with the tax administration (administrative appeal), which dispute moves to litigation (judicial appeal) if settlement is not reached. Therefore, appeals provide all parties with a level platform to protect their interests. Governments can secure their tax revenues and taxpayers have the opportunity to challenge arbitrary or unfair taxation. Our task as concerns this attribute is to examine existing appeal mechanisms and their contribution in preventing disputes from unnecessarily spilling over into protracted and costly tax litigations.

The **administration** of tax appeals is ideally handled conventionally first by the fisc, and latter on by the courts if dispute persists. In the US for example, **IRS's Appeal Division** first handles the dispute and it has stated its main purpose in the process as seeking "to resolve tax controversies, without litigation, on a basis that is fair and impartial to both the government and the taxpayer".²⁰⁵ Litigation in the US starts with to the **Tax Court** all the way upward to the Supreme Court. In Cameroon, it moves from the **Tax Appeals Division** of the Tax Directorate to the **Minister** in charge of Finance (Administrative), to **Administrative Courts** all the way upward to the Supreme Court.

²⁰⁴ Mahalingham (2009), supra note 201 at p.51

²⁰⁵ Wrappe S., *APAS: The IRS Discovers Alternative Dispute Resolution*, pp.181-194 TNI (June 13, 1993)

2.3 Chapter Conclusion

In conclusion we note that transfer pricing and effective anti-avoidance are two concepts used frequently in this thesis. As concerns TP it is retained that there are two main competing views on the concept. On one hand, *management accountancy* sees TP as a tool to be used in motivating managers and facilitating performance monitoring within MNEs. On the other, *international taxation* mainly treats TP, as a mechanism that can and is being used by MNEs to erode domestic tax bases. In view of the fact that this study is grounded in taxation, we adopt as basis for our analysis the international taxation view of the concept. On the issue of judging effectiveness of TP anti-avoidance regimes, it should be noted that the concept of effectiveness *as used in the study* is the perceptible gap or conceptual distance between the given-regime-state and an ideal-regime-state. Given that these system attributes are complex and interrelated in nature we opt for qualitative analysis as basis for comparing and judging effectiveness of anti-avoidance regimes in our select countries.

In Section 2 of this chapter, we presented the analytical framework that is used to judge effectiveness of TP regimes in the GoG. It is observed that governments commonly build anti-avoidance regimes around four main attributes namely *–the arm’s-length standard, compliance, adversarial and appeal rules or procedures*. These attributes are definitively retained for purposes of the present analysis and the proposed matrix used to analyze effectiveness of the regime reveals two main *sub-frameworks* within which this can be done. Firstly, it can be done upstream in which case the focus of analyses is on the matrix/relationship between baseline canons of taxation (*equity, neutrality, efficiency, certainty*) and system attributes. Secondly, it can be done downstream at which level the focus of analyzing effectiveness is the matrix/relationship between system attributes and certain performance criteria (*deter, detect, remedy*).

As we move on into the next chapter, it is worth recalling that we have already examined both the importance of oil to GoG economies and justifications for selecting oil as our case industry in judging effectiveness of TP regimes (see chapter 1). However, we have until this point omitted to present vital background information on fiscal systems used to tax oil companies and possible vulnerabilities in such systems as far as TPM is concerned. We thus present in the chapter that follows essential information on hydrocarbons taxation that is needed to enhance/ boost understanding of discussions developed later in chapters 4, 5 and 6.

CHAPTER 3

TAXATION OF OIL & GAS COMPANIES: MARKETS AND FISCAL REGIMES

For a variety of reasons the extractives industry has been historically treated differently from other major international industries.²⁰⁶ Hydrocarbons and minerals, it is often argued, are not ordinary commodities, the political and economic circumstances surrounding resource extraction are not ordinary, and therefore natural resource taxation is no ordinary taxation. Although there is correctness in this view, it is not entirely true since many issues affecting resource companies equally affect those operating in other industries. What actually distinguishes extractive from others is arguably the **scale** of issues the industry grapples with. Take for example profits. In 2008, whilst some oil majors like ExxonMobil and Shell earned a whopping \$45.22 billions²⁰⁷ and \$26.28 billions²⁰⁸ respectively, Britain's largest supermarket Tesco only made £2.80 (US\$.4.78) billions in profits.²⁰⁹ Broadway and Keen²¹⁰ identify the following as major factors distinguishing extractives from other industries: (i) high sunk costs and considerably long production periods,²¹¹ (ii) prospects of earning gargantuan rents, (iii) potential for host governments to tax industry for revenues to drive wider economic transformation, (iv) huge uncertainties in long-term investments and geology, (v) international by nature since investments must be made where the deposits are found, (vi) information asymmetry. Others include (vii) constant tussling for power, control, and resource ownership between states and companies, and (viii) finiteness of resources.

Of these factors two clearly illustrate the unique nature of extractives. Firstly, it is hard to think of any other industry where the principles of direct State ownership and right to participate in operations are so emotively debated by stakeholders and resolutely established as a key industry

²⁰⁶ Pharmaceuticals, finance and automotive

²⁰⁷ ExxonMobil, *Summary Annual Report 2008*, http://www.exxonmobil.com/Corporate/Files/news_pub_sar_2008.pdf [Last visited: May 21, 2012]

²⁰⁸ Shell, *Annual Reports and Publication Archives*, http://www.shell.com/home/content/investor/financial_information/annual_reports_and_publications/archive/ [Last visited: May 15, 2012]

²⁰⁹ Tesco, *Annual Report and Financial Statement*, http://www.tescopl.com/files/pdf/reports/annual_report_2008.pdf, [Last visited: May 20, 2012]

²¹⁰ Daniel et al. (2010), *supra* note 7 at p.14

²¹¹ Sometimes lasting between 25 to 50 years between exploring, discovering, developing, producing and decommissioning oil fields

feature. But, by far the most unique feature of the extractive industry is its fiscal system designed to address industry specific challenges and opportunities. As we shall see (*infra* Section 3.2) resource taxation contains more layers of taxation, imposes cost recovery limits; and unlike other industries accepts payments in both cash and kind. Broadly, governments have to address three important questions when designing fiscal regimes: (1) what policies and laws should be adopted to optimize fiscal revenues? (2) How should these revenues be spent?²¹² And, (3) what institutional or capacity frameworks are needed to effectively implement these policies and laws? This thesis focuses on issues related to the *first* and *third* questions as concerns the O&G industry.²¹³ This chapter mainly examines two important issues relating to the *first question* namely, ascertaining the types of fiscal regimes widely used to extract resource rent and fiscal instruments used to achieve this goal. Issues pertaining to the *second* question are only incidental to and not covered in this study.

Governments are increasingly challenged not only by the need to design systems robust enough to optimize government take without affecting project economics, but also keeping it simple enough to ensure effective implementation by taxation authorities. This is essential in protecting government's share of revenues from being eroded although achieving the right balance between both imperatives is not easy. It can be achieved however, and the fundamentals of fiscal regimes used in the petroleum industry to achieve this are discussed in **Section 3.2**. As noted earlier, the scale and size of profits and rents generated by the industry can be quite gargantuan and are particularly quite attractive targets of taxation. In designing a system intended to optimize the states take on extractive resources; governments have an interest to fully understand the dynamics of commodity markets. Short of this the result would and has always been defective and potentially unstable designs that capture rents insufficiently, and exposes them to risks of tax avoidance.²¹⁴ Therefore, logic dictates that we begin by examining historical and present dynamics of oil markets from a price-setting prism (**3.1**). Finally, **Section 3.3** presents conclusions to the chapter.

²¹² The spending of revenues earned from extractives is post-taxation as opposed to pre-taxation and has very little direct bearing on questions of transfer pricing that we seek to address in this thesis

²¹³ Increasing requirements for effective design, transparency, accountability, and good governance in handling natural resources are some of the issues likely to arise as we examine these issues

²¹⁴ Through schemes like transfer pricing, gold plating and treaty shopping.

3.1 Oil Markets: Price Considerations

Right from its very early years, the tussle for market power and control has been a key feature of the hydrocarbons industry. This first started as a struggle for market control between oil majors, and later on between oil majors and independents. When states gained control over their resources it evolved into a tussle between IOCs and governments, and is today more a struggle between IOCs and National Oil Companies (NOC) some of which have taken on a truly global character and more or less operate as pure commercial businesses. Examples include, Rosneft of Russia, PdV-SA of Venezuela, Petrobras of Brazil and CNOOC of China. Control over oil prices has largely followed a similar pattern depending on which stakeholder exercises control over the markets. Initially, market forces of demand and supply dominated spot markets. Later, oil firms and then oil producer's (OPEC) used posted prices as a means of controlling markets. Today, it is back to spot markets in which all have a role to play in determining oil prices, including traders who own neither upstream nor downstream value addition operations. This context is essential to our understanding of crude and cost pricings (3.1.1). Further, governments need to master pricing mechanisms, cost elements and issues that feed into various oil tax bases; since the issues of *volume*, *price* and ultimately *value* of output are contentious and have real implications on the states ability to optimize take on oil operations. For an industry in which over 60% of trade takes place on an intragroup basis, there is little doubt that prices charged for these transactions largely influence tax bases on which States collect their share of revenues (3.1.2).

3.1.1 The History: Prices, Actors and Markets

In this subsection we briefly examine the emergence of oil markets and integrated IOCs as key players in these markets (3.1.1.1). We also briefly discuss attempts by companies and States to individually or collectively control hydrocarbon markets (3.1.1.2).

3.1.1.1 Emergence of Oil Markets and Integrated IOCs

Since Edwin L. Drake first successfully drilled for oil in Titusville Pennsylvania in 1859 crude markets and volatile prices²¹⁵ have remained central themes in the industry. Initially, buyers on

²¹⁵ From \$10 in 1861, down to 50 cents in 1862, edging upwards to \$4 by the end of 1862, \$7.25 in 1863, \$13.75 by end of the American Civil War, again plummeting to \$2.40 in 1867 due to frantic overproduction and speculation

horseback rode from well to well purchasing crude on a ‘hit-or-miss basis’. This evolved into more orderly systems with the introduction of informal oil exchanges where buyers and sellers met to agree prices (hotel in Titusville and curbside exchange near railway tracks in Oil City); and later more formal exchanges during the 1870s for example Titusville Oil Exchange, Oil City, Oil Regions and New York. Transactions on these exchanges were spot and regular. However, Rockefeller made radical long-term changes to the way oil was priced and traded for over a full century to come. He integrated petroleum supply and distribution chains in his **Standard Oil Company**, thus gaining significant control over all key stages of the US industry’s value chain. By the close of 1880s Standard controlled *production* (owned 90% of Penn/Lima Oil a major crude producer); *transportation* (most pipelines and gathering systems); *refining* (90% of capacity);²¹⁶ and *marketing* (about 80% of market share). In 1882 the **Standard Oil Trust** was created to supervise fourteen wholly, and twenty-six partly owned companies thus introducing the era of vertically integrated oil majors. On the world stage Standard Trust incorporated Anglo-American Oil Company its first foreign affiliate in Britain, thereby transforming the company into the first multinational oil major.

This integrated structure practically gave Standard effective control over transportation, and made it the main buyer of crude oil in the US. Its buying arm **Joseph Seep Agency** (JSA), bought 85% of Certificate Oil on the exchanges or directly at wellhead from producers. Standard also accounted for over 90% of US kerosene exports giving it unprecedented market leverage. JSA exploited this unique position to begin posting *daily price quotations*²¹⁷ being the price Standard was willing to pay for a specified quality of crude. It swiftly moved to undermine the roll of oil exchanges by increasing direct wellhead purchases instead of acquiring similar crude on the exchanges. This plummeted transactions on exchanges as many other independent refiners followed suit.²¹⁸ At this point ‘standard set the price’ in the US. It further consolidated its near monopoly control in 1899 with the creation of Standard Oil of New Jersey (SONJ) under New Jerseys revised laws that permitted the establishment of holding companies.²¹⁹ SONJ soon held stock in 41 companies, which themselves held stock in other companies, which others controlled yet others. This group of firms traded amongst themselves and used TP for this purpose.

²¹⁶ Yergin, D., *The Prize: An Epic Quest for Oil, Money & Power*, p.27 (2009)

²¹⁷ By 1895 JSA effectively started determining oil prices after issuing a historic “Notice to oil producers” stating that dealings on the exchanges were no longer reliable and a true reflection of the value of crude; an average of the days highest & lowest prices on the exchanges

²¹⁸ Yergin (2009), *supra* note 216 at p.37

²¹⁹ Under this law, corporations could now own stock in other corporations

A major **milestone** in the transformation of corporate structures in the industry occurred in 1911 when the US Supreme Court in an antitrust suit upheld a Federal Court decision to dissolve Standard: *Standard Oil Co. of New Jersey v. United States*.²²⁰ Dissolution resulted in the creation of Standard Oil of New Jersey (Exxon),²²¹ Standard Oil of New York (Mobil), Standard Oil of Ohio (Sohio, later American arm of BP), Standard Oil of California (Chevron), Standard Oil of Indiana (Amoco), Continental Oil (Conoco), and Atlantic Oil (later became part of Sun). The court's decision opened avenues for competition in transport, refining and the marketing segments. If one adds Shell and Anglo-Persian to the list of Standard sisters, it can be argued that control of markets had merely shifted from Standard's monopoly to a relatively small group of highly integrated companies known collectively today as the *Seven Sisters*.²²² It is important to note that the initial Standard model (*integration*) had proven its strategic value to those seeking control of the oil industry, such that even before dissolution of SONJ, W. Mellon had merged Guffey Petroleum and Gulf Refining to create Gulf Oil Corporation, an integrated major. After dissolution *the sisters* found no logic in abandoning integration. Instead they moved to replicate integration in their operations worldwide.

It is argued that prices can be easily manipulated in context where complex and highly integrated corporate structures (horizontal/vertical) are used for *intragroup transfers*. Although it is premature to contend this is the case in the oil industry, one should nonetheless note that a historic feature of the industry is the recurrent creation of mega-players through integration. During the 1970's and 1980's restructuring and megamergers reemerged throughout the industry. For example, Shell acquired a leading American crude producer Beldridge for \$3.6 billion in 1979 and also bought the remaining 31% shares in Shell Oil USA for \$5.7 billion to complete its ownership.²²³ A similar pattern can be observed during the 1990s and early 2000s when some *majors* merged their operations to become super-majors with cost reduction and efficiency considerations in mind. BP acquired Castrol and AMOCO to produce BP AMOCO, which later combined with ARCO to become

²²⁰ 211 US 1 (1911)

²²¹ Almost half of the total net value after dissolution, and later became Exxon. This company was left with a very large refinery with no oil of its own, making it vulnerable to suppliers and markets. It had to secure crude supply and by 1919 bought over half of Humble Oil that became the largest Texas producer by 1921. This was a clear indication of recommencement of the integration process within the industry.

²²² That is Gulf, Texaco, Mobil, Standard oil of California (Socal or Chevron), Humble (Exxon or Esso), Royal Dutch Shell and British Petroleum

²²³ Others include: DuPont took over Conoco for \$7.8 billion in 1981; US Steel took over Marathon for \$5.9 billion; Phillips acquired General American (crude producer) for \$1.1 billion; Texaco acquired Getty Oil for \$10.2 billion (latter sued by Pennzoil; Chevron acquired Gulf (1 of 7 sisters) for \$13.2 billion in 1984; BP first took 51% of SOHIO, and later paid \$7.6 billion to complete ownership

BP, as we know it today.²²⁴ Further, Exxon merged with Mobil (ExxonMobil), Chevron with Texaco (ChevronTexaco –now Chevron), Conoco with Phillips (ConocoPhillips), Total with Elf Aquitaine and Petrofina to create TotalFinaElf (now Total SA), and Royal Dutch Petroleum and Shell Transportation and Trading combined management of operations to create Royal Dutch Shell Plc. Today these corporations and other integrated IOCs own countless subsidiaries and affiliates throughout the world engaged in all aspects of the industry's value chain -*exploration, production, transportation, refining and marketing* operations.

3.1.1.2 Landmark Attempts at Collective Control of Markets

After Standard lost its near monopoly influence on oil prices and markets, oil companies and governments alike have made several attempts to exercise control of markets.²²⁵ Two major instances quickly come to mind, namely the 'As is' agreement (A) and OPEC (B).

A. International Oil Companies: The 'As is' Agreement²²⁶

The *first* major attempt at collective control of the industry occurred in August of 1928 at a conference in Achnacarry Castle where Shell, Exxon, Anglo-Persian, Gulf, and Amoco met to solve the problem of *overproduction* and *capacity* in the industry.²²⁷ They aimed to share markets, stabilize the industry and defend profitability by controlling costs. The meeting resulted in the 'As Is' agreement. Amongst others: (1) each company was allocated a sales quota in various markets, that is, a percentage share of total sales; (2) costs would be driven down; (3) facilities were to be shared; (4) markets would be supplied from nearest production fields to reduce transactional costs, and increase efficiency and profits. Sales prices would be based on an agreed formula (***American Gulf Coast Price + going freight rate from that coast i.e. gulf to the market***), even if oil were supplied from a close field. This literally established a uniform selling price. Masseron notes that such a pricing system largely facilitated the fixing of crude selling prices between the production companies and

²²⁴ However, the name British Petroleum (BP) was changed to Beyond Petroleum (BP) in 2000

²²⁵ Examples include: (1) Rockefellers attempt to bring the industry under Standard Oil control, (2) The 'as is' agreement in 1929, (3) the Texas Railroad Commission, and (4) attempt by the British and US governments (Anglo-American Petroleum Agreement) to create an eight-member International Petroleum Commission to balance discordant supply and demand, manage surplus in market, bring order and stability in the market to keep prices at acceptable levels in 1944.

These agreements commonly collapsed for want of support from non-pool stakeholders (*independents, other governments*), or sometimes oil majors themselves, depending on who initiated the particular scheme

²²⁶ Also called the 'Pool Association'

²²⁷ Production surged in US, Venezuela, Rumania, and Soviet Union, flooding the markets and weakening oil prices

refining affiliates.²²⁸ (5) Further, production quotas were agreed and companies could produce above their quota if production was then sold to a pool member. (6) The Russian Oil Products Company was given a share of the British market, but the US market was completely excluded to avoid breaching US antitrust laws. The 'As Is' agreement eventually collapsed because it was neither binding on those who agreed to it, nor on producers outside its framework.²²⁹

B. Petroleum Exporting Countries: OPEC

A second key attempt to control oil markets was led by the Organization of Petroleum Exporting Countries (OPEC). A couple of landmark events weakened the grip of IOCs on markets and led to the creation of OPEC. In **Venezuela** for example,²³⁰ the government renegotiated upstream contracts with IOCs on the basis of fifty-fifty profit split. It also sought to capture downstream revenues by insisting its royalty be paid in *oil* not *cash*, which oil was then sold directly on the world markets reaping value-additions on transportation, refining and marketing. Traders could now directly negotiate and buy crude from the government of Venezuela on the markets, thus dismantling the cloak of opacity surrounding crude marketing over which Anglo-Saxon corporations had so closely held a monopoly. Another landmark event was the concession negotiated between Pacific Western Oil Company and the Saudi's (1948-49). *Pacific* agreed to pay a 55 ¢/bbl royalty for operations in the Neutral Zone²³¹ at a time when Aminoil (a co-developer in the same zone) paid only 35 ¢/bbl to Kuwait, Aramco paid only 33 ¢/bbl to the Saudi government, Iraq Petroleum Company and Anglo-Iranian paid only 16½ ¢/bbl to Iraq and Iran respectively. The *Pacific* deal caused other companies operating in the Middle East to accuse it of destabilizing the *status quo* and fomenting greed amongst the governments.²³² The deals in Venezuela and Saudi Arabia went viral. By 1949 the Saudis decided the Aramco conglomerate was earning too much profits²³³ on the Standard Concession (1933) and sought to renegotiate on a 50-50 basis.

²²⁸ Masseron, J., *Petroleum Economics*, p.51 (1990)

²²⁹ The final death to the pricing convention agreed upon at Achnacarry occurred when as a result of difficulties in implementing the Marshall Plan due to high oil prices, consumer governments forced IOC's to drop oil prices to bellow US Gulf Coast prices

²³⁰ Oil dominated the economy, accounting for about 90% of export earnings by late 1930s, and about 65% of government revenues by 1948

²³¹ This was 2000 square miles of barren desert carved out by the British in 1922, whilst drawing the Saudi-Kuwait boarder. Both countries were to share sovereignty over this area. Therefore Kuwait (Aminoil) and Saudi Arabia (Pacific Western) issued concessions in the Area and share in revenues on a fifty-fifty basis

²³² Yergin (2009), *supra* note 216 at p.426

²³³ The Aramco partners alone made profits estimated at about 3 times what the Saudi's earned in 1949

In 1951 **Iran** nationalized British owned Anglo-Iranian operations in the country, marking another **milestone** in the shift of market control from IOCs to producing governments. Between the years 1945 and 1950, Anglo-Iranian earned profits amounting to £250 (US\$ 427) millions on its operations, paid only £90 (US\$ 153) millions in royalties to Iran, paid more taxes to Britain than it did to Iran, and most of the remaining profit still went to the British treasury (in dividends) as majority shareholder of AIOC. Dissatisfaction in Iran resulted in the nationalization of AIOC facilities including Abadan refinery in April 1951.²³⁴ The newly created National Iranian Oil Company (NIOC) took over AIOC operation's leading to a British embargo on Iranian oil.²³⁵ The deadlock came to an end in 1954 when Iran signed a new deal with a consortium comprising AIOC (40%), SONJ, Sacony-vacuum and Shell (14%), Texaco (8%), Socal (8%), Gulf (8%), and CFP (6%);²³⁶ to bring back Iranian oil to world markets. The deal marked a turning point in oil contracting as the concept of foreign-owned concessions was replaced by negotiation and mutual arrangements. Indeed, the principle was agreed that the host country through its vehicle NIOC would own all resources and facilities. Further, it was agreed that the consortium would manage these facilities, buy the entire output and will then distribute it through their respective marketing systems.

Another **milestone** occurred in 1960 when oil companies as a result of over supplied markets began offering huge discounts in order to secure market share. This resulted in regular cuts in 'posted prices' leading to a drop in oil revenues of producing countries. Five producing countries²³⁷ met in Baghdad to discuss falling oil prices and the influence exerted by the seven sisters on oil markets. The Organization for Petroleum Exporting Countries (OPEC) was created during this meeting as an equalization force to the tremendous control exercised by the sisters on both production and prices. OPEC's main objective was to collectively influence markets as a means of improving host country revenues on resource extraction. By gaining control over global crude supply its members both individually or collectively became major drivers of oil prices. For example, a few years after the Libyan revolution in 1969 the Revolutionary Command Council forced Occidental and other operators to accept a 20% increase in royalties and taxes, a 30 cents increase in posted prices, and secured a 55-45 split of profits at a time when other oil producing countries were locked in deals struck on the 50-50 principle. At the Tehran negotiations (1971) between Gulf States and 23

²³⁴ The 'As is' agreement established Abadan as an important point in the international crude pricing system

²³⁵ The result was that Iranian output plummeted from 666,000 Barrels/day to about 20,000 Barrels/day in 1952

²³⁶ This group of influential companies were referred to as the 'Seven Sisters' (Sette Sorelle) by Enrico Mattei of ENI

²³⁷ Iran, Iraq, Kuwait, Saudi Arabia, and Venezuela. These countries accounted for about 80% world exports

multinationals that followed Tripoli, the issue of posted prices was addressed (infra 3.1.2.1 (A)). In many ways Tehran marked an end to the buyers market, since initiative with respect to setting tax 'reference prices' passed from the companies to exporting countries. Tehran and Tripoli established a new price setting order. Going forward, prices would be **negotiated** between oil companies on one hand and exporting countries on the other, and a new implied understanding that initiative rests with the latter to drive this process. Exporters could now improve their earnings by increasing posted prices or volumes pumped into the market place.

OPEC again changed the price mechanism in 1973. The Arab-Israeli war disrupted supply to markets at a time when world demand was growing.²³⁸ Oil prices rose to a point where market prices for the first time exceeded Official Posted Prices (OSP). The difference between the 'posted price' and 'market price' created windfall profits for the oil companies causing Libya first and other exporters to seek cuts on these windfalls. It soon became clear that pricing systems agreed in Tehran and Tripoli had become obsolete and needed to be changed, either unilaterally or via negotiations. Negotiations on the issue stalled when companies offered a 15% increase in OSPs (45 cents/bbl) whereas exporting countries stated their desire to increase prices by 100%. In an unprecedented move, the exporters met in Kuwait City (1973) and **unilaterally** announced a 70% increase in posted prices (\$5.11/bbl) effectively aligning posted to spot prices. This established the principle that exporters, not IOCs, would henceforth fix oil prices and negotiation had received a decisive blow. OPEC argued in defense of its move that while its members received only 9% of the retail price of oil in taxes consuming governments earned about 66%. Going forward posted prices would in principle be aligned to what consumers were willing to pay in the markets. In march 1979 OPEC decided that members could add on their prices whatever the spot market could bear, thus initiating abandonment of the OSP mechanism in favor of a free-for-all market in which the forces of demand and supply set prices. Only the Saudis maintained the OSP and indeed warned the Aramco partners²³⁹ against adding premiums on Saudi crude for sales to their off-take subsidiaries, affiliates, and third parties in what is now famously known as the "*Yamani Edict*".²⁴⁰ Thus systems used to determine oil prices had evolved from: (i) companies unilaterally setting oil prices (ii) to exporters receiving the right to veto unilateral IOC actions, (iii) to jointly negotiated prices, (iv) to exporters

²³⁸ The US had just become a net-importer of oil moving into the world oil market to procure domestic needs

²³⁹ Exxon, Mobil, Chevron and Texaco

²⁴⁰ See Chapter 4.2.1.2.C for detailed discussions of the 'Yamani edict' in the *Aramco Advantage Cases*

obtaining complete control over matters of price setting,²⁴¹ and (v) finally to an open system where the spot market forces of demand and supply influence prices for most crudes although governments maintained OSPs in respect to certain others.

3.1.2 Current Oil Markets: Crude and Cost Pricings

Transactions in the O&G industry predominantly occur within two market structures. An **open market** in which independent and unrelated firms buy and sell crude or related services; and a **controlled market** where transactions take place on an intragroup basis and for which TP's are charged. As would be seen later IOCs sometimes manipulate these prices for tax purposes.²⁴² Signs of producers objecting to price manipulation first emerged in 1953 when the Saudis noticed Aramco was using TP to reduce taxes payable to the Saudi government. In effect, Aramco was discounting the price of crude sold to parent corporations and affiliates, a practice abandoned after serious Saudi objections.²⁴³ From a technical standpoint, it is easier to manipulate TP relating to costs (Capex and Opex) than the sale of crude. Considering that spot prices are published at frequent intervals on global commodity exchanges it is questionable whether it is even possible to manipulate crude TP's. Response to this preoccupation is found in the details of how prices are actually determined in the industry. We hereinafter examine how crude prices are established, occasionally pointing out ways in which these prices can be manipulated (3.1.2.1). This is followed by an analysis of major E&P expenses that are equally susceptible to price manipulation (3.1.2.2).

3.1.2.1 Systems for Pricing Crude Oil

Oil companies broadly acquire crude for their downstream operations via two ways. Either crude is gotten from a company's share of production in which case the upstream segment uses TP to move the crude to its downstream segment, or it could be purchased from independent parties like NOCs at **official prices** (A),²⁴⁴ or intermediaries at **market prices** (B) under short-term, medium-term or long-term arrangements. As concerns markets commodity exchanges in the US, Europe and increasingly other parts of the world play an important role in bolstering trade in oil thus diminishing the direct influence of majors and exporters on oil prices. Major crude exchanges include the New

²⁴¹ Yergin (2009), supra note 216 at p.588

²⁴² Chapter 4 on TPM

²⁴³ Smith (1993), supra note 36 at p.307

²⁴⁴ IOCs have considerably lost direct access to crude to NOCs (60% -1971, to 15% -1988, about same today)

York Mercantile Exchange (NYMEX),²⁴⁵ Intercontinental Exchanges, International Petroleum Exchange (IPE),²⁴⁶ Rotterdam and Dubai Mercantile Exchange (DME –Oman Crude Oil Futures Contract).²⁴⁷ Trade in crude was introduced on NYMEX in 1983 and rapidly became popular amongst those wishing to hedge their risks on future price volatilities. In the same year, two great developments occurred on NYMEX with respect to oil trading. These were the emergence of: (1) a new benchmark crude stream called **West Texas Intermediate -WTI**²⁴⁸ and (2) introduction of Futures trade. It didn't take long for WTI to replace **Arabian Light** as the main benchmark crude on the US market. By 1993, oil markets had moved from 'term' to 'traders' markets comprising speculators, traders and brokers who directly shape crude prices alongside IOCs and producers.

A. Posted Prices²⁴⁹

Early in the first half of the 20th century the sisters had agreed to pursue a policy that kept crude oil prices low, and in 1949 also developed the **Posted Price System** for crude oil sales. The posted price is the "published price at which producers are prepared to sell to all comers in tanker-cargo lots."²⁵⁰ Until World War II the Gulf of Mexico product prices served as benchmarks (Texas prices –equality of CIF prices) for all crudes traded in the world.²⁵¹ The center of gravity moved to the Mediterranean in 1944 and later back to the US' eastern seaboard. In the US, selling prices at the wellhead for a given country was determined by the equation:

$$a + f = X + f'$$

Where:

a	= FOB selling price Texas
f	= Texas/East Coast (New York) Transaction Cost
f'	= Transaction cost from the selling point to the East Coast

During this period, IOCs were sometimes accused of setting low prices in order to avoid host country taxes. After objecting to majors reducing prices OPEC took control of the posted price setting

²⁴⁵ Initially named Butter & Cheese Exchange and founded in 1872 by a group of merchants to trade dairy products

²⁴⁶ See, <https://www.theice.com/homepage.jhtml>, [Last visited: March 13, 2012]. NYMEX and IPE are futures markets

²⁴⁷ See, <http://www.dubaimerc.com/>, [Last visited: March 13, 2012]. The DME was launched in June 2007 with the goal of bringing fair and transparent price discovery and efficient risk management to the East of Suez. The DME lists the Oman Crude Oil Futures Contract (DME Oman) as its flagship contract, providing the most fair and transparent crude oil benchmark for the region. The DME Oman is the explicit and sole benchmark for Oman and Dubai crude oil Official Selling Prices (OSP's)

²⁴⁸ To compete with others like Brent, Iranian light, Arabian light

²⁴⁹ Named for the sheet that was literally posted in the producing fields, and now established by buyers, often refiners

²⁵⁰ *From Concession to Participation: Restructuring the Middle East Oil Industry*, 48 NYULR, 774, 778, n.13 (1973)

²⁵¹ *Supra*, see Chapter 3.1.1.2 (A) on the 'As Is' Agreement

system from IOCs during the 1970s.²⁵² It successfully obtained a **price floor** to be used for computing royalties, profit oil sharing and/or taxes irrespective of market prices. Posted prices are defined in **Article 1** of the Abu Dhabi concession as:

“The f.o.b. price published from time to time for each grade, gravity, and quality of crude oil offered for sale to buyers generally for export at the relevant point of export ruling on any day which price shall be a price of comparable grade, gravity, quality in the Arabian Gulf and having regard to geographic location.”

The Tehran agreement of 1971 resulted in Gulf states agreeing that: (1) the tax rate on oil exports would be set at 55%, with regular increments of 35 cents/bbl on posted prices at Gulf terminals (including 2 cents in settlement of price differentials); and (2) the posted price of Gulf crude would be determined according to a new **gravity differential system** and increased annually by 2.5% to atone for worldwide inflation. Producing countries agreed not to demand further price increments or changes to financial obligations until 1975. OPEC produced a variety of crudes and had to adopt an appropriate pricing system to assess and determine prices for all these crudes. *Arabian light* was selected as the ‘marker’ crude for the gravity differential system. It became the benchmark crude for pecking all other OPEC crudes and making price adjustments depending on differentials in quality (low/high sulfur), gravity and transportation costs to major markets. Under this new system posted prices experienced a series of upward movements rising “...from \$1.80 in 1970 to \$2.18 in 1971 to \$2.90 in mid-1973 to \$5.12 in Oct 1973- and now to \$11.65.”²⁵³

Further, issues pertaining to **foreign exchange movements** also affected posted prices. The US dollar was, and is still being used in many countries for O&G accounting and financial reporting purposes. If a requirement to convert to local currencies is imposed dollar fluctuations often impact financial results reported by IOCs on their host country operations. Oil producing countries pressed for a solution to this problem in the 1970s following devaluation of the dollar. The issue was resolved with oil companies in a supplementary agreement to Tehran, called the Geneva Supplementary Agreement of January 2, 1972 that remains applicable till date. Geneva had two main

²⁵² During the 1950’s oil markets were oversupplied forcing oil companies to offer huge discounts in order to secure market shares. This eventually led to a divergence between *Official Prices* and actual *Market Prices* used by governments to compute taxes and royalties. It is worth noting that “Posted prices” were intended to more or less match the “market price” but was now higher than it, effectively eating into company share of earnings. In order to mitigate its losses, BP cut its posted oil prices on the eve of the Arab Oil Conference in Cairo -1959 causing participants to consider adopting a common front against such practices. This ultimately led to the creation of OPEC.

²⁵³ Yergin (2009), supra note 216 at p.607

clauses: (1) in addition to the 2.5% and 5 cents/bbl periodical increase agreed in Tehran, it uniformly raised posted prices quoted in dollars by 8.49% in 1972; and (2) guaranteed the revenue of exporters in case of currency fluctuations against the dollar. Increases of 8.49% + 2.5% would be compared with the arithmetic mean of the increase of the exchange rates of nine industrialized countries (Germany, Belgium, France, Italy, Japan, Netherlands, UK, Sweden, Switzerland), that is, 11.2%.²⁵⁴ It was agreed that the arithmetic mean would be computed every three months, and new prices set according to an agreed formula if the newly calculated mean exceeded 13.02% or was less than 9.02%. The formula was as follows:²⁵⁵

$$X_2 = X'_1 + 0.0849 \quad X_1 \frac{B - A}{11.02}$$

Where:

X_1	=	Former price
X'_1	=	Price on eve of calculation
X_2	=	New price
B	=	New arithmetic mean of nine currencies
A	=	Former arithmetic mean of nine currencies
X_1 & A	=	Correspond to the same date

Three months was a very long time to wait before responding to currency and price fluctuations and so a further supplement was agreed in June 1973 to address the time issue. It was designed to secure a faster and more suitable response to international currency fluctuations. The principle remained unchanged although minor variations were made: Australian and Canadian dollars were added to the *nine* other currencies, calculations would be done every month on the 23rd, the moderator coefficient was dropped in favor of a simple percentage, and only a difference of 1% was needed to automatically trigger computation of new posted prices. The new formula was:²⁵⁶

$$X_2 = X'_1 + X_1 \frac{B - A}{100}$$

It is worth noting that OPEC members used the quality of crude notably its sulfur content to calculate premiums for transportation through the Suez Canal. Premiums would be determined on basis of the ratio X_2/X_1 . Crude has different qualities depending on *gravity* (°API) and its *impurity* (mainly sulfur), and this factor complicates the estimation of a universal oil price. Historically, the reference API gravity for crude is 36°API. A specific gravity of about 0.863 corresponds to °API

²⁵⁴ Masseron (1990), supra note 228 at p.34

²⁵⁵ Idem

²⁵⁶ Idem

ranging between 32° to 34° (for example Urals 32°, WTS 33° 1.6%S, Arab Light 33°, Iranian Light 34°).²⁵⁷ Specific gravity and API gravity are linked by the formula:

$$\begin{aligned} \text{°API} &= (141.5/\text{sp. gr.}) - 131.5 \\ \text{Sp. gr. (15°)} &= \frac{141.5}{131.5 + \text{°API}} \end{aligned}$$

The **quality of crude** is an influential element in the determination of crude price quotations. Lighter crudes are more expensive than heavier ones, since sulfur impurities in heavier crudes make them more difficult and costly to refine and also produce more heavy-end products (residue oil) than light-end ones (petrol/gasoline). In effect, Middle Eastern crudes²⁵⁸ have higher sulfur contents than North African ones,²⁵⁹ and some Gulf of Guinea crudes (Nigerian Bonny Light with 37°API gravity) are even lighter than North African and Middle Eastern crudes. If one considers that oil-producing states set posted prices, it is unlikely that IOCs would manipulate TP and go unchallenged after doing so by the relevant tax authorities. This however is likely under the spot and futures pricing systems.

B. Spot and Futures Prices

The growth of trade in oil on commodity markets has been largely favored by the fact that it has certain distinct advantages over other energy sources.²⁶⁰ It has a high energy content per unit weight (energy-to-weight ratio), is often available in sufficient quantities, and is easy to handle and transport over long distances at reasonable transport costs. Over the years, three main sales contracts have developed on commodity exchanges namely: **Spot sales** –immediate delivery and payment; **Regular sales** –requires transaction to be completed within 10 days (B.1); and **Futures** – specified quantity to be sold at a specified price within a specified time in the future (B.2).

Trade/Transactions on the Spot Market

Prior to spot markets, crude was primarily locked in long-term off-take contracts in which buyers agreed to take or pay specified quantities of crude at predetermined prices. Over time, spot markets moved from the fringes of international crude trade (about 10%) in the 1970s, to occupy a slightly more than equal position to term trade in 1983 (more than 50%). Today it occupies a central

²⁵⁷ Johnston, D., *Economic Modeling and Risk Analysis Handbook*, p.216 (2002)

²⁵⁸ Arab heavy 28°, Dubai 29°, Arab Light 33°, Iranian Light 34°

²⁵⁹ Libyan Es Sider 37°

²⁶⁰ Hannesson, R., *Petroleum Economics*, p.1 (1998)

position in crude transactions (about 80-85%).²⁶¹ The industry has been transformed from one heavily dominated by a few highly integrated multinationals, and exporters to one in which many buyers and sellers interact in the market place. Oil, has become just 'another commodity'.²⁶²

Factors that Historically Contributed to Development of Spot Market

Growth in spot trade was made possible by the following factors. **Firstly**, the loss of flow of Iranian supplies in the late 1970s forced upstream operators and downstream refiners to surf the spot market to makeup for short inventories. BP, which sourced most of its crude from Iran, was forced to shop around the spot market for crude after losing its Iranian holdings. Buyers were willing to pay premiums to acquire undersupplied but over demanded crude, forcing spot market prices up by 150% above official prices. By December of 1979 OSPs were between \$18-\$28 whilst spot prices stood at between \$40-\$50. To exporters the spot market quickly became an attractive alternative to long-term off-take arrangements. They started diverting crude to spot markets thus rupturing a long established trading system and further moving crude marketing towards the spot system.²⁶³ **Secondly**, speculators had begun playing an important role in crude trading on the then peripheral spot market. They had taken to building inventories when prices were low in order to sell when they rose, and easing inventories when the market was sluggish in order to cut losses by selling when prices were expected to drop even further. **Thirdly**, exporters were losing enormous revenues by selling at low OSPs compared to spot prices. In order to capture this portion of rents, exporters (1) added premiums to posted prices and even went as far as insisting that "long-term buyers take higher-priced spot oil along with contractual officially priced oil",²⁶⁴ and (2) shifted much of their own share of production from long-term contracts into more profitable spot markets. As exporters moved to sell their share of crude directly to willing buyers (majors, independents and traders) on spot markets, oil traders suddenly became very important. Traders ingeniously secured new forms of term contracts that afforded better prices for exporters, but low enough to enable them turn to the markets to exploit high price volatilities earning huge profits. Fourthly, by 1982 non-OPEC production

²⁶¹ Hussein, R. & Fereidun, F., *Fundamentals of Petroleum Trading*, (1991)

²⁶² Note however that during 1860s and 1870s it was treated as any other commodity until oil companies integrated operations from the wellhead to refill stations thus altering this perception

²⁶³ BP took about 40% of Iranian crude. With this lost, it cancelled long-term supply contracts with Exxon, invoked *force majeure* with other 3rd party buyers; Exxon had lost the Aramco concession and Venezuela as well and also wound-up many long-term 3rd party supply contracts; Japan was also hit and the government advised buyers to go directly into the market place to make-up for shortages; so did independent refiners; and some national oil companies; thus increasing the importance of spot trade

²⁶⁴ Yergin (2009), *supra* note 216 at p.671

surpassed OPEC's output with much of the crude finding its way into spot market.²⁶⁵ This caused spot prices for same quality of crudes to drop below term prices. It was the turn of IOCs to surf the spot market for cheap crude. For example, in 1984 the Aramco partners seriously cutback on their Saudi off-take volumes since the OSP was more costly than comparable crudes on the spot. To reverse this trend, OPEC in 1983 slashed its prices by 15% to \$29/bbl (from \$34); a dollar cheaper than the \$30/bbl at which the North Sea Crude sold on spot markets.

Initially it was difficult to monitor the changes and reliability of prices offered by sellers. For this reason, buyers feared that crude prices charged them were unfavorable. This sparked a desire on commodity markets to secure an **international reference price** so traders started publishing transactions on commodity especially on Rotterdam.²⁶⁶ It became hard to arbitrarily fix prices of crude oil and finished products since reference prices became available. Instead an average of prices on transactions concluded or published on commodity markets became the spot price. In most cases oil companies and their clients either used these prices directly or adopted it to index OSPs for their transactions.²⁶⁷ Being unstable these prices proved very unreliable and resulted in the introduction of the **netback pricing system** in 1985.

The netback system emerged out of a unique **purchase-and-sale contract** between **Gulf** (which was long on crude and short on markets, *off-loader*) and **Shell** (short on crude and long on markets, *off-taker*). This contract lasted an initial 10 years and was later extended by another 13 years with highly complex accounting formulas and schedules for calculating profit (about 85 of 170 pages). Due to the long-term nature of the agreement both parties decided not to base it on fixed prices but rather to develop an innovative *netback* pricing system for the deal. The Saudis also used this pricing system to defend their volumes in 1985 through deals with the Aramco partners and others in strategic markets²⁶⁸ effectively nailing the coffin to Saudi OSPs. According to these deals the Saudis did not charge a fixed price. They accepted to be paid on the basis of what the refined products earned in the markets, guaranteeing the refiner a prearranged margin off the top (example \$2/bbl) regardless of the market price. Saudi Aramco would get the rest, less cost (refining,

²⁶⁵ After Shell and Esso discovered natural gas in Groningen, Holland in 1959, IOC's made major oil finds in the North Sea: Phillip Petroleum operating on the Norwegian side -Ekofisk 1969; BP on UK side -Forties 1970; Exxon -Brent field 1971. The Brent later became a *benchmark crude*

²⁶⁶ See Wyer, J. & Arnest, P., *The Rotterdam Oil Price Swindle*, pp.22-23 EIR Volume 6, Number 22, June 5, 1979, for more on quotations and controversies surrounding pricings on Rotterdam:

<http://www.larouchepub.com/eiv/public/1979/eiv06n22-19790605/index.html> [Last visited: March 10, 2012]

²⁶⁷ Masseron (1990), *supra* note 228 at p.84

²⁶⁸ Yergin (2009), *supra* note 216 at p.729

transportation, etc.) retained by the partners. The refiner's profit was therefore locked in the deal and provided an opportunity for refineries to again start making money. Masseron²⁶⁹ uses Rotterdam spot prices of Arabian Light refined products to illustrate how the netback pricing system works. The **yield by volume** of a barrel post-refining is used to determine the total market value of Arabian light, from which is deducted refining and transport costs in order to obtain the spot price payable to the Saudis.

Table 3-1: Example Of Netback Calculation (*Arabian Light, December 1988*)

PRODUCT TYPE	ROTTERDAM SPOT PRICE (\$/BBL)	YIELD (% VOL.)	VALUE (\$)
Naphtha.....	15.3	7	1.07
Gasoline.....	19.2	21	4.03
Gas oil.....	19.1	33	6.30
Fuel Oil.....	9.6	33.5	3.22
Total value of Arabian Light			14.62
Less:			
• Refining cost.....			-2.00
• Transportation cost (W30).....			-0.63
= FOB value of a barrel of refined Arabian Light.....			11.99

Current Spot Markets: Crude Oil Benchmarks

Systems used for pricing crude evolved from OPEC-administered pricing arrangements that collapsed in 1985, to the netback pricing system agreed with IOCs and used by some OPEC countries only for a short time. Today crude benchmarking is by far the most used pricing system in spot markets. In essence, it is a market-linked pricing mechanism used by oil exporting countries to determine prices for specific qualities of crude in the market.²⁷⁰ Market-linked pricing as a viable alternative to the preceding systems was first adopted by PEMEX in 1986, and by 1988 became widely accepted by other exporters. It remains the main method for pricing crude oil in international trade with notable benchmarks such as WTI, Brent, and Oman.

Some Shortcomings of the Spot Pricing System

As noted in the preceding paragraph spot prices for a given quality of crude oil can be determined by reference to benchmark crudes. Nonetheless, the importance of spot prices can be largely attributed to lack of a better indicator, that is, any other viable and objective-pricing system that is representative of oil markets. Thus, the spot system of gauging oil prices has significant shortcomings and is sometimes criticized for its *lack of accuracy*.²⁷¹ Without questioning reliability of

²⁶⁹ Masseron (1990), supra note 228 at p.85

²⁷⁰ Mabro, R., *Oil in the 21st Century: Issues, Challenges and Opportunities*, in OPEC p.351 (2006)

²⁷¹ Masseron (1990), supra note 228 at p.85

published crude and finished product prices worldwide, these publications remain the result of transactions often communicated to brokers who use them to calculate a weighted average. For example, consider an average of quotations on the Rotterdam market provided by six of the most reliable publications (Platts, Petroleum Argus, Reuters Agency, Telerate, London Oil Report and Petroflash). Depending on the origin of crudes and other factors, there are sometimes significant price differences of up to 40 or 50 cents/bbl for same quality of crude. For experts on the subject (buyers, sellers) who know how spot prices function and who understand the mechanics behind price fluctuations of given crudes or finished products, the spot price *only represents a reference and not an effective/actual price*. Often adjustments need to be made to get the actual price of specific crudes. Hence, it is premature to presume -as is often done- that existing spot systems do not permit IOCs to manipulate transfer prices because prices are easily gotten on oil exchanges.

Prices are often determined on a transactional basis, notably when using the *netback pricing system*. Since spot prices quoted on exchanges are only indicative, one needs to take a close look at transactional details when determining the appropriate price. This is vital because each refinery, transportation system and market has its unique range of transactional costs that impact sales prices. Under the netback system and depending on the off-taker, each quality of crude could end-up with a different value.²⁷² These shortcomings are compounded by four other factors: (i) It is hard for exporters to track with accuracy the markets in which their crudes are consumed due to the global character of IOCs; (ii) It is also hard to determine exact prices charged for crudes or finished products since discounts are granted, premiums added, or diverse terms of payment won; (iii) Further, commercial confidentiality sometimes makes it hard to obtain exact refining/processing cost; And (iv) the cost of transporting crude from the wellhead to the refinery is hard to determine with exactitude. These distortions are hard to detect and will not be immediately visible to clients or observers who are not directly parties to the contract. In seeking to determine the appropriate prices for tax purposes, exporters need to master the technical definition of quality of crudes, quantities, freight costs, precise refinery yields and complete processing costs involved. Unless they fully understand these issues, one cannot reasonably work out the true value of crudes extracted and sold thus creating avenues for TPM.

²⁷² Masseron (1990), supra note 228 at p.86

Futures Market/Transactions

In essence, a futures contract is a standardized forward contract in which the buyer and the seller accept the terms with respect to product, grade, quantity and location and are only free to negotiate the price.²⁷³ By these contracts, a buyer acquires a right to buy crude at some specified month and predetermined price in the future, thereby locking the purchase price in a deal that contractually binds the producer to sell his output forward even before production. Futures was born of uncertainties and volatilities in spot markets which pushed buyers and sellers of crude to look for a mechanism to mitigate risks. Crude was first traded on the futures market in 1983, when the Chicago Board of Trade (CBOT) and the NYMEX both attempted to take advantage of the US government's deregulation of petroleum operations. NYMEX gained an upper hand over CBOT, when the latter fell out of favor with clients due to initial delivery issues. Crude oil was soon traded extensively on *futures markets* with NYMEX contracts for light (sweet) crudes accounting for the largest-volumes of futures traded in physical quantities. In the US, a typical futures contract is traded in units of 1,000 barrels of several grades of domestic (WTI) and foreign crudes deliverable to Cushing, Oklahoma; a hub that is accessible to other international spot markets via pipelines.

Both parties by this mechanism hedge the price risk. This in effect means that futures crude prices are only speculative, with the effect that it binds buyers to take and pay the contracted price, or to pay or receive the difference between the contracted price and 'regular' price at the time of settlement. The mechanism may create handsome profits or devastating losses for those holding futures instruments irrespective of whether the buyer ever takes actual possession of the crude. Standing in-between buyers and sellers are speculators who hope to make profits in the markets by speculating on demand and supply and futures prices. In a bid to further insulate themselves against excessive fluctuations on disturbed markets, additional forms of risk management contracts and trading opportunities have emerged on futures markets, notably: barter deals, compensation deal options, buy back arrangements, calendar spread options, crack spread options on the pricing differential of heating oil futures and crude oil futures and average price options.²⁷⁴ This complex context and structure of spot/futures markets arguably makes it possible for IOCs to manipulate crude oil transfer prices.²⁷⁵ Likewise, costs of the type presented below can also be manipulated.

²⁷³ Garner, C., *A Trader's First Book on Commodities*, p.19 (2010)

²⁷⁴ Masseron (1990), *supra* note 228 at p.89

²⁷⁵ See discussions on how this is possible in Chapter 4

3.1.2.2 Costs: Capital and Operating Expenses

The technical costs of exploring and producing (E&P) petroleum is another very important aspect to consider when discussing transfer pricing. Depending on whether one approaches the issue from an accounting or economics perspective, there are three main classifications of cost: tangible and intangible, fixed and variable, or capital and operating. For purposes of this study we adopt the accounting classification of capital and operating expenses, whilst bearing in mind that some are tangible and others intangible, or fixed and variable as the case maybe. It is important to note that these costs are accounted for using either of two main accounting methods, that is, **successful efforts** or **full cost** accounting. Suffice to note, the method that is chosen by a country determines cost elements to be allowed or disallowed for tax computation purposes. This is an important issue because companies spend huge amounts in **exploration costs** -*typically three years or more*- to discover commercial deposits. Costs include geological, geophysical, wildcats, seismic surveys and often represent approximately 10-20% of total technical costs. Then in order to produce the reservoir, **development costs** such as installation of development and drilling facilities and transportation need to be engaged. This could easily represent between 40-60% of total technical costs. The third major category is **production** or standard **operating costs** linked with pumping crude out of the reservoir during the buildup, peak and decline phases of production. It typically accounts for about 20-50% of overall technical costs. In the following paragraphs, we discuss both onshore and offshore technical costs of exploration and production (E&P).

A. Onshore Technical Costs of E&P

From a technical standpoint it is hard to allude to crude production costs or to determine an effective international average selling price of crude oil since costs vary widely from averages of between \$0.4-\$6.0 per barrel in the Middle East; to \$1-\$6 per barrel in Africa;²⁷⁶ \$2-\$10 per barrel in America; and \$8-\$25 per barrel in Europe. The cost-range-factor for conventional E&P fields is from 1 to 30 and up to 60 or increasingly for marginal and unconventional fields.²⁷⁷ This incredible range of costs is driven by three main factors: various success ratios for exploration wells in different regions, varying output per well, and varying geographical and geophysical conditions. We hereinafter examine expenses of both a capital and income nature.

²⁷⁶ Gulf of Guinea onshore: Nigeria \$1.8-3/bbl; offshore GoG \$3-6 with 7.5 to 15 cost range factor

²⁷⁷ Masseron (1990), *supra* note 228 at p.98

Technical Capital Expenses (Capex)

Acquisition Costs: Before commencing exploration, IOCs have to acquire rights to the property or target area. This obviously raises two questions, one relates to ownership of these properties and another to the award of these rights. In the US where private ownership is allowed license can be obtained from owners in two ways: Land **purchased in fee** –both mineral rights and surface rights are acquired, or **leasing** in which case mineral and surface rights are secured separately. In other countries around the world (including the GoG) where ownership of resources is vested in the state, IOC's contract with the host government or its agent the National Oil Company. In most of these countries land/area **rentals**, signature **bonuses**, amongst other payments are required.²⁷⁸

Exploration Costs: The process of oil production is always preceded by exploration. **First**, there are costs associated with determining the **Geology**. The IOC does detailed analysis of existing geological data to ascertain its chances of success. It then does both *aerial photography* to chart a topographic map of the area, and *stereoscopic analysis* of photographs to situate outcrops, faults, and other geological features for a total cost of approximately \$10/km² for a scale of 1/50,000. At this point it is important to send out a **Geological Team** to identify source rocks and potential reservoirs. These costs range from \$70,000-\$200,000, or \$800,000-\$1.5 millions depending on whether terrain conditions are normal or hostile. The team does **Geophysical Surveys** to test formations for crude. Initially this takes the forms of *gravimetric*²⁷⁹ or *magneto-metric* (mainly aeromagnetometric)²⁸⁰ methods, for an estimated monthly cost of between \$50,000-\$200,000; and \$40/km² respectively. Nowadays, *seismic* methods²⁸¹ are also used to explore for crude. Seismic methods (dynamite charges, weight drops, vibrators) represent about 98% of geophysical surveys, and account for the bulk of geophysical costs. These costs vary depending on whether they are incurred onshore or offshore. **Onshore** costs per km/month range between \$1,600-\$2,600²⁸² or team costs represent between \$160,000-\$320,000 per month. However, **offshore** costs stand at \$200-\$600 per km/month, or \$340,000-\$460,000 for the entire team.

²⁷⁸ Duval, L. et al, *International Petroleum Exploration and Exploitation Agreements: Legal, Economic and Policy Aspects 2nd ed.*, chap. 2 (2009)

²⁷⁹ The gravimetric team sets up between 500-800 measurement stations per month, to analyze differences in density in subsurface layers by measuring the variations in force of gravity

²⁸⁰ 'Analyzes variations in magnetic susceptibility of the subsurface to gain an understanding of the deep structure of sedimentary basins'

²⁸¹ Generating disturbance at a point on surface and measuring time elastic waves take through subsurface layers to return to surface

²⁸² IFP from Geophysics, October 1989

A third category of exploration costs is the **Drilling of Exploration Wells**. This category of costs generally represents about 65-80% of total exploration expenditures. In Africa for example this represents between \$1-\$1.5 million/well in mild areas, and \$6-\$9 millions/well in harsh areas (e.g. Angola).²⁸³ Drilling costs are often expressed as cost per meter drilled, and stood at between \$800-\$2,000/m in 1990. As a rule of thumb this cost increases sharply if drilling continues beyond the probable discovery area. It is also worth noting that total well costs are expressed in one of two ways, namely: the contractors or operators price. The **contractor's price** (price-per-day) is paid as a function of the duration of operations. This daily price comprises the following elements –manpower, rig depreciation, maintenance and repairs, overheads and profits. Consumables such as drilling bits, fuels, drilling fluids may or may not be included depending on the contract with an operator. As concerns the **operator's price** or **price-per-meter**, it is the total price expressed as a function of total number of meters drilled. This encompasses the following elements:

Table 3-2: Details of Exploration Costs

NO.	COST ELEMENT (EXPLORATION)	DETAILS	% EXPLORATION COSTS ²⁸⁴
1	Contractors fee	Manpower costs, overheads, Rig depreciation, maintenance and repairs Profits	35%
2	Consumables	Fuel and lubricants, drill bits, drilling fluids, casing and tubing, cement, sundries	45%
3	Payment to service companies	Geology, logging, cementing, drilling fluid, Hire of sundry equipment Special operations Civil engineering	10%
4	Transportation	Move in and move out	10%

Development Costs: Once a commercially viable reservoir is found extraction of the resource requires significant developing expenses divided into three main categories: *Drilling of production wells*, *surface installations* and *completion costs*. For accounting purposes, a distinction is often made between **wells drilled** for exploration (discussed above) and **production** purposes. Tens to hundreds of production wells can be drilled in a discovery basin. Companies that decide to develop a reservoir would already have gathered sufficient data during exploration so that drilling risks are considerably low since much is known of the basin. However, some 10-20% of wells drilled still turn out to be dry especially those drilled to determine the fringes of a reservoir. The cost elements of drilling production wells are same as with exploratory wells and accounts for about 80% of total

²⁸³ Masseron (1990), supra note 228 at p.109

²⁸⁴ These are more or less estimates

development costs. For its part, **surface installations** could represent up to 30% of technical development costs. These include gathering systems/networks, separation and processing units,²⁸⁵ storage tanks, production and metering centers, ancillary facilities, and communication networks. Lastly, the company has to incur **completion costs** to equip the installations and provide shipment facilities such as connections to pipeline networks. The actual costs incurred at this stage depend on the development scheme opted for and the distance from production basins to the coast. Often, transportation will be by pipelines that are expensive to build. If shipment is by sea, an imperative is created to build export terminals. This would no doubt significantly add to total technical costs, especially in cases where new export ports need to be specially built for fields being developed.

Table 3-3: Details of Development Costs

N ^o .	COST ELEMENT (DEV'T)	DETAILS	% DEVELOPMENT COSTS ²⁸⁶
	Drilling of Production Wells	Consumables Payment services, transportation	
2.	Surface installations	Gathering systems/networks Separation and processing units Storage tanks, production and metering centers Ancillary facilities & communication networks	Up to 30%
3.	Completion cost	Equipping of installations, shipment facilities	

Technical Operating Expenses (Opex)

After investing huge sums of money to explore and develop petroleum reservoirs, IOCs move into production. At this stage, much of the costs going forward would be operational and treated as Opex for tax purposes since most of the Capex would have been incurred already. For the operator this would be money spent to lift oil to the surface, and to gather, treat and store the same. Production expenses include manpower, maintenance of facilities and variable production costs. It is important when determining total operating costs to consider the number of **producing wells** and **volumes** produced.²⁸⁷ After primary recovery of crude oil reserves (between 25-30%) ceases, costs are bound to increase sharply as companies move to employ *improved* or *enhanced* recovery techniques to force the remainder of *oil in place* out of the reservoir. Secondary recovery techniques include: (i) conventional water and gas flooding, steam drive, in situ combustion, and (ii) increasingly injection of **surfactants** (reduces rock/hydrocarbon friction). Costs associated with each of these

²⁸⁵ That is, valve or manifold to transfer production to processing Centre's, and units to separate water, crude oil, gas, and possible treatment

²⁸⁶ These are more or less estimates

²⁸⁷ Total Opex $K = K + K_1(n) + K_2(p)$. Where n is number of wells, and p is production volume

recovery methods differ. For example, injecting surfactants is more expensive than using other conventional methods (water/gas flooding). Hence, tax authorities need to understand differences between improved and enhanced recovery methods so as to effectively monitor costs.

Table 3-4: Details of Development Costs

No.	Item	Successful effort	Full Cost
1	Acquisition costs	Capitalized	Capitalized
2	G&G costs	Expensed	Capitalized
3	Exploratory wells, successful	Expensed	Capitalized
4	Development dry hole	Capitalized	Capitalized
5	Development well, successful	Capitalized	Capitalized
6	Production Costs	Capitalized	Expensed
7	Amortization cost center	Property, field, reservoir	Country

B. Offshore Technical Costs of E&P: Some Key Points to Note

Except for a few cost elements unique to offshore E&P, the technical costs for offshore activities are quite similar to onshore ones. Although offshore has relatively lower **geophysics** costs per kilometer, water depth remains its main challenge causing IOCs to deploy dynamic positioning ships with operating capacity in areas having depths of about 2,300m.²⁸⁸ Drilling platforms used vary as a function of water depth, marine currents and subsurface features. Here, costs typically fall between US\$1-30 millions. Three major platforms used in offshore operations are the jack up platform –for depths of up to 150 m; semisubmersible platforms -depths of 300 m, and dynamic positioning ships -extreme water depths above 300 m. It is worth noting that three cost elements differentiate offshore from onshore **exploration** activity. In offshore exploration: (i) rigs are more expensive to hire –represents about 50% of offshore expenditures; (ii) transportation is twice as expensive; and (3) the drilling rate is more than usual a function of both geological and geographical conditions. Lastly, **development** of offshore fields results in amortization of expensive production equipment (rigs) and transport systems (subsea pipeline).²⁸⁹

C. Other Relevant Downstream Costs: Transportation

In addition to the key categories of costs discussed above and depending on the point of FOB sales, one also needs to take into account **transportation** and **refining** expenses. Oil is either

²⁸⁸ Masseron (1990), supra note 228 at p.121

²⁸⁹ Depending on water depth, pipe accounts for 33%, laying 38%, burial 11%, and testing and finishing 18%.

transported by means of tanker or pipelines. The former represents the bulk of internationally transported crude. In practice three systems are used to charter vessels to transport crude globally, namely: **spot charter** in which case the ship-owner agrees to a one-off transport of cargo from one designated port to another, **consecutive voyage charter** for a determined period often less than two years, and **time charter** where vessel is chartered for a period of up to twenty years. In 1989, maritime crude trade accounted for about 42% of worldwide trade.²⁹⁰ This is largely driven by the fact that consuming countries produce only about 1/3rd of what they consume, whereas producers (mostly developing countries) consume between 15-20% of their output. Maritime transportation has historically linked both producers and consumers markets. Transportation represents about 5% of the cost of crude delivered to consuming countries (and roughly the cost of refining).²⁹¹

Although little is done at this stage of the study to relate the range of costs discussed above to TPM, the subsection as designed provides a clear picture of upstream oil operations and the necessary background information on the industry. Ex post facto (or hypothetical) examples of how these costs are (or can be) manipulated is presented in Chapter 4. This notably takes place when IOCs seeking to minimize their liability to tax use intrafirm transfers to shift and report as much of their costs in high tax countries instead of low ones.²⁹² It is worth noting in passing that Accounting Rules of petroleum E&P agreements provide certain useful guidance on how to prevent abuse of costs linked to oil operations.²⁹³

²⁹⁰ Masseron (1990), supra note 228 at p.159

²⁹¹ Masseron (1990), supra note 228 at p.20; Transportation cost includes: depreciation and financing costs, insurance and pollution at sea, personnel and related expenses, victualing, maintenance, overheads and miscellaneous, fuel, and harbor/canal fees. These are all taken into account in determining freight rates. Typically, the size of a standard vessel and the relevant daily hire element provide the best practicable basis for a scale. Since the 1990s, a standard vessel with a carrying capacity of 75,000 Mt and a daily hire element of \$12,000 provides a basis for the scale to be used and adjusted to determine freight rates. The transportation of gas as Liquefied Natural Gas (LNG) requires even more special tankers, and may cost about twenty times more than oil. Transportation of petroleum via pipelines also constitutes an important portion of crude trade. As with tankers (LNG) note that costs for transporting natural gas through pipelines are about four or five times more than transporting petroleum with equivalent energy content. Increasingly, bigger sea going vessels sometimes exceeding 300,000 DWT are built to ease transportation of crude oil through long distances spanning thousands of kilometers. For example, tankers chartered to transport petroleum from the Arabian/Persian Gulf to USA cover a distance of 13,500 km. Oil tankers are designed to respond to specific safety and other industry concerns and cannot be easily diverted to transport other cargo. Therefore it is difficult to transfer/share capacity with other industries in times of crisis. **Next**, we examine the variety of fiscal regimes applied to the hydrocarbons industry (3.2).

²⁹² For a more detailed analysis on this issue in the US O&G sector; see, Deloitte & Touche, *Transfer Pricing in the Oil & Gas Sector*, pp. 8-10 (2012).

²⁹³ See Nigeria and Cameron Model PSCs; Also, Duval et al, (2009) supra note 282 at chaps. 10 & 13; ONORATO, T. & PARK, J., World Petroleum Legislation: Frameworks that Foster Oil and Gas Development, 39 Alberta L. Rev. (2002) 70 at 101-02

3.2 Petroleum Fiscal Regimes

Taxation of the upstream O&G industry is highly complex, tremendously diverse and to an extent distinct from the taxation of other major industries. In this section the rationale and design of petroleum fiscal regimes is examined. Salient issues pertaining to the subject are examined and foundation is laid for identifying and analyzing pricing and valuation schemes deployed by IOCs within the context of intragroup transfers. Before delving into the subject it is important to note that O&G are currently major sources of energy and excessive taxation of these energy sources could inevitably affect other global industries. However, approaches to taxing petroleum are varied and a country's **objective** in doing so informs its choice of instruments. In this respect the approach adopted by oil producing countries (net-exporters), would be different from that of consuming countries (net-importers). The former strives to optimize revenues, while the latter are more likely to provide tax incentives aimed at encouraging production to meet domestic consumption.²⁹⁴ Since there is no clear-cut formula on how best to share resource wealth between project stakeholders (state and companies), a country's capacity to achieve its revenue optimization objectives, whatever this is, rests in government's ability to design and implement effective resource taxation regimes. The ideal scenario would be to engineer a regime that optimizes state revenues, whilst providing enough return to companies to ensure continuous investments in what is without doubt a capital intensive and technically challenging sector. Most experts agree that a perfect design should target the entire **economic rent**. Another issue that has shaped existing regime designs is the ownership of natural resources. Hereinafter, we analyze two petroleum tax systems used to extract resource rents (3.2.1), and various fiscal instruments used to achieve this (3.2.2).

3.2.1 Major Petroleum Taxation Regimes

The question of effective taxation is often debated in countries endowed with resources, and the *fair distribution* of resource wealth between industry (oil companies) and the state is central to this discussion. Since 2007 when oil prices increased the subject has attracted significant public attention with focus being placed the two conventional forms of fiscal systems used in the extractive industry to share revenues, namely Concessionary (*Royalty-Tax or R/T*) and Contractual (*Production*

²⁹⁴ Following the 2008 economic slowdown it seemed for a while, albeit briefly, that competition for investments was fast pushing even net-exporters to provide incentives.

Sharing or PSC) systems (3.1.1.2).²⁹⁵ Existing R/T and PSCs have been largely influenced by the view that they are efficient if designed to flexibly target resource rent (excess profits). This enables greater fairness in the sharing of wealth without which “a rich discovery means a dissatisfied landlord...[who] knows that his tenant’s profit is far greater than is necessary to keep him producing, and he wants some of the rent. If he gets some, he wants more.”²⁹⁶ This excess profits, called the economic rent is discussed in 3.2.1.1 below. In both subsections our purpose is not to develop these issues in-depth. Rather it meant to provide the reader with key information that is needed to understand analysis in later chapters of the study.

3.2.1.1 Natural Resource/Economic Rent Theory

In this subsection the economic rent theory is examined (A) and its relevance to discourse on hydrocarbons and mineral taxation is briefly discussed (B).

A. Description of the Theory

The fixity of O&G deposits and diverse qualities of crude creates basis for the existence of *rent*. Rent as pertains to O&G is the amount by which receipts for bringing a barrel of crude to the market exceeds that which investors would be willing to earn and still undertake the activity. That is, rent is the difference between the value of production and costs incurred in extracting it, where costs include exploration, development and operational outlays, plus an appropriate markup to reward effort.²⁹⁷ Costs are incurred to employ factors of production like capital (*interest*), labor (*wages*), entrepreneur (*profits*), land (*rent*); including opportunity cost as pointed out by Hotelling. If the fiscal regime targets 100% of economic rent, this would be neutral and not influence investor behavior since the latter still gets the minimum return required to undertake the project. Using rent as the taxable base is to this extent ideal. However, isolating rent is full of challenges one of which is the lack of willingness by companies to declare to authorities the minimum IRR required to make an investment. A review of the literature indicates that three major types of rent exist, namely: Ricardian, Hotelling and Quasi rents’.

²⁹⁵ Concessions are also called *Royalty/Tax* regimes; And contractual regimes are *Production Sharing & Service* based

²⁹⁶ Adelman, M.A., *The World Petroleum Market*, p.42 (1972)

²⁹⁷ Johnston (1994), *supra* note 120 p.6

B. Types of Economic Rent

Differential or Ricardian Rent

Ricardo was amongst the first to apply the rent theory.²⁹⁸ He classified *arable land* into groups on the basis of productivity and then used this to demonstrate that greater levels of rent accrue to lands of increasing productivity. He argued that marginal lands receive no rent. If one groups oil fields into classes on the basis of mounting costs of production, his argument on rent is every bit relevant. Efficiently managed fields or those with favorable geology are likely to produce at costs lower than market prices making them more profitable. This class earns the Ricardian rent. However, marginal fields with unit costs that equal or surpass market prices generate no rent.²⁹⁹

Scarcity or 'Hotelling Rent'

Rent also accrues from the natural scarcity of a given resource resulting in limited output. It represents the forgone future profits due to a decision by its owners to extract today. In addition to production costs, Harold Hotelling³⁰⁰ argues that mining firms should also consider the opportunity cost of producing one more unit of output today, bearing in mind that reserves extracted today are not available for extraction in future. Put differently, the cost of extracting a barrel of oil today is the revenue forgone by the inability to extract it at some future date. The cost equals the net-present value of the loss in future profits associated with producing one more unit of the deposit today.³⁰¹ It is not clear that other authors consider the question of opportunity cost to be relevant in fiscal regime design. This is because if a decision is made not to extract today, this only truly affects the optimal time profile of lifting the oil, and not the amount of rent that would ordinarily accrue over the life of the project. Since the resources are finite and in place, the opportunity cost of a decision not to extract today is compensated for when actual extraction takes place in the future.³⁰²

Quasi-rent

Rents of this nature derive from previous outlay of sunk costs. It accrues to firms due to past investment, innovative practice or market changes; and are earnings over and above that which is required to keep a business running in the short-run. *Q-Rs* represent the present value of future

²⁹⁸ Ricardo, D., *On the Principles of Political Economy and Taxation* (1817)

²⁹⁹ Where costs include the investors return on capital outlays e.g. Internal Rate of Return

³⁰⁰ Hotelling, H., *The Economics of Exhaustible Resources*, (1931)

³⁰¹ Carole, Nakhle., *Petroleum Taxation*, at p.17 (2008)

³⁰² Daniel et al. (2010), *supra* note 7 at p.16

expected revenues, minus estimated costs for developing and extracting the known deposit. In the O&G industry, a project's life is divided into five phases: exploration, development, extraction, processing and abandonment/decommissioning. At the end of *phase one* (exploration) there would have been a substantial investment outlay and questions of uncertainty with respect to size of the reservoir would have been resolved. When the investor engages development costs, *Q-R* would be expected revenues less extraction costs. A few issues arise as regards costs for unsuccessful exploration ventures. Sunk costs associated with exploration activity are quite significant with an estimated nine of ten exploration ventures turning unsuccessful.³⁰³ Effective capturing of rent requires IOCs to factor unsuccessful ventures as part of exploration cost. That is, in determining *Q-R* at the exploration phase, one should account for costs of both successful and unsuccessful ventures. Integrated IOCs act to maximize overall rent and optimizing *Q-Rs* at each stage of the petroleum value-chain, less its initial capital outlay enables this. In cases where the exploration firm is independent from that which develops the deposit, the overall *Q-R* for the project will be maximized if O&G rights are appropriately priced during transfers from one stage to the other.

3.2.1.2 Principal Types of Petroleum Fiscal Agreements

Of petroleum agreements designed to capture economic rent **concessions** and **contracts** are widely used to allocate profits or other rights between states and oil companies. The latter was designed as an alternative to the former, and *resource ownership* is determinant as far as the structure of fiscal instruments built into these agreements is concerned.³⁰⁴ One needs to bear in mind when examining O&G fiscal regimes that there are two notions of ownership. The first allows private ownership of resources, whereas the other only allows state ownership. Suffice at this stage to note that views differ over which of these approaches best serves the interest of parties. On one hand it can be argued that the position of IOCs is stronger under R/T than in PSC systems, and on the other that PSCs give states more control than concessions do. It can even be argued that existing differences, if any, are more philosophical and legal in nature than fiscal.³⁰⁵

The Concessionary (Royalty/Tax) System

The concessionary system derives from the Anglo-Saxon concept of ownership of mineral resources and is deeply rooted in the common-law legal tradition, by which, private ownership of

³⁰³ Johnston (1994), *supra* note 120 at p.6

³⁰⁴ Developing countries mostly use contractual systems and Developed ones, concessions. See Duval et al, *supra*.

³⁰⁵ Johnston (1994), *supra* note 120 at p.39

natural resources is allowed.³⁰⁶ Although this still underpins concessions, few countries in the world today allow private ownership of natural resources *in the ground*. Most countries, including those with an Anglo-Saxon tradition only allow transfer of resource ownership upon production.

Private Ownership of O&G Resources

The concept of *private ownership* of natural resources is not alien to stakeholders in the resource industry. Although rare, countries like the US and Canada allow this form of ownership. Under the US system, a company may obtain ownership/title in two ways: by purchasing **land in fee** –both mineral rights and surface rights are acquired, or through **leasing**³⁰⁷ in which case both mineral rights and surface rights are secured separately. Historically, classic concessions granted to western oil companies by Middle Eastern sheiks transferred ownership of O&G in the ground to them. In the absence of a rival concept and considering that Middle Eastern kingdoms were weak during early development of the industry, early concessions reflected this reality. They granted companies ownership of O&G resources in licensed areas in return for a bonus, royalty and exemption from other domestic sovereign tax obligations. Examples include the 1933 concession granted to **Socal** by the King of Saudi Arabia, the **Gulf** concession by Kuwait and **IPC** concession by Iraq.³⁰⁸ These were often one-sided deals burdened by untenable shortcomings amongst which were: long leases -99 years, covering vast areas, with little financial benefits for the grantor; and for which ownership of resources passed to companies without an option to renegotiate. A substantially better -but not conceptually different- concession was that granted by the Shah of Persia to **William D’Arcy** in 1901. The Shah netted a bonus of \$100,000, royalty of 16% and \$100,000 worth of stock in D’Arcy’s company at a time when others only secured fix royalties, little or no bonuses and rarely any stocks in companies.³⁰⁹ Today, concessions are much different from those described above.³¹⁰

³⁰⁶ Johnston (1994), supra note 120 at p.21

³⁰⁷ By 1930s a standard O&G lease had evolved to guarantee the landowner royalty of 1/8 production in case of oil, and 1/8 sales price in case of gas; the lease terminated after 5 or 10 years depending on the lease term, if drilling and production does not occur at the end of the primary term

³⁰⁸ Suleiman, A., *The Oil Experience of the Middle East Emirates and Its Legal Framework*, 6 J.E.N.R.L 1,3 (1984)

³⁰⁹ Resulted in the creation of Anglo-Persian Oil Company to control D’Arcy & Burmah Oil’s interest when oil was finally stroke in 1908. During renegotiation of the D’Arcy concession in 1933 the Shah secured (i) a fixed royalty of 4 shillings per ton, i.e. protection against price fluctuations, (ii) the right to receive 20% of the company’s worldwide profits, (3) minimum annual payment of £750,000, and (4) an engagement to speedup the *Persianization* of the work force

³¹⁰ As states became concessions were renegotiated to: (i) reduce concession areas to blocks with restrictions placed on the number of blocks a single company could bid for, (ii) relinquishment provisions were introduced; (iii) financial return was significantly improved with bonuses, royalty, income tax, special petroleum taxes; etc.

State Ownership of Petroleum Resources

In most countries around the world the trend has been for states to retain ownership of all natural resources. Oil in the ground is owned by the host country, held on trust for the people by their government and can only pass to companies at **wellhead** or some other **agreed point** after extraction. Here, concessions are granted to produce oil (at wellhead) and to dispose of the same, subject to payment of royalty, taxes, and the performance of domestic market obligations (DMOs). This explains why it is also referred to as the R/T system. A concession is therefore an agreement or standard license between the host government and an oil company granting it exclusive rights to engage in petroleum activities (explore, drill, produce, store, transport and sell petroleum) within the designated concession acreage for a fixed period of time.³¹¹ Both developed (UK, Canada) and developing (Cameroon, Chad, Gabon) countries operate this system.

Back of the Envelope Computation and Analysis of R/T System

In designing R/T systems, host government are guided by an objective to capture as much economic rent as possible in a manner that doesn't affect project economics. That is, host countries should tax all of windfall profits earned by oil companies. This trend actually started between the 1940s and early '50s when producing states became dissatisfied with the fact that companies and home governments earned more revenues from oil resources than they did.³¹² For example, in the 1950s Aramco³¹³ paid only 21 cents/bbl in royalties to Saudi Arabia even though the barrel sold above \$2. Today it is not uncommon to find royalty, various layers of taxes, sliding scales or "R" factor mechanisms built into these systems to improve government's share of oil revenues.³¹⁴

Sample Back of the Envelope Computation

Let us assume that a barrel of crude oil sells at \$120, cost is \$54, a royalty charge of 20%, provincial taxes of 10%, and federal income taxes of 40%. Below is a simple R/T flow diagram.³¹⁵

³¹¹ Blinn, et al, *International Petroleum Exploration and Exploitation Agreements*, (1986)

³¹² Yergin (2009), *supra* note 216 at p.413

³¹³ Emerged from Casoc (California-Arabian Standard Oil Company) owned by Socal & Texaco; in 1943 the US gov't acquired 1/3rd stake in Casoc for \$40 millions, used to finance a new refinery at Ras Tanura. Government had right to buy 51% of Casoc production in peacetime & 100% in wartime but the deal failed; in 1946 Socal & Texaco opened negotiations with Standard Oil of New Jersey, to broaden the joint venture resulting in Aramco (1947) with the following holdings: Socal (Chevron) -30%, Texaco -30%, Standard of Jersey (Exxon) -30%, and Sacony-Vacuum (Mobil) -10% in

³¹⁴ Some of these systems tend to be hybrids. Cameroon actually operates a few of these kind of contracts

³¹⁵ *Infra*, see Chapters 4 for further details on how pricing systems can be manipulated

Table: 3-5: R/T System Flow Diagram

SYSTEM FLOW	US\$/BBL	CONTRACTOR SHARE	GOVERNMENT SHARE
One Barrel of Oil	\$120.00		
Royalty 20%	\$ 24.00		\$24.00
Net revenue	\$ 96.00		
Deductions	\$ 54.00	\$54.00	
Taxable income	\$ 42.00		
Provincial taxes 10%	\$ 4.20		\$4.20
	\$ 37.80		
Federal Income Tax 40%	\$ 15.12		\$15.12
Net income after tax	\$ 22.68	\$22.68	
TAKE (figures)		\$76.68	\$43.32
TAKE (rate)		64%	36%

In the example above, we use the value (\$120/bbl) and not physical output (barrel) to determine government and operators shares. Some countries (e.g. Nigeria) require that payment is done in kind, in which case take is calculated on physical barrels as opposed to values. Notwithstanding the method payment chosen, three main instruments are used to share revenues under a R/T system. **First**, royalties are charged on gross revenues right off the top at an agreed point, leaving net-revenues of \$96.00 (*gross revenues – royalty = net revenue*). **Next**, Capex and Opex are deducted in order to get taxable income (*net revenue–deductions = taxable income*). **Finally**, an income, supplementary, or other form of profit-based taxes is charged on taxable income to get the operators after tax profit (*taxable income–taxes = net income after tax*). It is worth noting that this illustration is kept fairly simple given that in many countries today, royalty collected on the basis of a sliding scale, cost recovery is ring-fenced, and other specifics render these systems way more complex than it looks above. One can, on basis of the flow diagram above, observe that royalty and income tax payments are susceptible to transfer price manipulations. **Royalty** is mostly computed using values such that the *valuation of crude* is highly important. If paid in kind, the issue does not arise. With respect to income and other profit-based taxes, two main issues often arise regarding the deductibility of expenses. Are certain costs allowed for tax purposes? And are deductible costs properly valued? The prices used to value both revenues and costs for intra-group transactions are matters of great concern with far reaching implications, some of which are seen in later chapters.

Contractual Systems: Production Sharing Contract (PSC)

There are primarily two types of contractual systems used to develop petroleum resources: production sharing and service contracts. Under **risk service** contracts an oil company contracts with

the host government to explore an area and to evaluate discoveries. If no commercial deposits are found, the company is not compensated. Thus the company bears the financial risk involved in exploration, but does not have title to the service area or resource. In deed, title does not pass at any stage of the exploration process to the company. If however commercial reserves are found, it might be by required contract to bring these on-stream, receive payment for its service and is often allowed the option to buyback crude from the area at discounted prices.³¹⁶ The taxation of IOCs operating under these contracts is pretty much the same as companies operating in non-extractive sectors. On account of this and for purposes of this study, our interest is in examining PSCs.

The concept of production sharing first originated in Venezuela and later adopted by Iran and Indonesia in the 1950s and 1960s. It is widely used today to develop hydrocarbons outside the OECD countries. Under the PSC a country grants an oil company a contractual right to explore for hydrocarbons within a specified area and in the event that commercial deposits are found, the right to produce the resource. Also guaranteed are the rights to recover pre-production (sometimes) and production costs and to earn agreed profits for the effort. The host country contributes the acreage, is entitled to a share of production, and exercises the right to tax the company's share of profits (in most cases). Unlike concessions that are *administrative contracts*,³¹⁷ PSCs are *binding commercial contracts* in which the rights and conditions of E&P are *agreed* between IOCs and the state. Unlike concessions, O&G is owned by the state and it takes a government's explicit consent after lifting for ownership to pass to a contractor at an agreed point of delivery (for in country sales) or point of export (for sales abroad). Since many exporting countries lack the capital and technical knowhow to produce oil deposits, IOCs habitually employ their technical knowhow and funds to ensure success of E&P projects. Further, it is rare for governments to contribute to pre-production funds, and typically rely on the contractor to carry them through E&P with guarantees of compensation as a share of production or cash-fee if effort is successful. The difficult part is compensating contractors adequately for their risk and work. Under PSCs clarity is needed over: *which* and *how* costs would be reimbursed; interests to be paid for financing operations; revenues to be received by the state during cost recovery; whether royalty, bonuses, taxes and others will be directly paid by IOCs from their share of oil; and what should happen after the IOC has been reimbursed completely.³¹⁸

³¹⁶ Smith (1993), *supra* note 36 at p.379

³¹⁷ See Daintith, T., (Ed.) *The Legal Character of Petroleum License: A Comparative Perspective* (1982)

³¹⁸ Smith (1993), *supra* note 36 at p.342

An example of a petroleum regime that offers a comprehensive mix of fiscal instruments is the Indonesian PSC. This model PSC has evolved through generations more or less in terms of actual fiscal terms than contract features. First generation Indonesian PSC's secured a stable share of at least 49% of annual production for the country. Fiscal terms included *capping of cost recovery* at 40% of total revenues in any single year; the balance thereof (60% revenues) being *profit oil* was split at 65% to 35% in favor of government.³¹⁹ Under this cost recovery system, companies were expected to recover E&P costs within 3-5 years. Indonesia's national oil company (PERTAMINA) paid all contractor taxes *in lieu* from its 65% share. Following the first oil shock in 1973 IOCs began earning windfalls due to price increases, such that government in 1974 devised a mechanism to capture part of this windfall. This mechanism allowed PERTAMINA to amend the contractor's equity share in line with a base price valuation of \$5/bbl, escalating proportionally with rising oil prices so that any difference between the base price and actual sales price constituted a windfall to be split between PERTAMINA and the contractor at 85% to 15% in favor of the former.³²⁰

Sample Back of the Envelope Computation and Analysis of PSC's

The distribution of resource wealth under PSCs is slightly more complex than it is under the R/T system. The nature of distribution of revenues and taxation of companies is very different.

Table 3-6: PSC Flow Diagram

SYSTEM FLOW	US\$/BBL	Contractor Share	Government Share
One Barrel of Oil	\$120.00		
Royalty 20%	\$24.00		\$24.00
Net revenue	\$96.00		
Cost Recovery (40% limit)	\$38.40	\$38.40	
Profit Oil	\$57.60		
Profit Oil split 45/65%	\$23.04/34.56		\$34.56
Tax on Contractor share 30%	\$6.91		\$6.91
Net contractor income after-tax	\$16.13	\$16.13	
Take Statistics (Figures)		\$54.53	\$65.47
Take Statistics (Rate)		45.44%	54.56%

³¹⁹ In Section VI, 1.3 of the 1977 Model Contract, the profit oil split was fixed at 65.0901% and 34.0909% in favor of government

³²⁰ Fabrikant, R., *Production Sharing Contracts in the Indonesian Petroleum Industry*, 16 Harv. Int'l. L. J. (1975) 303; Machmud, T., *The Indonesian Oil and Gas Industry – Its Evolution and Current State*, 3(1) OGEL - www.gasandoil.com/ogel/ (March 2005)

The first stage relating to determination of *net-revenues* is pretty much the same as in R/T systems. However, it actually changes from the second layer of the flow diagram. The concept of state ownership discussed earlier means that the contractor is only entitled at this stage to recoup its investments by recovering costs (Capex and Opex). The portion of oil allocated for this purpose is called **Cost Oil**. States are wary of companies cheating on costs and have tended to impose *cost ceilings* or *cost recovery limits* in PSC systems. These are in fact limits placed by governments on how much cost a contractor may recover in any one year (often between 30-60% of revenues), although unrecovered costs can be carried forward into subsequent years. This ceiling guarantees early cash flows to governments since a minimum amount of profit oil is made available for sharing between contract parties during early stages of the project. That is, recovery of initial E&P costs is scheduled over a longer period. Ceilings are less important in later stages of a project because the contractor would have recovered much of its initial capital outlay, and is left with mostly operating costs to recover representing about 15-30% of revenues. Once cost oil is recovered what is available for sharing is called **Profit Oil** ($net\ revenues - cost\ oil = profit\ oil$).

At the third stage, there is a split of profit oil between the state and contractor on the basis of a ratio agreed in the contract. This varies between countries, but almost always favors the state ($profit\ oil \times \dots \% = government\ share$). The remainder, that is, what remains in the profit oil basket after the state has taken its share is the contractor's share of profit oil ($profit\ oil - GS = contractors\ share$). Government then imposes a final layer of tax, on the contractor's share of profit oil ($contractors\ share - tax = net\ after-tax\ revenues$). As with the R/T system discussed earlier, this PSC has been kept fairly simple. Many other fiscal terms and instruments have not been factored into this design. These include amongst others domestic market obligations, bonuses, investment credits, uplifts and government participation. Suffice to note that prices used to value crude especially in controlled intragroup transactions is an issue of great concern in PSCs. In most cases, regardless of whether government accepts payment in kind or cash, or both kind and cash, it is always necessary to establish a price at which physical stock of crude will be valued and/or converted to dollars for purposes of calculating cost recovery, taxes and internal transfers. An added dimension of complexity is created by many layers of taxation and direct state involvement in operations under PSCs. These issues are further examined in Chapter 4.

3.2.2 Petroleum Fiscal Instruments

Fiscal instruments applied to the O&G sector can be broadly classified into profit and non-profits based categories. Some of these instruments are only applied to minerals and hydrocarbons while others are applied to most other businesses. Examples of taxes that fall within the common domain are the income, capital and wealth, sales, value added, payroll, and withholding taxes for *remittances abroad*;³²¹ import and export duties, land rents, application and registration fees, stamp duties, local taxes and environmental taxes. Due to the limited scope of this work, we limit our analyses to special taxes applied on extractives. For convenience, we hereinafter classify these special taxes into **revenue** (3.2.2.1) and **profit** (3.2.2.2) based instruments. We pay a little more attention to instruments whose yield is likely influenced by pricing considerations, including royalty, bonuses, bid auctions, surtax, resource rent tax, brown tax, petroleum revenue or special tax. Some of these devices are the result of creative efforts by dissatisfied governments to capture more economic rent than they currently do when oil prices are substantially high.

3.2.2.1 Revenue (Non-Profit) Based Instruments

Bonus Payments –Bid, Signature, Production

Bonuses are lump sum payments made by the licensee/contractor to the host government upon occurrence of some specified event at some determined point in the resource value chain. Often bonuses are paid upon: the host government signing a contract, discovery of commercial deposits, attaining production thresholds, startup, payout, and relinquishment. The precise bonus to be paid is determined in one of three ways, namely, via bidding process, negotiations or simply fixed by statute. Governments find bonuses attractive because it guarantees early revenues for the host country regardless of exploration efforts turning successful or not. However, these payments have a regressive effect and could in many cases impact project cash flows negatively. Unless prospectivity is high governments need to keep bonuses at commercially acceptable levels to attract investors. Often, two types of bonuses are built into O&G fiscal systems namely: (i) *standard* bonuses and (ii) *bid* auctions. Companies pay **standard** bonuses that take the forms of *signature*, *discovery*, *production* or other recent variations on *startups*, *cumulative production*, *payout* ('R factor'), and

³²¹ Otto, J.M., *Mineral Sector Taxation Methods: A Global Review*, in *Minerals Industry Taxation policies for Asia and the Pacific*, p.15 (1992)

relinquishment.³²² These could be left open for negotiation especially in cases where prospectivity causes companies to show little or much interests over blocks open for bids. For its part, **bid auctions** are designed to target economic rents. Interested investors place closed bids and the contract is awarded to the investor with the highest bid. This is premised on the thinking that investors are best judges of extractable rent, and would voluntarily only bid a value reflecting the company's true assessment of prospectivity in the bid area.

Royalty Payments –Specific, Ad-valorem

Traditionally, royalty is the principal reward to landlords for granting tenants access and use of land.³²³ It is variously referred to as royalty tax, production tax, products tax or severance tax. Technically it is a charge (not a tax) for extracting depletable resources. Royalties broadly fall within one of two categories namely: (i) *specific* or *unit of production*, and (ii) *ad-valorem* royalty. As concerns **Specific Royalty**, the amount payable is pegged to physical quantities and quoted as US\$/ton, US\$/ounce, US\$/barrel or equivalent measures. From an administrative standpoint, Unit based royalties are easy to handle since the state only has to worry about monitoring volumes produced, and not price movements. Although this has the advantage of securing constant cash flows, it is disadvantageous in that government revenue does not increase with market prices nor takes into account inflationary pressures. Some countries use **Ad-valorem Royalty** systems by which an agreed percentage is charged as royalty on referenced market prices or other agreed value. Payment may be received in kind or cash. By basing calculations on value and not volumes, two major preoccupations relating to the basis, and point of evaluation arise. Firstly, valuation is either based on *actual* or *estimated* sales revenues. Depending on the agreement between parties, prices used would be: (i) the domestic price for the quality of crude at the time of sale, (ii) the FOB price in cases where the crude is exported, or (iii) an external reference price such as Brent, WTI or other spot prices. Secondly, there are four possible points at which crude can be valued for royalty purposes. These are at *export terminal*, *field* (last valve off platform –LVOP, petroleum comes ashore), *wellhead*, and the *reservoir*. Let us assume a barrel is valued at \$120 at export terminal, the following assumed possibilities may determine value at each of the points listed above:

³²²Johnston, D., *International Petroleum Fiscal systems and PSCs Course Workbook*, p.102 (2008); Silvana Tordo, David Johnson & Daniel Johnson, *Petroleum Exploration and Production Rights: Allocation Strategies and Design Issues*, (World Bank, 2010); Silvana Tordo, *Fiscal Systems for Hydrocarbons: Design Issues* (World Bank, 2007)

³²³ Kemp (1987), *supra* note 119 at p.127

Table 3-7: Diverse Valuation Points³²⁴

No.	Item	Full Cost
1	Value at export terminal (FOB)	\$120.00/bbl
	<i>Pipeline tariff</i>	<i>2.00</i>
2	Value at field (LVOP)	\$118.00
	<i>Processing costs</i>	<i>3.00</i>
3	Value at wellhead	\$115.00
	<i>Production costs</i>	<i>4.00</i>
4	Value at reservoir	\$111.00/bbl

If the point of valuation is the wellhead (UK), or value off the reservoir, this poses significant challenges in determining the price. There is need (as illustrated above) to reverse the process from the point of sale to a desired point thus rendering the system even more complex. Final values are not quite accurate in such cases since account needs to be taken and deductions made of relevant costs from sales revenue in order to obtain the royalty base. The trend today is to use actual sale values evidenced by definitive receipts to calculate royalty.³²⁵ In spite of its relative simplicity the classic royalty is criticized for its lack of sensitivity to costs,³²⁶ is not profit based, and therefore has the potential to reduce the NPV of a project. Another shortcoming is that it is often imposed irrespective of field size and might, in certain cases, cause operating profits to turn negative even when gross revenues exceed extraction costs. This non-neutral effect could lead to premature abandonment of mature fields or deter development of marginal ones. Thus many critics view royalties as regressive. While some countries (Norway and UK) have abolished royalty, others have sought ways to address its shortcomings while maintaining the instrument. Mechanisms include sliding scales or R-factors that are designed to improve royalty payments by IOCs as production levels increase³²⁷ and/or make allowance for costs in ascertaining the royalty base.³²⁸

Domestic Market Obligations (DMO's)

DMOs are not very common in the petroleum industry. Only 6% of producing countries in the world require the contractor or licensee to undertake some form of domestic supply. DMOs are

³²⁴ Johnston (2008), supra note 322 at p.113

³²⁵ Otto, J., *Legal approaches to Assessing Mineral Royalties*, in Otto (ed.) *The Taxation of Mineral Enterprises*, p.134 (1995)

³²⁶ As it pushes risks to investor without commensurate cushions against cost increases or price falls

³²⁷ There are two models of sliding scales: incremental and Slab. As concerns incremental, the increased royalty rate is charged only on the portion of increased production; As concerns slab the increased royalty rate is charged on the entire output as opposed to the increased portion only

³²⁸ *Direct deduction* of cost in which case certain clearly defined costs are deducted from the revenues to get the royalty base, and *R-factor* model which is more complicated because it takes into account the cumulative revenues divided by cumulative costs to determine the present day threshold of royalty rate chargeable. Silvana Tordo, et al. (2010), supra note 306

mainly designed to ensure that the host country is constantly supplied at highly discounted prices with a minimum quantity of O&G made available for domestic use. In cases where they exist, the oil agreement would stipulate that the contractor is required to sell to the host government an agreed portion of its share of oil at discounted prices. Trends indicate that DMO sales are often discounted at between 15%-35% of market prices. The host country sometimes requires that the contractor accept payment in local currency at predetermined exchange rates. An example of a country that requires IOCs to supply its domestic market is Indonesia. Under standard post-1996 contracts, the contractor is required to supply domestic markets with 25% of its share of crude oil (whereby contractor entitlement is 26.79%) at a discounted price equal to 25% of market prices.³²⁹ In others countries, DMO's are optional upon request of the host government (Equatorial Guinea).

Of these instruments it is worth noting that governments risk losing revenues as ad-valorem royalties if IOCs manipulate TP. This outcome is also likely in respect of production bonuses if the R-factor (rather than direct sliding scales) is used as mechanism for determining the applicable bonus threshold. It would be noted that the R-factor is determined using cumulative values of revenues earned and costs incurred in relation to acreage area such that **intragroup mispricing's falsify the true ratio factor that is applicable to the contract at any given point.**

3.2.2.2 Profit-Based Fiscal Instruments

Corporate Income (CIT) or Petroleum Profits Tax (PPT)

The Income Tax³³⁰ charge is clearly an important component of both R/T and PSC fiscal regimes. Although most tax legislations around the world refer to taxable income, there is hardly any statutory definition of *income*. Defining income tax has therefore proven notoriously difficult as one sometimes inadvertently brings within its ambit earnings that would ordinarily be excluded from it, or excludes earnings that are normally charged to tax. Lord Macnaghten in the English case of *LCC v. A-G*³³¹ simply stated that 'Income tax, if I may be pardoned for saying so, is a tax on income' and chargeable on annual 'profits' and 'gains'. Nonetheless, to be liable to tax, income must fall within a taxable source listed in the statute or no charge to tax may be placed on such income -*NPI v. Brown*.³³² It is a perfect example of a neutral tax because if income is zero, tax will be zero except in

³²⁹ Johnston (2008), supra note 322 at p.188

³³⁰ Personal income and Corporate income taxes

³³¹ [1900] 4 TC 265 at p. 293

³³² [1921] 8 TC 57

cases where there exists a statutory requirement for taxpayers to pay a minimum or advance income tax.³³³ This peculiarity makes it a perfect target for TPM since a direct correlation exists between the amount of profits transferred abroad and the amount of CIT that the company ends up paying. This also applies to O&G companies that pay CIT or PPT on corporate profits and on chargeable gains. However, the applicable rates might vary if a system is designed as a sliding scale or surtax.³³⁴ CIT rates in the extractives sector range widely between countries from 25 to 55% or more in some countries.³³⁵ For example, Article 17 of the Abu Dhabi concession³³⁶ requires a consortium of IOCs awarded license to pay a basic income tax of 55% on its net-income from operations under the agreement. The rate increases to 65% if production averages 100,000 bbl/day and 85% if it averages 200,000 bbl/day. Thus, a CIT rate of X% is charged on a *tax base* of X amount. Although rates in some cases are similar between countries, the actual tax basis might be significantly different as a result of States offering diverse tax reliefs.³³⁷

Tax Base = Total Revenues – Total Tax Deductions (*Opex, Capex -DD&A, loss carried forward, cost uplifts, abatement of base, etc.*)

Therefore, costs are very important components to examine in determining the CIT base such that host states have tended in almost all contractual arrangements with IOCs to include clear provisions on Accounting Rules. These costs are either deemed as operational and expensed immediately, or capitalized and expensed over a period of time defined by statute or contract. The extent to which a government shares in investment risks is reflected in legislation often through provision of allowances.³³⁸ By providing an extensive package of tax allowances the host country could transform an otherwise unattractive petroleum fiscal regime into a highly attractive one. Allowances include: (i) **tax deductions** -*reduction of Opex, interest, and DD&A from the base*, or (ii) **tax credits** -*reduction of amount of tax payable*, (iii) **tax holidays**, and (iv.) **tax abatements**. Further, extra relief could be given to companies as **uplift allowances** on Capex in order to incentivize development of marginal fields. Notwithstanding its apparent neutral character, CIT is limited in two main respects: (i) it fails to allow *threshold returns on capital* by taxing total return to equity; and (ii) in

³³³ For example, Cameroon where a minimum Advance income tax of 1.1% is required

³³⁴ Surtax is a percentage of an existing tax payment. For example a 5% surtax on an income tax of 30% equals an aggregated rate of 31.5%

³³⁵ In Cameroon for example the CIT rate for petroleum sector activities ranges between 35% and 57%

³³⁶ Detlev F. Vagts, *Transnational Business Problems*, p.448 (1986)

³³⁷ James & Nobles (1992), *supra* note 9 at p.214

³³⁸ Kemp (1987), *supra* note 119 at p.132

cases where huge tax reliefs/allowances are permitted, this may create incentives for costs gold-plating, that is, overstated capital and operating costs and TP. In order to correct these limitations, Garnaut and Ross recommend that countries could introduce Higher Rates of Proportional Income Tax (HRPIC) aimed more at economic rent than profits.³³⁹ This could result in increased CIT payments for extractives compared to other industries.

Resource Rent Tax (RRT)

The RRT was first proposed by Garnaut and Ross in 1975³⁴⁰ and is also known as the Additional Profits Tax (APT) or Rate of Return Profit Sharing (RRPS). It aims to tax positive NPV that is actually realized from a project. Put differently, the RRT 'taxes cash flows once their value, cumulated at an appropriately chosen interest rate, becomes positive'.³⁴¹ In principle, it can only be collected from a project when a certain threshold of IRR on total cash flows has been realized.³⁴² Losses under this system are not immediately reimbursed by government, but rather carried forward at same interest rate into and imputed in periods with sufficient positive cash flows. If there is not enough positive cash flows to impute carried over losses, then such losses will have to be imputed only at the end of project life provided cumulative cash flows can cover this. If not, another option would be for government to fully reimburse the tax value of any unrelieved losses at the end of the project life. Therefore in designing RRT systems, there are three main parameters that need to be taken into consideration: (i) The threshold rate or applicable discount rate to cash flows for purposes of getting NPV, (ii) the applicable RRT Rate, and (iii) types of costs allowed for deductions. It is worth mentioning that RRT is commonly applied alongside other taxes, whereby these taxes are treated as deductible expenses for RRT computation purposes. The potential advantages to investors of states applying this form of rent-based tax are that it is fairly directed only at economic rents, payment is likely to kick in late in the life of a project, and risk borne by investors is lower than for other taxes.

There is in addition to RRT, other types of rent based instruments applied worldwide, namely: (ii) *R-based cash flow tax* (also Brown Tax or supplementary tax in Britain).³⁴³ This is in essence a tax on real as opposed to financial cash flows and no deduction is allowed for financial costs; (ii) the *S-based cash flow tax* imposed on net distributions to shareholders (dividends less new equity) and

³³⁹ Garnaut & Ross (1975), supra note 91

³⁴⁰ Garnaut & Ross (1975), supra note 91

³⁴¹ Daniel et al. (2010), supra note 7 at p.33, notably the chapter by Bryan Land.

³⁴² Garnaut & Ross (1975), supra note 91 at p.277

³⁴³ See Brown, E., *Business-Income Taxation and Investment Incentives*, (1948)

captures rent on both financial and real cash transactions;³⁴⁴ and the *Allowance for corporate equity* (ACE)³⁴⁵ which allows firms to deduct both the interest on finance or debts, and the notional return on their equity. Retained earnings are calculated by using the same depreciation rate that is used to calculate taxable profits.

3.3 Chapter Conclusion

As noted above the petroleum industry is unique from a fiscal perspective and the question of how to *fairly share* resource wealth between states and oil companies is central to debates in the industry. Ideally, the state strikes a balance between optimizing its revenues and providing enough return to encourage investments in this capital-intensive sector. This inevitably results in system designs that are complex and often heavily loaded with instruments aimed at capturing most, if not all of the resource rent generated by O&G operations. The panoply of taxes paid and complexity of petroleum fiscal regimes places huge compliance burdens on both IOCs and government agencies charged with implementing the same. It is worth noting that the challenge is deepened by the fact that most O&G companies (e.g. ExxonMobil, Shell, BP) are horizontally or vertically integrated businesses that operate worldwide as a controlled network of subsidiaries and affiliates.

The importance of prices in ascertaining tax basis cannot be overemphasized and one can, on the basis of analysis in this chapter conclude that two main types of markets exists in which O&G are traded.. The one is an **open market** in which independent and unrelated firms buy and sell crude, goods or services; and the other a **controlled market** in which similar transactions for which TP's are charged take place on an intragroup basis. In section 3.1.2, we discussed the various pricing systems (*posted, netback, spot/futures*) and note that exporters nowadays prefer spot prices. Broadly nowadays, the market pecks prices to accepted marker crudes like –*WTI, Brent* and *Oman*. We highlighted key weaknesses of this system and also pointed out that several factors (API gravity, sulfur impurities) need to be taken into account when adjusting spot prices of specific crudes. This is because spot prices quoted on exchanges are merely indicative, requiring one to take a closer look at transactional details in order to ascertain actual TP's. It was also argued, albeit sparingly, that crude and other prices impact tax basis an with it a country's fiscal yield from petroleum operations. Indeed,

³⁴⁴ Meade, J., *The Structure and Reform of Direct Taxation*, (1978)

³⁴⁵ This system has been tested today: Belgium uses it; Brazil and Italy have previously or still use it.

a government's ability to get a fair share of tax revenues largely depends on the proper or improper pricing of its crudes.

Finally, we examined and illustrated by way of system flow diagrams that two petroleum fiscal regimes are commonly used around the world to apportion resource wealth. These are the royalty/tax and production sharing systems. Looking at the flow diagrams it may be argued that the R/T structures are more vulnerable to TPM than PSCs. The basis on which these assertions are made shall be examined in Chapter 4. Further, we noted that crude or other mispricing's can impact actual payments in terms of production bonuses, royalty, income tax or other fiscal liabilities to which IOCs are subject. Likewise, it matters whether payment of these taxes is done in **cash or kind**. If made in cash, the risk of TPM is relatively high since the IOC values the crude and pays taxes on the value that it gives. If payment is made in **kind**, it is unlikely that transfer prices will be substantially manipulated since governments receive taxes as a share of produced volumes and themselves convert it via sale into revenues. Further, in sub-section 3.2.2.2 we examined the basic structures of both profit-based and non-profit based fiscal instruments used to split resource wealth. Some of these instruments are susceptible to mispricing practices. Therefore, in the chapter that follows we examine if and how crude oil pricing systems and other cost elements are manipulated by IOCs to minimize tax liabilities. This includes presenting and discussing globally available cases in which governments have detected and redressed TPM in the O&G sector.

PART II

SUBSTANTIVE ANALYSIS ON EFFECTIVENESS OF TP ANTI-AVOIDANCE REGIMES IN THE GOG

CHAPTER 4

EVIDENCE OF TRANSFER PRICE MANIPULATION IN THE OIL INDUSTRY

The trend since the start of the 21st Century has been to globalize world trade resulting in enormous cross-border transfers of goods and services much of which are exchanged between related parties. Statistically, the WTO estimates that about 1/3rd of total annual trade are related party transactions.³⁴⁶ As far as oil is concerned estimates of related party transactions stand at about 60%. This trend is showing no signs of easing up given that BRICS³⁴⁷ nations are joining their western counterparts to compete globally for the control of energy resources. Indeed, as companies expand their operations abroad a need emerges to build appropriate cross-border channels to trade these resources.³⁴⁸ Further, expansions abroad inevitably result in increased tax liability and in many cases a desire to counter the effects of such tax increases given that firms are predisposed to optimize after tax profits. The risk to governments that IOCs might create undue tax advantages for themselves by unduly shifting taxable profits between jurisdictions is high. Therefore, in response to the 2nd research question [see chapter 1.3] we hereinafter examine available evidence of the extent of TPM and the mechanisms that have been used by IOCs to achieve this end.

It is worth emphasizing the point earlier made in chapter 2.1 that there are different perspectives on the use of TP by companies. It would be recalled that the international taxation discipline mainly took the view that MNEs used TP to minimize their tax liability, a practice referred to in the literature as TPM.³⁴⁹ The argument on the importance of investigating this issue in the GoG was also made in chapter 1 especially given that economic transformation in the region is highly tied to extractives revenues. Coupled with fears that IOCs may use TPM to erode domestic tax bases one is inclined to wonder if there exists sufficient evidence to support claims that IOCs engage in TPM globally and whether the practice, if it exists, extends to their GoG operations. From a policy

³⁴⁶ WTO, *referenced in* Mehafdi, M., *The Ethics of International Transfer Pricing*, JBE (Dec, 2000); while other sources place it at about 50% Reich, R., *Havard International Review* (summer 1991)

³⁴⁷ Brazil, Russia, India, China and South Africa. Represent 25% of global GDP; More than half of global growth in 2012

³⁴⁸ PWYP Norway, *Piping Profits*, (2011); As an indication of how extended these networks are **ten** of the worlds most **powerful resource companies** are estimated to own 6038 subsidiaries of which 2038 are found in tax havens.

³⁴⁹ TP are applied to: (1) international/cross-border transactions where parties operate from separate tax jurisdictions, or (2) domestic transactions if related parties operate in same jurisdiction

standpoint, answers to these questions should comprise the basis for authorities to reform existing regimes.³⁵⁰ With this in mind the chapter reviews evidence of TPM drawn from inferences by commentators, litigation and published research (Section 4.2). Given however the complex and challenging nature of the subject it has proven essential to precede any discussions of the evidence, by explaining fundamentals on the workings of TPM using *model avoidance schemes* (4.1).

4.1 Fundamentals of TPM: Model Schemes

In principle, IOCs could manipulate transfer prices relating to both revenue and cost elements including transactions relating to crude oil, technical assistance fees, royalty payments, or financing. The goal as illustrated in the diagrams below is to boost post-tax earnings by reporting higher taxable profits in countries where taxes are lower.³⁵¹ Three main techniques have been used to achieve this end including the reduction of taxable incomes arising in high tax countries, lodging earnings and/or investment income in low tax jurisdictions for as long as possible by delaying the same from entering high tax jurisdictions, and moving financial operations to low tax jurisdictions. These mechanisms can be directly engaged between two or more related companies without necessarily using intermediates in tax havens -*direct transactions* (4.1.1), or by arranging such transactions to involve associated/related intermediaries in tax havens -*indirect transactions* (4.1.2). The evidence of TPM discussed in section 4.2 [infra] involves one or more aspects of the mechanisms presented below.

4.1.1 Direct Transactions -*Between Two Related Parties*

Direct transactions between two related parties are less complex and easy to plan. It simply entails IOCs moving profits from high tax to low tax jurisdictions via setting controlled prices (non arm's-length) for intragroup transactions if the incentive and ability to do so exists.³⁵² Below is a schematic of mispriced intragroup transactions (costs and revenues). The parent Oil Co. 'A' [hereinafter '*Parent*'] is tax resident in Country X with an Effective Marginal Tax Rate (EMTR) of 40%. It's wholly owned refining subsidiary Oil Co. 'B' [*Refinery*] is tax resident in Country Y with an EMTR

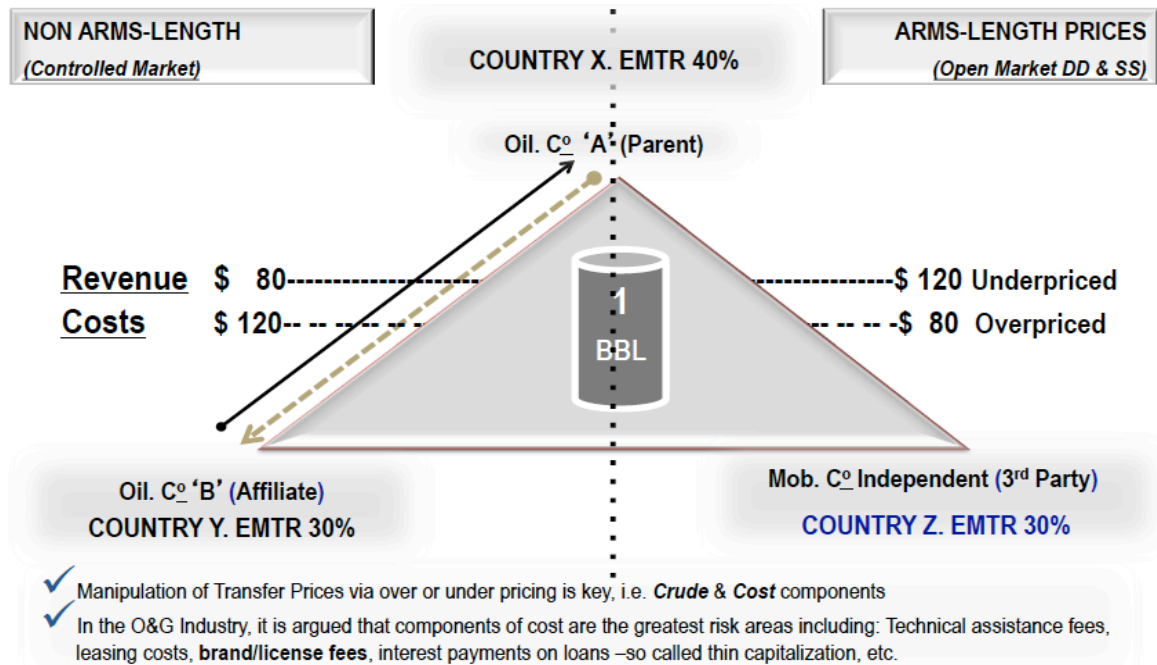
³⁵⁰ These questions should assist authorities to: (i) fully appreciate the importance of O&G as a potential source of the scale of funds needed to finance economic growth, (ii) understand that there exists the risk that governments are not getting a fair share of oil revenues owing to TPM, and (iii) the present structural disposition of the GoG petroleum industry comprise elements that facilitate TPM

³⁵¹ The Economist, 29 January 2004

³⁵² Bernard & Weiner (1989), supra note 83 at p.8

of 30%. Ceteris paribus, 'Parent' by virtue of residence in a high tax country should pay more tax than 'Refinery'. This generates two main scenarios: (i) a situation whereby the IOC could decide to move income from the high tax Country X to the low tax Country Y, or (ii) allocates higher costs in the high tax jurisdiction by shifting such costs from the low tax one.

Figure 4-1: Schematic of Direct TPM Transactions



A. Income Shifting from High to Low Tax Jurisdictions

Supposing that 'Parent' habitually engages in producing crude oil and supplying refined petroleum products to its customers in markets around the world and that crude oil currently sells at \$120/bbl on the open market in Country X. Lets assume that this price is ideal but management determines that a high EMTR of 40% substantially erodes profits earned on sales to a non-related company Mob. Co.['Independent']. If a decision is made to optimize profits by keeping tax costs low, 'Parent' may incorporate 'Refinery' in Country Y; followed by mispriced transactions in which 'Refinery' sources from 'Parent' crude that is fed into its distillation systems. If 'Parent' then charges \$ 80/bbl for sales to 'Refinery' at a time when 'Independent' is willing to pay US\$120/bbl the result is that it receives in Country X \$40 less of income than it otherwise would, had the full market price of \$120 been charged on the trade. 'Parent' reports a reduced taxable base in Country X, transferring via underpricing a certain portion of its 'lost' earnings to be taxed in Country Y. Inversely, 'Refinery' in

Country Y reports an equivalent amount in higher earnings. Technically, the group's overall tax costs drops since much of its profits end-up in Country Y where the EMTR is 30% compared to 40% had the profits been lodged in Country X. Therefore, it makes more economic sense in matters of income shifting to report higher revenues in jurisdictions with low EMTRs.³⁵³

B. Costs Allocation from Low to High Tax Jurisdictions

Costs are also used to transfer profits to more favorable tax jurisdictions. Costs are often perceived to be more likely targets for TPM by IOCs, given that comparable crude prices can be easily sourced on commodity exchanges when adjusting perceived mispricing's.³⁵⁴ Major cost areas used by IOCs to shift profits include: (1) leveraged debt finance provided by related parties at above-market interest rates; (2) related parties claiming high technical assistance fees including management or consultancy fees, headquarter expenses, R&D costs; (3) Leasing arrangements in which capital goods and machinery are charged above-market rates by a related lessor; and (4) Royalty payments a good example of which is discussed in 4.2.1.1 infra. If '*Parent*' decides to use cost (Opex and Capex) to optimize operational profits, it would have to shift costs from Country Y (EMTR of 30%) to Country X (EMTR of 40%). Lets assume that '*Refinery*' provides technical assistance to '*Parent*' in sourcing from third parties a specific blend of crude oil needed for its operations. The transaction can be structured so that '*Parent*' overpays for the technical assistance it receives compared to arms-length rates for similar assistance sourced from '*Independent*' an unrelated party. Note that '*Independent*' would have provided assistance to '*Parent*' at \$80, instead of the \$120 charged by '*Refinery*'. Thus, '*Parent*' unduly offsets an extra charge of \$40 against revenues in Country X, while '*Refinery*' unduly reports high earnings in Country Y. If tax is factored into this mix, Oil Co.'s overall tax liability drops as less tax is paid on profits reported in Country Y. These schemes get more complex if profits are shifted via intermediaries resident in tax havens (B).

4.1.2 Indirect Transactions -Via Use of Intermediary in Tax Haven

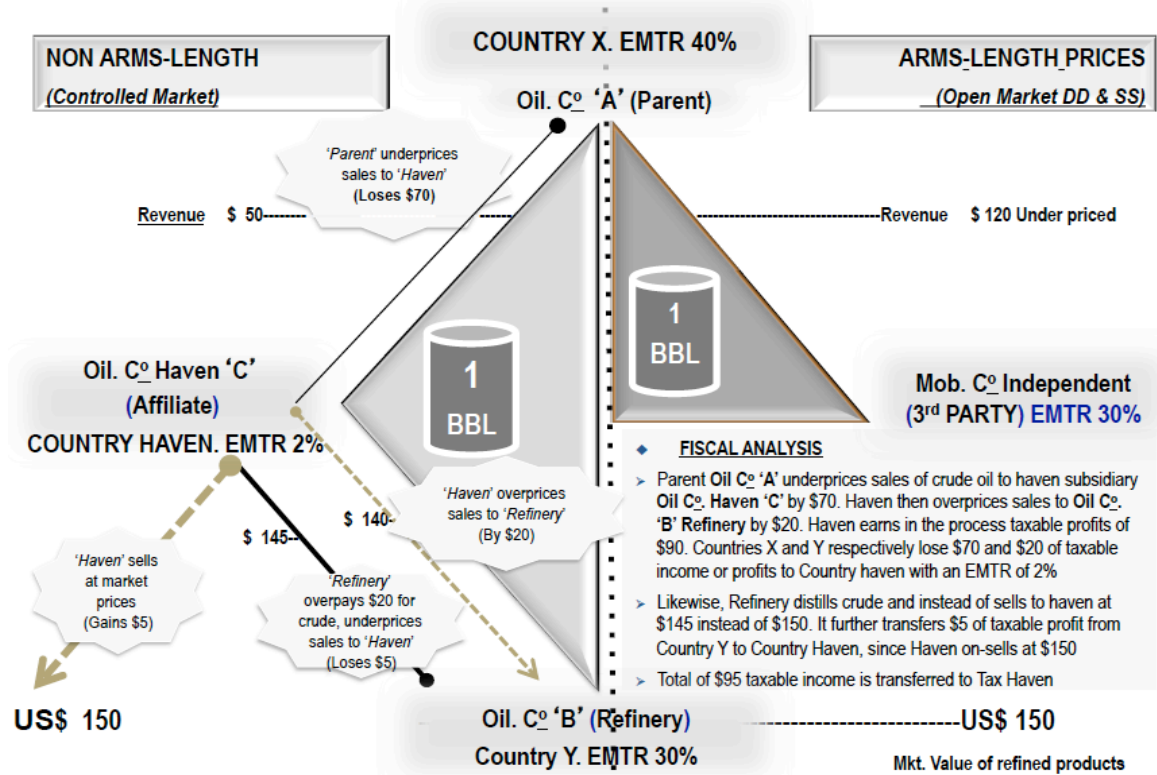
These direct schemes offer only limited advantages compared to possibilities resulting from IOCs using related haven incorporated intermediaries. In the preceding example (A), we showed how intragroup transfers could be used to create undue tax advantages if tax rate differentials exist

³⁵³ Instruments intended to hedge price risk can be used in this way: *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622

³⁵⁴ As discussed in Chapter 3.1.2.1 (B) supra, this is not necessarily correct since over 200 types of crude exists and benchmark prices quoted on exchanges are often only indicative quotations for many crudes

between two countries. Let us assume that 'Parent' decides to further optimize profits by further reducing the groups overall tax liability. This can be achieved by maintaining trade with 'Refinery', while incorporating and routing transactions through a related tax haven intermediary Oil Co. Haven 'C' ['Haven']. Below is a schematic showing transactions with the haven-based intermediary.

Figure 4-2: Schematic of Indirect TPM Transactions -Use of Tax Haven Subsidiary



Due to low or no tax rates haven intermediaries are often used as profit centers while other units of the business serve as loss/cost centers. To illustrate the role of haven-based intermediaries in shifting income from high to low tax countries, we again suppose that 'Parent' (EMTR of 40%) is in the business of producing and supplying crude to customers worldwide. Lets further assume that it controls two wholly owned subsidiaries, 'Refinery' that is tax resident in Country Y (EMTR of 30%) for the purpose of refining crude oil, and another 'Haven' resident in a tax haven (EMTR of 2%) that trades crude oil, petroleum products and services to both group and non-group customers.

A. Income Shifting from High to Low Tax Jurisdictions

In the diagram a barrel of crude oil trades on the open market at \$120/bbl. However, 'Haven' procures underpriced crude from 'Parent' for a mere \$50/bbl. that it then sells to 'Refinery' at an

overpriced \$140/bbl, earning \$90 on the transaction. In effect, the group reports less income in Country X with 40% EMTR while reporting higher costs in Country Y with 30% EMTR. After refining, 'Refinery' underprices sales of petroleum products to 'Haven' at \$145 whereas the same products can be sold to non-related parties for \$150. 'Haven' then sells these products to independent buyers at the full market price of \$150 earning a further \$5 profit. 'Refinery' earns only \$5 (\$145-140) of taxable profits in Country Y, whilst transferring the other \$5 to 'Haven' to be taxed at an EMTR of 2%. By structuring operations in this manner, 'Parent' transfers the bulk of its profits from **Countries X** and **Y**, to its shell subsidiary in **Country Haven**. MNE's can thus misprice sales to subsidiaries for onward transfer to off-takers at market prices. Russia for example, is said to have lost huge amounts in taxes to such transactions. Oil companies exported crude to foreign affiliates for prices as low as \$10 a metric ton, which affiliates then sold the same to independent buyers at market prices of \$120 per metric ton. Gazprom's Jacksonville trading affiliate (ITERA) procured gas from Gazprom at domestic Russian prices of \$2-4/thousand cubic meters and resold at market prices between \$30-90 with profits booked in the US.³⁵⁵

B. Costs Allocation from Low to High Tax Jurisdictions

Tax authorities sometimes encounter cost related schemes with huge implications. Lets assume 'Refinery' develops knowhow on the determination of crude oil qualities, and transfers this to 'Haven' for a measly fee of \$40, which then turns to 'Parent' and provides technical assistance at a relatively high fee of \$60. Provided similar services can be sourced from 'Independent' at \$50, there is overpricing on the market fee by \$10 that 'Parent' then unduly offsets against income for CIT computation purposes in Country X. In other words, Country X charges 40% EMTR on 'Parents' profits short of \$10 that has been unduly transferred to Country Haven. If agreement can be reached between 'Haven' and 'Refinery' so that the former exclusively supplies crude oil to the latter's refinery, this could be structured -in the interest of optimizing overall group profits- in such a way that 'Haven' overprices crude on sales to related group member 'Refinery'. In the diagram, 'Haven' charges \$140 for crude that 'Refinery' could have procured from 'Independent' at a price of \$120. 'Haven' earns a windfall of \$20 whilst 'Refinery' files as deductible costs \$140 instead of \$120 that reflects the true market rate. In both cases, transactions are structured to shift costs to higher tax jurisdictions whilst income is systematically transferred to and charged in a low tax haven.

³⁵⁵ Baker, R., Capitalism's Achilles Heel, pp.152 &156 (2005)

Concrete examples abound of IOCs using lease arrangements for TPM purposes. In the UK North Sea, they were successful in minimizing CIT and PRT tax liabilities by mispricing leases on *Sale and Lease-Back* schemes.³⁵⁶ Companies with interests in North Sea oil fields could raise finance by selling to related firm's assets used in the field, and then leasing them back. For fields subject to PRT sale proceeds were PRT chargeable, all rental payments qualified for PRT relief,³⁵⁷ and the interest component also qualified as deductible cost for CIT purposes. Two main loopholes existed in this system. Oil companies could structure their operations so that no PRT was due although a charge existed on such proceeds, and they could claim CIT relief for rentals and interest payments on leases. IOCs exploited these loopholes by selling assets to related companies at below market prices and then leasing back the assets at rentals above market rates, and in excess of the prices at which they were sold. They took relief of *high rentals* and *interest payments* associated with borrowing the assets even though these transactions were clearly intended to 'game' UK taxes. Reforms to the system subsequently made it impossible to offset rentals that exceeded sale proceeds on which there was an effective PRT charge. In like manner, if finance raised through S&L-B deals were not used for North Sea purposes, the interest element would be disallowed for CIT computation purposes.

4.2 Proof of TPM in the Oil Industry

IOCs operate complex vertically integrated structures with the size and capacity to mobilize funds needed to engage in hugely profitable long-term extractive projects around the world. That these corporations also have the expertise and technological knowhow to shoulder risks linked to such projects, and have the ability to compete efficiently in the markets,³⁵⁸ has made them highly attractive targets of taxation for host and home countries. In some cases these companies have deployed tax avoidance schemes including TPM in order to mitigate tax liability. This section discusses in-depth contemporaneous and case law evidences that IOCs have, and are using TPM to avoid taxes. Companies drawn to such an enterprise often control upstream resources and a web of downstream interests via which cross-border intragroup transactions with real opportunities to shift chargeable profits between tax jurisdictions take place. From this angle, TPM is a problem to oil producing and consuming countries alike. Schemes vary depending on whether the type of intragroup

³⁵⁶ Shipwright (1997), supra note 10 at pp. 442-443

³⁵⁷ However, interest payments did not qualify for PRT relief

³⁵⁸ Smith (1993), supra note 36 at p. 25; Also Jack Calder, in Philip Daniels et (Eds.) supra note 7 at pp. 320-321

transfer is a sale, purchase, finance or other. Further, determinations on the subject by courts have been mix reasoned in part by diverse policy, legal and administrative frameworks in these countries. This section reviews contemporaneous and case law evidences indicating that TPM is an issue of global concern (4.2.1).³⁵⁹ Next we analyze case-law evidence showing that it is an issue of increasing concern to oil producing countries in the GoG (4.2.2).

4.2.1 TPM as an Issue of Global Concern in the Oil Industry

In preceding sections it was asserted that IOCs engage in TPM without necessarily analyzing the available evidence. In this subsection, therefore, evidence affirming that TPM is a challenge to tax authorities in both producing and consuming countries as inferred by experts and commentators on the subject is discussed (4.2.1.1). Given that tax avoidance defeats the very *compulsory* character of taxes and turns compliance into a *voluntary* affair, tax authorities seeking to prevent this alternative paradigm from becoming irreversibly attractive to the wider taxpaying public have often responded by challenging these schemes in law courts *with mixed results* (4.2.1.2).

4.2.1.1 Contemporaneous Insights into Claims of TPM

There is inferential evidence that IOCs have used TP as an elaborate conjuring scheme to essentially reduce their liability to tax. These illicit schemes are designed to optimize corporate profits by cheating governments of taxes resulting sometimes in billions of lost tax revenues. This subsection presents contemporaneous claims of TPM in the oil industry by subject experts, notably: Professor Michael Hudson (A) and the 2005 merger of Shell's UK and Dutch operations by the UK Guardian Newspaper (B).

A. Expert Insight Into the Role and Use of TPM by IOCs (Prof. Hudson)

Early signs that mispricing was being used on an international scale to avoid taxes can be traced back to the oil sector. In a 1965-66 study commissioned by Chase Manhattan Bank on the oil industry's impact on US balance of payments, Prof. Hudson concluded that the oil industry had

³⁵⁹ It affects all major international industries including information technology, pharmaceutical, manufacturing, financial and hydrocarbons. In IT for example, Google during the years 2007-2010 is believed to have reduced US\$ 3.1 billions in taxes by funneling the majority of its foreign profits through Ireland and the Netherlands to Bermuda. In **pharmaceuticals**, GlaxoSmithKline PLC settled a long-standing TP dispute with IRS for US\$ 3.4 billions. The Canadian Tax Court also made similar adjustments on Glaxo Canada's profits (CAD\$ 51 millions).

invented the practice of flying ‘flags of convenience’ in tax havens nearly a century earlier.³⁶⁰ IOCs used this as a means of avoiding income taxes in both *host* and *home* countries. For example, some oil companies registered their tanker companies in Liberia or Panama, which tankers then flew these “flag(s) of convenience” for tax and other purposes. Transportation from this perspective appears to have played an important starting role in the implementation of TPM schemes within the industry. Hudson argued that identifying the point in the value chain at which IOCs effectively earned their profits had always been a challenge since no clear distinction was historically made by integrated IOCs of their exploration, production, transportation, refining or distribution activities.

IOCs created trading companies in tax havens and declared the bulk of their operating profits as having been earned by these companies. Jack Bennett treasurer of Standard Oil of New Jersey (SONJ)³⁶¹ noted that profits were created and shifted between segments of the business right in his office. In effect, IOCs through vertical integrated structures set transfer prices to allocate the bulk of profits in jurisdictions where taxes were lowest as crude oil left the wellhead all the way down to refill stations or fuel pumps.³⁶² SONJ sold crude oil to tanker affiliates at very low prices, which in turn sold the crude at very exorbitant prices to refineries in industrialized countries. A combination of low purchase prices from producers and high sales prices to refiners resulted in excessive profits for transporters in havens. Considering that trading and transport affiliates were resident in tax havens, both host and home governments lost taxes to IOCs. Hudson noted that:

“...Esso and other oil majors were able to “game” the world’s tax systems by selling their crude oil at so low a price to their tanker companies as to leave little income for Saudi Arabia, Venezuela or other oil producing countries...The corporate shipping affiliates turned around and sold their oil to their downstream refineries...located safely offshore... The oil was transferred at so high a price that despite the heavy capital investment in these facilities, the refiners and distributors reported losses year after year, decade after decade.”³⁶³

In most of these cases IOCs sought to avoid taxes by exploiting available loopholes in the law. The objective was to keep profits out of the reach of tax authorities in the US, Europe, and also host countries. An example of how TP schemes can be structured to facilitate the transfer of profits to

³⁶⁰ Schaefer, S., *An interview with Michael Hudson: An Insider Spills the Beans on Offshore Banking Centers*, Counter Punch, 25th March 2004 at <http://www.counterpunch.org/schaefer03252004.html> [Last visited: January 12, 2013]

³⁶¹ Old Esso, latter became Exxon

³⁶² See Chapter 3 supra: Early in the 1950’s Saudi’s rejected similar practices by the Aramco partners

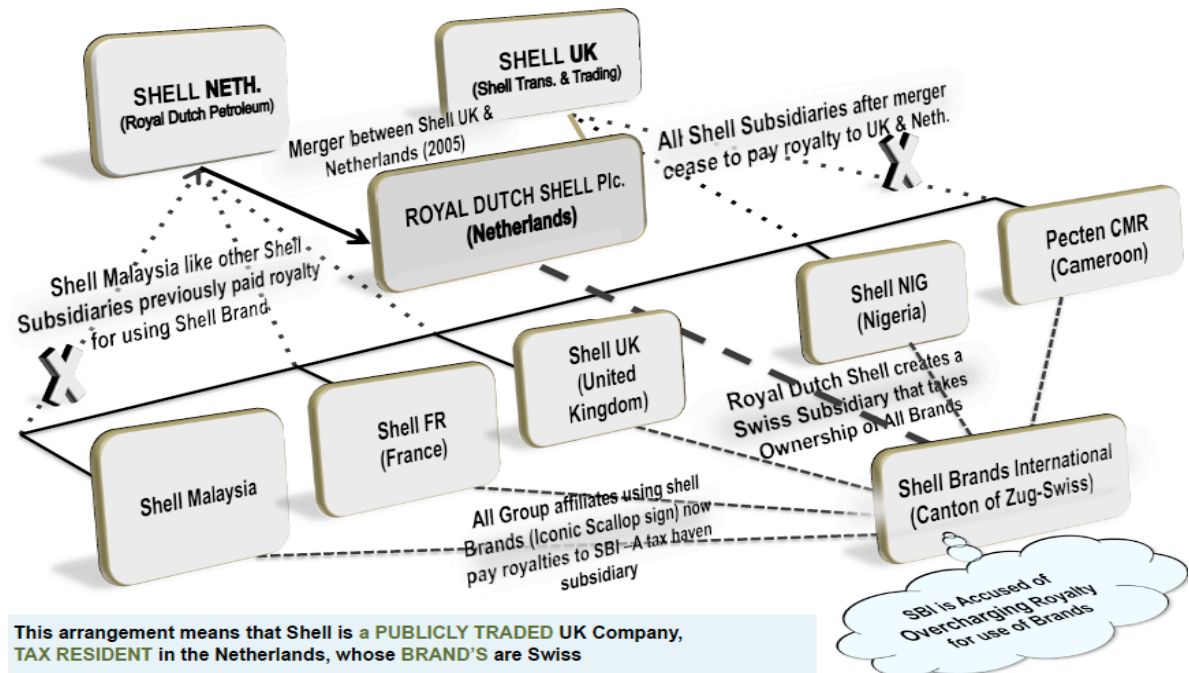
³⁶³ Schaefer (2004), supra note 360

more favorable tax jurisdictions can be seen in the 2005 merger and acquisition (M&A) deal that consolidated Shell UK and Shell Holland into today's Royal Dutch Shell (B).

B. Royal Dutch Shell Merger (2005)³⁶⁴

One might question the exclusive business purpose of M&A deals taking place within the energy sector, worth US\$ 321.5 billions in 2012 alone.³⁶⁵ A good example of such a deal criticized for its non-commercial consideration is the transfer of Shell's tax-residence from the UK to Holland, and the legal ownership of its iconic scallop sign to a Shell subsidiary in the Swiss Canton of Zug.³⁶⁶ The importance to the UK and host countries around the world of Shell's decision to shift operations weighs-in when one takes into account that the groups pretax profits amounted to US\$ 50 billions (£35 billions) in 2007, US\$ 18 billions of which went to paying taxes. In addition, Shell is said to own a string of offshore subsidiaries for the purpose of avoiding taxes. But, how are these factors relevant to the 2005 merger? The transaction is illustrated in the diagram below:

Figure 4-3: Schematic of Indirect TPM Transactions by Use of Tax Haven Subsidiary



³⁶⁴ The Guardian (2011), supra note 51

³⁶⁵ Deloitte, *Stable oil prices support a healthy deal market*, Oil & Gas M&A Report Year-end 2012,

³⁶⁶ The Guardian (2011), supra note 51

In 2002 following the British Chancellor of the Exchequer's (Gordon Brown) announcement that new rules will be introduced to check UK companies transferring tax-residence abroad Ernst & Young moved to incorporate Forthdeal that was transferred to Shell. Shell then merged both its UK and Dutch operations in Forthdeal and renamed it Royal Dutch Shell PLC with tax-residence in Amsterdam where companies can receive tax-free foreign dividends. Secondly, a deal was reached in 2005 by which ownership of the iconic brand –one of the company's most valuable assets- was sold by Shell UK to a newly created subsidiary Shell Brands International AG (SBI) based in Zug. Zug is a small Swiss canton having the following characteristics: an 8% corporate income tax rate, a whopping 18,000 registered companies, a population of about 100,900 people, and covers a small surface area of about 239 KM². Following both transfers, namely Shell's tax-residence to Holland and the legal ownership of Shell brands to Zug *The Guardian* notes that the result is a complex web of integrated legal structures in which "...Shell is now simultaneously a British public company, tax-resident in Amsterdam, whose brands are Swiss."³⁶⁷

From a TPM perspective it is argued that *tax* is the main motive behind Shell's decision to transfer the iconic scallop sign to a controlled subsidiary to Zug. This assertion is based on two reasons both of which should worry tax authorities in the UK and possibly other Shell host countries. Previous to transferring the Scallop sign, subsidiaries paid royalties to Shell UK for the use of certain brands chargeable to UK income taxes. After transfer however, Shell UK now pays royalties to SBI for using its brands. It would be recalled that we identified royalty payments as a high-risk area used for TPM. Further, gains earned from transferring the Shell brand to Zug and the group's tax residence to Amsterdam were chargeable in the UK as Capital gains. However, the UK government was unable to collect any tax as Shell UK was entitled to offset these gains against accumulated losses. In essence SBI as owner of Shell Brands now invoices royalty to Shell subsidiaries and affiliates worldwide using its brands. This presents two main challenges: (i) SBI is structured as a *profit center* resident in a tax haven and paying little tax on income earned from transactions with related companies; and (ii) SBI as a division within the vastly integrated Shell network can be used to shift profits from *host states* to Zug through over-invoiced royalties.

In spite of the above claims it must be noted that Shell has denied tax to be the driving motive behind the 2005 M&A stating that the deal indeed enabled the company to "...maintain tax neutrality... that is, maintain the tax position prevailing before unification." Shell maintains that the

³⁶⁷ Ibid

reason for moving the brand was “entirely commercial”. Hitherto, control of the brands was “very fragmented” and the shift allows for a “more effective and consistent management of the Shell trademarks”.³⁶⁸ Nonetheless, this structure presents opportunities to manipulate royalty payments. Further, this Royal Dutch Shell example illustrates how the restructuring of corporate operations through M&As can facilitate TPM. Whilst tax is not definitively said to have driven the transfer, we note that Shell’s new structure could have serious tax implications for host and home governments around the globe. Further to the above, there are a number of landmark litigations/court cases dealing with claims of TPM in the oil industry (4.2.1.2).

4.2.1.2 Landmark TP Litigations

There is also case law evidence of income and cost-related TPM schemes being engaged in the US, Canada and Russia by IOCs. It is worth noting that laws and regulations on establishing the ALS, compliance with the standard, audits, penalties and appeals differ between countries, as are contexts in which tax authorities apply them. Therefore courts in different countries applying domestic laws to similar facts on mispricing schemes are likely to reach different conclusions. Supposing statutory measures are adopted post litigation to close the gaps that triggered litigation in the first place, it is possible that courts in the same country would reach different conclusions by applying revised laws to the same set of facts as those used to decide the cases discussed below.³⁶⁹ One should, therefore, read these results in the full understanding that findings of avoidance and/or evasion were based on the context and laws existing at the time of litigation. It should be noted that courts in Russia and the US have sometimes agreed with tax authorities that IOCs had engaged in TPM (A). There is evidence that courts in the US and Canada also rejected claims of TPM (B).

A. Successful Claims: The Yukos (2000) and Qui Tam Cases

Tax authorities around the world have successfully convinced courts that IOCs engaged in TPM and have sometimes won huge recalls of unpaid taxes.

The Yukos Case (2000)

Following the auditing of Yukos’ tax payments for tax years 2000, and 2001-2003, Russia’s Tax Ministry sued the company for engaging in ‘an enormous amount of [illegal] assets stripping and

³⁶⁸ Ibid

³⁶⁹ Avi-Yonah, et al. (2011), supra note 29 at Chap.1

transfer pricing³⁷⁰ causing huge financial losses to the state. Yukos was accused of implementing “illegal tax evasion schemes by means of artificially founding dummy companies in the oil and after product movement chain and registering them in territories with preferential tax treatment.” It had then used complex trading schemes known as the “Jurby Lake Structure”³⁷¹ to misprice sales of crude oil and petroleum products to shell entities³⁷² that on-sold the same to domestic and foreign buyers at full market prices. Transactions between these companies were mere illusions as Yukos remained at all material times “the true owner of the oil and after products”,³⁷³ receiving the earnings of its affiliates that were being “funneled... through Menatep”. Indeed, these shell companies neither took physical delivery of the oil or products nor did the materially participate in its storage and transportation. They therefore had no real business purpose and rather merely served to reduce Yukos’ taxes by shifting much of its operational profits to tax havens in contravention –*one would argue*- of Russia’s tax law, tightened in 1998 as part of efforts to fight illegal transfer pricing. The law codifies the principle that intragroup transfer prices should be consistent with market prices. It empowers the Ministry to audit,³⁷⁴ assess additional taxes, and to impose penalties³⁷⁵ if transactional prices diverge upward or downward of 20% of those used in comparable uncontrolled transactions.

Yukos maintained throughout litigation that its tax schemes complied with Russian Tax Law at the time. However, the Moscow Arbitration Court (MAC) upheld deficiency adjustments against Yukos determined at a total sum of US\$ 27.5 billions in principal taxes, interests and penalties.³⁷⁶ The tax bill ultimately forced Yukos into bankruptcy. Yukos’ founder (and CEO) was sentenced to a nine years jail term (later on increased by another *four*) for personal income tax fraud estimated at \$1 billion. Notwithstanding the MAC’s decision in the Yukos case some experts argue that the schemes and strategies were legal under then Russian Tax Law, as they were not clearly illegal during the tax

³⁷⁰ The Observer, 26th March 2006

³⁷¹ Named after a lake in England

³⁷² Yukos registered at least seventeen (17) trading affiliates including OAO Business Oil, Mitra, Vald-Oil, and Forrest-Oil in the ZATO of Lesnoy, thus enjoying tax reliefs granted by local authorities. Further, Yukos incorporated subsidiaries in tax havens including Switzerland (Behles), Liberia (South Petroleum) and the Isle of Man (Baltic petroleum).

³⁷³ Operations and finances of affiliates fell under direct *Yukos* control via placement of directors, power of attorney, and an agreement by which *Yukos* organized the purchase, sale, transport, processing and shipment of oil for a nominal commission of between 0.01-0.5% only.

³⁷⁴ Article 40 (2) of RFTC

³⁷⁵ Article 40 (3) of RFTC

³⁷⁶ Arvedlund, E., *Russian Court Upholds Tax Claim Against Yukos*, New York Times: June 30, 2004

<http://www.nytimes.com/2004/06/30/business/russian-court-upholds-tax-claim-against-yukos.html>. Further, note that similar tax recalls for abusive TP as that taken against Yukos, had been imposed against Lukoil (US\$ 200 millions) and TNK-BP Oil Co. (US\$ 1 Billion).

period that constitutes basis of the dispute.³⁷⁷ The view is taken that the effects suffered in 2003 and early 2004 were the result of an unforeseeable “novel interpretation by authorities of Russian tax law”, highlighting *Yukos* as a classic example of how taxation could be used to expropriate or harm domestic or foreign investment.

However, this view disregards tax related prejudices suffered by the Russian government by the *Yukos* schemes given the strength of arguments that exist in support of the MAC’s decision.³⁷⁸ Firstly, the schemes implemented by *Yukos* and for which deficiency notices were issued were made illegal under *Article 40(1)* of Russia’s tax law since 1998.³⁷⁹ Peter Clateman argues that the Menatep/*Yukos* schemes were “illegal in Russia, as it would be in just about any ...country” and it is hard to find any Russian lawyer who believes the practices to be legal under Russian law. *Yukos’* auditor Ernst & Young opined in its 2002 Audit Report that its financial information provided to auditors did “not constitute complete financial statements... prepared in accordance with international accounting standards.” Further, in *Tax Inspectorate No.5 of Moscow v. ZAO PricewaterhouseCoopers*,³⁸⁰ the Tax Ministry accused PwC of preparing two financial statements for *Yukos*, the one destined for internal use and another concealing tax avoidance that was intended for tax reporting purposes. Although PwC argued that *Yukos* had misled it by providing inaccurate information regarding its financial statements, the Moscow Arbitration Court agreed with the Tax Ministry’s request to render ‘null and void’ a 2002–2004 Audit Service Agreements (ASA) between both companies, and ordered PwC to pay the government US\$ 643,500 in audit fees received from *Yukos*.³⁸¹ PwC’s acknowledgement (in 2006) of inaccuracies in *Yukos’* financial reports is akin to E&Y’s opinion in 2002, and consistent with the Tax Ministry’s decision to disallow for tax purposes abusive TP schemes deployed by *Yukos*.

In view of the above, it can be concluded that the *Yukos Case* proves two key points: (i) Oil companies in Russia were engaged in transfer pricing manipulation intended to minimize their tax liability; and (ii) Russian courts have been forthright in characterizing some transfer pricing schemes as unacceptable avoidance and others as fraud. Where evidence exists to that effect, the Russian

³⁷⁷ This alternative perspective is notably promoted by investment law experts and arbitration tribunals. See *Quaskar de Valores SIVA V.S.A. et al. v. The Russian Federation* [Stockholm, 2012]

³⁷⁸ This proposition is supported by the decision of the ECHR in *Yukos v. Russian Federation*, (*Application no. 14902/04*), 20 Sept 2011.

³⁷⁹ Komisar (2005), *supra* note 53

³⁸⁰ [No. A40-77631/06] Suit commenced on December 14, 2006

³⁸¹ Zakharov, A., *Moscow Arbitration Court Rules Against PwC in Yukos Case*, Reprinted from *Tax Notes International*, p.1196 [March 26, 2007]; Art. 169 of Russia’s Civil Code entitled government to confiscate amounts deemed illegally derived from the illegal activities of *Yukos*

courts have concluded that schemes amounted to tax evasion. Broadly, the Yukos case qualifies as proof of the point that oil companies engage in TPM.

*U.S. ex rel. Johnson et al. v. Shell Oil Co., et al*³⁸²

This was a class action filed under the *Qui Tam* provisions of the Federal False Claim Act.³⁸³ The US Department of Interior (DOI) had issued companies with Mineral Lease Agreements granting them the right to extract oil from US Federal and various Indian lands, in consideration of which they would pay a percentage of the value of the O&G extracted as royalty and severance tax to the US government and Indian tribes. After reviewing tax payments by these companies the plaintiffs (Johnson, Martinek, US) found evidence of underpayments.³⁸⁴ In 1996, they moved to name Shell and other oil majors as defendants in a Texas lawsuit; on grounds of historically underpaying royalties and other taxes on crude oil extracted from these lands pursuant to sections 3729 *et seq.* of the FCA.

Plaintiffs claimed that defendants were engaged in a nationwide conspiracy to shortchange hundreds of millions of dollars in underpaid royalties for crudes produced in the US.³⁸⁵ The DOJ required companies to submit reports reflecting the value of oil produced pursuant to leases administered by the DOI. Instead, they allegedly submitted reports for a ten-year period that undervalued the oil traded resulting in less royalty payments than was otherwise due. Defendants were said to systematically underreport in quantities and values several millions of barrels of oil extracted from US lands, in effect reducing tax payments on their operations since royalty was calculated on deflated base-prices compared to what was effectively received. Defendants had knowledge of and were engaged in unlawful 'schemes and practices' aimed at cheating the US of its share of revenues in royalty.³⁸⁶ Examples of such 'schemes and practices' included using intragroup sales to mask the actual market value of oil traded and paying royalties on the basis of lower-priced "sour" crude oil, which crude was then commingled with and sold as higher-priced "sweet" crudes without adjusting the initial base to make a complementary royalty payment. While plaintiffs initially sought to recover US\$ 5 billions in unpaid royalties and penalties,³⁸⁷ they later agreed to settle for US\$ 400 millions representing about 8% of the initial back tax claim.

³⁸² 31 USC, ED TX No. 9:96 CV66 (E.D. Tex. Lufkin Division)

³⁸³ 31 USC Sections 3729 *et seq.*

³⁸⁴ 33 F.Supp.2d 532

³⁸⁵ Benjamin and Martinek (former employees of the Atlantic Richfield Company -ARCO) both filed the initial suit in 1996. In 1998, the US government joined as plaintiffs in support of B & M claims.

³⁸⁶ 33 F.Supp.2d 533

³⁸⁷ *Qui Tam Suit Seeks Record-Breaking \$5 Billion Recovery*, Texas Lawyer, March 16, 1998

The case supports the argument that IOCs do engage in abusive TP schemes. By agreeing to settle claims filed by plaintiffs for undervaluing output and sales, the oil companies either actively or passively acquiesced to manipulating both transfer volumes and prices for tax purposes. A similar outcome is observed in the case of *Texas Land Office, et al. v. Union Pacific Resources*,³⁸⁸ where petitioners alleged that UPRC had continuously computed and paid royalties on 'posted prices' that it knew to be lower than prices ordinarily charged for such crudes on the markets. UPRC had set-up a marketing subsidiary named Union Pacific Fuels Inc. (UPFI) to either directly or indirectly purchase crude oil from the parent at below market prices, and on-sold it to third parties at full market prices thus earning a substantial profit for which no royalty was paid.³⁸⁹ One could as such reasonably assert that there is valid case law evidence to support the argument that IOCs engaged in TPM, with *Yukos* and *Benjamin Johnson* being two of many case-law authorities affirming this assessment.

B. Unsuccessful Claims: Irving Oil and Aramco Advantage Cases

In spite of the evidence discussed above, the courts have in some cases and for different reasons decided not to uphold claims by tax authorities that IOCs engaged in TPM. The *Irving Oil* case and *Aramco Advantage* cases are good examples of this outcome.

Canada: Irving Oil Limited v. The Queen (Appeal)

Irving Refinery Ltd. (Canada) purchased Middle Eastern oil from Socal during the period of assessments (1971-80). Concerns over the tax consequences of the deal caused Irving to create a subsidiary Irvcal in Bermuda used as a vehicle to acquire crude oil from Socal. Irvcal purportedly bought underpriced crude oil from Socal between 60-65% of actual market prices³⁹⁰ and on-sold the same to Irving Refinery at market prices. The resale price of crude was higher than what Irvcal paid to Socal, thus creating profits in Bermuda whilst building huge deductible expenses in Canada. Thus, Irving had created an extra step, transaction and subsidiary in the chain of operations without necessarily adding value to preexisting operations. The fisc challenged this structure on grounds that

³⁸⁸ No. 95 CV-241, in the District Court of Fayette County, Texas

³⁸⁹ Claims of TPM in the US oil industry are not only limited to court rulings as other sources report deficiencies "in the [royalty and tax] collection system". For example, in 1972 GAO reported that USGS used prices that were artificially set to produce substantially low values when trading crude amongst its subsidiaries. Review of a small fraction of producing wells on federal and Indian lands revealed huge loses in royalties on account of artificially low prices.³⁸⁹ Independent oil producers in California have made similar claims that oil majors are using mispricing schemes to underpay royalties. They have argued that 'posted prices' are a completely artificial means of establishing crude values when crude oil is transferred from a major's production to its refining unit, which transactions are in principle carried out on non-arms length basis (see *The Oil Daily*, May 4, 1995)

³⁹⁰ Socal continue supporting the cost of delivering the crude to Irving Refinery as stipulated in already existing contract

the Bermuda link served no other purpose than to shift taxable profits from Canada to Bermuda. In the 'Irvcal assessments' for tax years 1971 through 1980, the fisc deemed Irvcal to lack a *bona fide* business purpose such that profits earned by the Bermuda subsidiary in fact belonged to and was chargeable against Irving. Irvcal pursuant to s.158 of the Income Tax Act made payments in 1980 through 1982 but filed Notices of Objections in respect of the assessments.

The question at issue turned on whether operations undertaken with Irvcal amounted to tax avoidance. The Tax Court upheld the tax assessments, which decision was appealed to the Federal Court (Trial Division).³⁹¹ The court disregarded initial arrangements between Irving and Socal, basing the relevant question on whether 'fair' prices were charged by Irvcal for crudes supplied to Irving. Muldoon, J., found that Irving acquired crudes from Irvcal at fair market values. The prices were reasonable and when compared to others were established at arm's-length. In its view this was suggestive of a clear business purpose. The Crown appealed the FC's ruling to the Federal Court of Appeal,³⁹² which agreed that the incorporation of Irvcal in Bermuda did not have a *bona fide* business purpose. The FCA saw it as existing for the unique purpose of avoiding taxes, but dismissed appeal on grounds that general anti-avoidance rules provided in s.245 of the Act could not be interpreted in a manner favorable to the Crown. The Crown was denied leave of further appeal to the Supreme Court.

Although the Irvcal scheme is a clear case of TPM, the fisc could not redress the scheme because Canada had simply not put in place the required legal infrastructure to permit this. While Irving's arrangements point to tax avoidance,³⁹³ the decision by Canadian courts not to apply general anti-avoidance rules contained in s.245 reaffirm the prevalent view that specific anti-avoidance rules are needed in order to successfully challenge TPM. Similar reluctance by courts to apply general anti-avoidance rules to TPM was *manifested in the Kenyan case of Unilever Kenya Ltd. (2005)*.

Exxon Corp. & Affiliated Companies v. Commissioner of Internal Revenue;³⁹⁴

The Aramco case is the "largest tax case ever brought by the US government" and is seen as a good example of TP analysis in the petroleum industry.³⁹⁵ Subsequent to Socal obtaining the Saudi

³⁹¹ Carswell Nat 281[1988] 1 C.T.C. 263, 16

³⁹² *The Queen v. Irving Oil Ltd* 91 DTC 5106 (FCA)

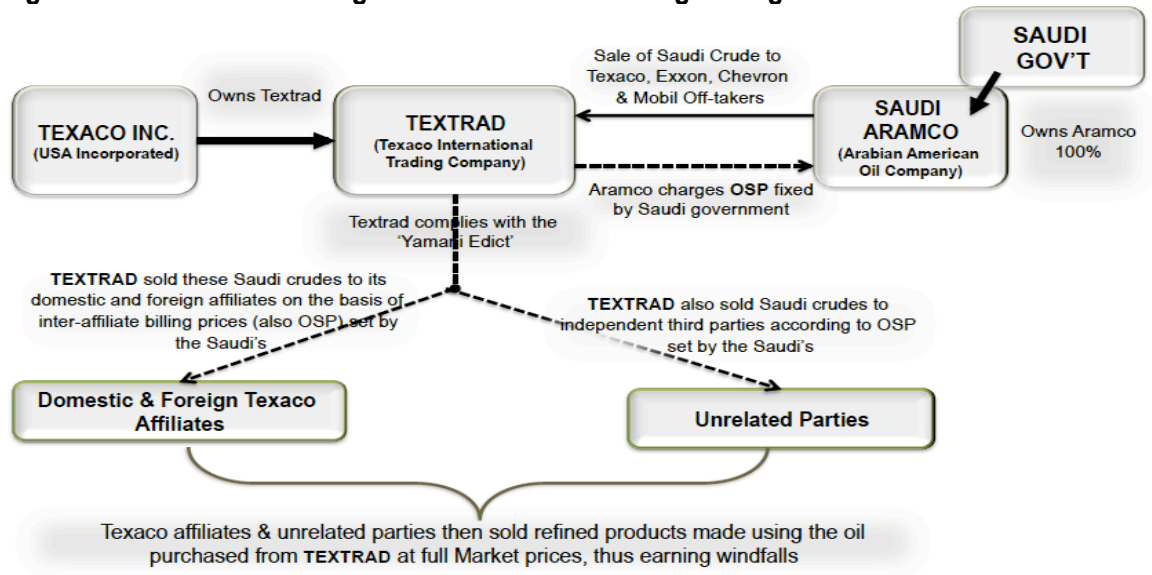
³⁹³ and had the courts adopted step-by-step test (*used in cases of general anti-avoidance*) in deciding the overall effect of these transactions its conclusion might have been different.

³⁹⁴ Exxon, supra note 36. Also *Texaco, Inc. & Subsidiaries v. Commissioner of Internal Revenue*, US Court of Appeals for 5th Circuit's Decision (No. 95-60696, Filed 10/17/96)

³⁹⁵ ITIC Special Report, *Taxes on Profits of Multinational Companies and Their Implications for Russia*, 15th March 2004, at <http://www.iticnet.org/publications/Default.htm> [Last visited: Feb.20, 2009]

Concession in 1933,³⁹⁶ three other majors joined it to create the Arabian American Oil Company (Aramco).³⁹⁷ In 1988 the Saudi government took ownership of Aramco in a deal that allowed all four participating majors to become privileged off-takers of Saudi Aramco's crude oil. The prices at which Saudi crudes sold to off-takers during the years 1979-1981 were lower than market prices. This was basis of IRS's statutory notices for federal income tax deficiencies to Exxon, Texaco, Chevron and Mobil, and subsequent petitions by Exxon and Texaco to the Tax Court (TC). The questions at issue were summarized as follows: (1) whether the Saudi's had imposed restrictions prohibiting the sale of their crudes at prices exceeding Official Selling Prices –OSPs; (2) if so, had petitioners complied with these restrictions; and (3) if so, whether these restrictions and compliance thereof by petitioners precluded IRS from allocating to the parent companies, profits earned by their refining subsidiaries/ affiliates in accordance with TP rules laid down in s.482 of the IRC.³⁹⁸ During the period in dispute petitioners were engaged in producing, refining, transporting and marketing crude and petroleum products in the US and abroad.³⁹⁹ Below is a diagram of transfers that led to tax deficiency recalls.

Figure 4-4: Aramco Advantage Cases –Transfer Pricing Arrangements



³⁹⁶ Against payment of a fee of 50,000 gold pounds, plus another 50,000 gold pounds payable upon discovery and production of hydrocarbons

³⁹⁷ Smith (1993), supra note 36 at p. 303. The Aramco equity structure was as follows: Standard Oil of California -30%, Standard Oil of New Jersey -30%; Texaco -30%; and Mobil Oil Corp -10%.

³⁹⁸ Supra, Chapter 5.2.1 for an analysis of what the relevant rules are

³⁹⁹ Also Chevron and Mobil

By 1979 both Exxon and Texaco⁴⁰⁰ trading subsidiaries accounted for a sizeable portion of Saudi crude off-takes that were then sold to their refining affiliates and third parties worldwide. These crudes were to be sold in accordance with official billing prices set by the Saudi's. OSPs sometimes differed from market prices such that when the price per barrel of oil as a result of the second oil shock more than doubled from \$14 in 1978 to \$35 in 1981, the base prices for Saudi crude's still remained around the \$14 mark.⁴⁰¹ The Saudi position on the prices at which all four Aramco off-takers were to sell Saudi crudes was explicitly stated in Letter 103/z famously known as the *Yamani Edict*. Yamani stated that: "(1) prices charged to the consuming countries for Saudi Arabian Crude Oil will not be higher than the FOB Ras-Tanura prices as conveyed to Aramco plus transportation cost to the particular countries concerned, and (2) Such condition will apply also to the buyers of Saudi Crude Oil through your company." While price restrictions could be enforced up to the point of refining, he later acknowledged that nothing could be done to stop IOCs from making huge profits by selling refined products at full market prices. Indeed Exxon and Texaco affiliates sold refined products to consumers and foreign buyers at full market prices earning huge profits in jurisdictions that were outside the reach of US taxation. IRS in its statutory notices argued that the Commissioner was entitled under s.482 to reallocate profits and charge s.6662 penalties. It accordingly increased sale prices on Saudi crudes and issued tax recalls amounting to US\$ 6.5 billions for Exxon, US\$ 1.5 billions for Texaco, US\$ 550 millions for Chevron and about US\$ 100 millions for Mobil.

The TC found both *majors* to have largely observed Saudi OSPs. It also noted that Letter 103/z effectively placed legal restrictions on the Aramco off-takers not to sell above Saudi OSPs. It determined on the basis of *Commissioner v. First Security Bank*⁴⁰² and *Proctor & Gamble Co. v. Commissioner*⁴⁰³ that petitioners had acted in compliance with these legal restrictions thus precluding IRS from applying s.482 on excess profits purportedly earned by refining subsidiaries and affiliates, wholly or only partly owned by petitioners. The US Court of Appeals (CA) responding to IRS's appeal

⁴⁰⁰ For Exxon: Mediterranean Standard Oil Co., Inc. (MEDSTAN), Exxon International Trading Co., Inc. (EITCO), and Exxon International Saudi Arabia Inc. (EISAI). For Texaco: Texaco International Trader Inc. (Textrad)

⁴⁰¹ OSP's traded at Light-\$14.5, medium-\$14.0, heavy-\$13.6, and Berri-\$15.3. WTRG Economics, *Oil Price History and Analysis*, at <http://www.wtrg.com/prices.htm> [Last visited: Dec. 20, 2008]

⁴⁰² 405 U.S. 394 [1972]; In this case, the Court of Appeal reversed a lower courts decision by ruling that since the parent bank did not receive and was prohibited by US law from receiving sales commissions, IRS could not consider reinsurance premiums as comprising part of the banks income. Exercise by petitioners' of authority under s.482 was unwarranted.

⁴⁰³ 95 T.C. 323 [1990], *aff'd* 961 F.2d 1255 [6th Cir. 1992]; In *Proctor & Gamble*, the same court held that P&G was under no legal obligation to arrange its subsidiaries in such a way as to maximize its tax liability. There was no doubt that the company could legally structure its affairs in its own best interest and unless abuse of such a right is shown, it agreed with the TC that Treas. Reg. §1.482-1(b)(6) did not apply to the case.

of the *Texaco Case* in 1996 upheld the TC's decision. The CA reasoned that IRS could exercise s.482 powers to reallocate profits if a taxpayer had full control over its proceeds and resource allocation processes. If its control of these processes is interfered with by legal or statutory restrictions the courts are inclined to regard as inappropriate the application of s.482 to such circumstances. The CA found that Letter 103/z had the effect of a legal restriction and IRS was without authority to reallocate Texaco's income under s.482. The *Aramco case* -as others on which it was decided- illustrates reluctance on the part of US courts to find abuse simply because a company from a series of transactions ends up paying less tax than it otherwise would had operations been structured differently. If a legal restriction not to earn chargeable income results in reduced tax liability for a law-abiding company, then IRS would be precluded from exercising s.482 authority. Given that that both Chevron and Mobil reached out-of-court settlements and paid back taxes to IRS on the basis of similar facts, one could argue that the facts of these cases would otherwise qualify as TPM.

In both *Irving Oil* and the *Aramco Advantage* cases one observes that the main reason for tax authorities failing to obtain judgment can be attributed to *points of law*, rather than attributed to the facts. While the facts suggest that intragroup transfer prices applied by taxpayers ensured that they ended up paying less taxes than they otherwise would have, these practices did not qualify as manipulation since tax anti-avoidance rules at the time might either not have existed, or regulation simply prohibited the fisc from qualifying them as such in cases where such rules existed.

4.2.2 TPM: An Emerging Concern in the GoG Hydrocarbon Industry

In Chapter 1.2 [supra] the importance of oil in select GoG producing countries was examined, and it was stated that the existing structural disposition of the oil sector creates clear opportunities for TPM. In this subsection, four structural factors that underpin presumptions of TPM in the GoG oil industry are examined (4.2.2.1). Further, the subsection discusses claims that IOCs have through mispricing schemes caused substantial losses in tax revenues to select GoG countries (4.2.2.2).

4.2.2.1 Outlook of GoG Oil Sector -*Potential Tax Implications*

Extreme Dominance of the Sector by Foreign Based IOCs

As demonstrated in section 4.1 the prerequisite for engaging in TPM is the existence of a parent-subsidiary relationship. Ideally, both should be located in different jurisdictions with tax rate

differentials or in some cases, within the same jurisdiction provided two or more fiscal regimes run alongside each other. It was explained that the oil sector in the GoG is mainly dominated by affiliates of international oil *majors* or *independents*. For example, **ExxonMobil** operates in Nigeria, Equatorial Guinea, Chad and Cameroon;⁴⁰⁴ **Shell** operates in Nigeria, Cameroon⁴⁰⁵ and other GoG countries; and **Total** has operating interests in Gabon, Nigeria and Cameroon. The existence of a parent-subsidary relationship between these IOCs and their GoG affiliates create opportunities for TPM.

High Levels of Trade Between GoG Subsidiaries and Home Countries of IOCs

Although the full extent of GoG intragroup transfers is not hard to ascertain, data shows that affiliates of IOCs operating in the GoG mostly export their crudes to home countries where parent companies are incorporated. For example both ExxonMobil and Chevron accredited with producing much of Chads 115,000 bbl./day of crude oil are both US incorporated. EIA statistics show that about 83.2% of oil produced in Chad is exported to the US. A similar pattern exists in Nigeria where Chevron, ExxonMobil, ConocoPhillips, Shell and Total account for the bulk of Nigeria's estimated 2.5 millions bbl./day production. The US imports 33% of Nigeria's crude while Europe off-takes 22%.

Substantial Revenue Earnings from the Sector

The industry earns substantial revenues for GoG producing countries, representing up to 90% in export earnings and government revenues in some cases. With the exception of Cameroon where oil contributes only about 28% in state revenues and 60% of export earnings, it is obvious that the commodity is a major financial lifeline to GoG economies. As noted in Chapter 3.2, governments mostly use R/T or PSC systems to share these revenues with IOC's. Since intragroup transfers constitute a sizeable portion of trade in oil between GoG producing and US/EU off-takers there is a risk that transactional prices charged could be manipulated.

Huge Potential Reserves, Long Production Periods and Fairly High Oil Prices

Lastly, the size of hydrocarbon reserves in the GoG is another factor with potentially huge tax implications. With Nigeria alone boasting 37.5 billion barrels, Chad 1.5 billion barrels, Equatorial Guinea 1.1 billion barrels and Cameroon about 800 million barrels; it is evident that the industry is poised to continue playing a major role in GoG economies for a long time to come. While domestic players are starting to gain inroads into the oil sector, no immediate shifts in the *status quo* are likely

⁴⁰⁴ As a major stakeholder in the Chad-Cameroun pipeline

⁴⁰⁵ Shell's upstream assets and production interests have been sold to ADDAX and Perenco

to be noticed as far as reversing foreign dominance of the sector is concerned. Hence, a combination of huge proven reserves, extensive timeframes to depletion, volatilities in oil prices likely to continue favoring already established producers and the continuous dominance by foreign subsidiaries constitute a huge challenge for tax authorities with possible international tax implications. In light of the industry's current structural outlook and the factors discussed above, IOCs can easily use intragroup transactions to manipulate transfer prices. Indeed, studies engaged by NGO's on TPM in Africa show that IOCs manipulate TP in the GoG (4.2.2.2).

4.2.2.2 Research based Evidence of TPM by IOCs in the GoG

There is concern amongst stakeholders in Nigeria⁴⁰⁶ and other GoG countries that IOCs could be exploiting the factors discussed above to ease to minimize their taxes through TPM. Research-based evidence to this effect can be found in a 2012 report released by Publish What You Pay on the mispricing of crude oil export to the EU and USA during tax years 2000 through 2010.⁴⁰⁷ The report compares declared import values with a '*fair market price filter*' based on data sourced from the US Census Bureau and EUROSTAT.⁴⁰⁸ Data includes commodity classifications, countries of origin, quantities traded, custom values and transportation charges. In cases where data included Cost, Insurance and Freight (c.i.f.) it was observed that insurance and freight charges ranged between US\$ 1/bbl. and \$3.50/bbl. After consulting import data records for 11 years totaling 23,454 and 16,360 in the US and EU respectively, the author concluded that IOCs had both overvalued and undervalued imports of crude oil from countries around the world.⁴⁰⁹ Major exporters whose crudes were either **overvalued** or **undervalued** include Canada, Venezuela, Saudi Arabia, Russia and Norway. While crudes from these countries fall within the top 10 tiers affected by mispricing schemes, similar patterns could be observed with respect to GoG crude exports to the US and EU.

Sample Mispricing Arrangements of GoG Crudes Imported by US and EU

In processing available data, J. Pak used the *price filter trade analysis method* to estimate mispriced amounts, which prices are deviations of the declared import value of crude oil from a

⁴⁰⁶ Eboh, M., *Nigeria Losing Trillions from Non-Regulation of Transfer Pricing-PWC*, Vanguard on April 6, 2012

⁴⁰⁷ Pak, J., *Lost Billions: Transfer Pricing in the Extractive Industry* (2012)

⁴⁰⁸ EUROSTAT External Trade Data, http://epp.eurostat.ec.europa.eu/portal/page/portal/external_trade/data/database; and the U.S. Imports of Merchandise U.S. Census Bureau, U.S. Foreign Trade Data Downloads, <http://www.census.gov/foreign-trade/download/dvd/index.html> [Last visited: Dec.15, 2013]

⁴⁰⁹ **Undervaluation**, import records revealed that 15% and 24% of total US and EU transactions examined were undervalued; being while 27% and 16% of US and EU imports examined were **overvalued**

measure of standard arm's length prices. In the study he considered the arm's length price to be the f.o.b. costs of crudes imported by API gravity published by the US Energy Information Administration (EIA).⁴¹⁰ EIA published a total of seven different ranges of crudes with API gravities varying between °API <20 to °API >45.1. However, much of the data used by the author is aggregated making it difficult to obtain accurate estimates of actual mispricing's. Pak nonetheless found that GoG crudes were mispriced thus resulting in governments losing huge amounts of tax revenues from hydrocarbon operations. In Tables 4-3 and 4-4 we present data on mispriced GoG crudes exported to the US market, and those sold to the E.U respectively.

Table 4-1: Under and Over Valuation of US imports of GoG Crudes

API<25	Imported from	Period	Quantity (bbl.)	Price (\$/bbl.)	Low	High	Ratio (Price/low)	Amount Mispriced
			C2	C3	C4	C5	C6=C3/C4	C7
Undervalued US Imports from GoG								Undervalued
API>25	Angola	2002-04	917,412	\$16.60	\$21.33	\$25.71	78%	\$4.34 m
API<25	Cameroon	2004-12	913,379	\$18.02	\$26.81	\$29.98	67%	\$8.03 m
API>25	Eq. Guinea	2005-08	524,558	\$32.75	\$50.67	\$65.81	65%	\$9.40 m
Overvalued US Imports from GoG								Overvalued
API>25	Nigeria	2000-12	1,956,619	\$34.85	\$19.00	\$27.83	125%	\$13.74 m
API<25	Nigeria	2003-04	341,931	\$46.00	\$18.98	\$21.54	214%	\$8.36 m
API>25	Chad	2009-01	2,457,860	\$49.50	\$33.98	\$35.35	140%	\$34.79 m

As shown above GoG countries fell victim to mispricing of crude oils sold to the US. In August of 2005 the US imported some 524,558 barrels with °API >25 from Equatorial Guinea at declared unit prices of US\$ 32.75. However, the lower-bound ALP range in August of that year for similar crudes was US\$ 50.67/bbl. After comparing similar crudes and adjusting for transportation differentials, Pak estimates that about US\$ 9.4 millions in revenues was lost to this undervaluation.⁴¹¹ Parallels exist with respect to US imports of Cameroon's crude oil over the years 2004-12. In one example, the US bought 913,379 barrels of crude with °API <25 at a price of US\$ 18.02/bbl whereas base reference prices for similar crudes was \$26.81. Undervaluation on this transaction is estimated at US\$ 8.03 millions. As far as overvaluation is concerned, Pak equally identified transactions in which Nigerian crude with °API >25 were sold at US\$ 34.85 whereas the going upper-bound price was US\$27.83. On another occasion, crude oil with °API <25 traded at US\$ 34.85/bbl whereas the going upper-bound ALP was US\$ 27.83/bbl. On both transactions, a combined loss of US\$ 22.10 millions occurred. Similar mispricing arrangements were identified with GoG crudes sold to the E.U.

⁴¹⁰ http://www.eia.gov/dnav/pet/pet_pri_imc3_k_m.htm [Last visited Jan 30th, 2014]

⁴¹¹ Pak (2012), supra note 407

Table 4-2: Under and Over Valuations of EU Imports of GoG Crudes⁴¹²

Importing EU State	Imported from	Period	Quantity (m. ton)	Price (c.i.f.) (€/m. ton)	Low	High	Ratio (Price/low)	Amount Mispriced
			C2	C3	C4	C5	C6=C3/C4	C7
Undervalued E.U. Imports from GoG								Undervalued
UK	Chad	2004-07	285,067	€142.49	€184.90	€251.20	77%	€14.04 m
France	Gabon	2005-08	38,300	€235.84	€340.30	€408.00	69%	€4.31 m
UK	Chad	2005-08	139,908	€206.81	€277.70	€344.30	74%	€11.06 m
Overvalued E.U. Imports from GoG								Overvalued
Portugal	Eq. Guinea	2007-04	51,779	€519.71	€306.30	€386.70	134%	€6.47 m

As concerns undervaluation, Pak notes that between the years 2004-07 and 2005-08, the UK acquired 424,975 metric tons of crude oil from Chad. During 2004-07, it paid only €142.49 for crudes with lower-bound prices of €184.90/metric ton. Likewise, it only paid €206.81 for crudes that fetched a lower-bound ALP of €277.70/metric ton during 2005-2008. This represents a combined loss of revenues amounting to €25.10 millions. Likewise, there was undervaluation of roughly 38,300 metric tons of Gabon's crude oil sold to France between 2005-08. French off-takers paid a meager €235.84/metric ton for qualities of crude oil which fetched a lower-bound market price of €340.30 and an upper bound price of up to €408.00/metric ton. Here, total estimates of undervaluation is €4.31 millions. The study also cites at least one instance of **overvaluation** of GoG source crudes. Portugal paid a whopping €519.71/metric ton for Equatorial Guinea's oil that should have fetched an upper bound price of €386.70, that is €6.47 millions in overvaluation. These are examples of mispriced transactions that E.U. and US based off-takers engaged in during the periods 2000 to 2012.

Cumulative Mispricing Estimates of GoG Crudes

When one aggregates revenues that are estimated to have been illicitly transferred through mispricing practices, the result is stunning. These loses are relevant to GoG countries that heavily rely on petroleum revenues to fund economic growth.⁴¹³ One can, in view of available evidence, make the case that TPM is a genuine menace to efforts by GoG government's to capture a fair share of economic rent from the oil sector. Cumulative revenues lost to undervaluation or over-valuation of GoG crudes sold to the EU and US are quite substantial, which revenues if collected, could go a long way to boost economic performance in the GoG. For instance, Cameroon is estimated to have lost US\$ 314 millions in taxable revenues to undervaluation during the period studied.⁴¹⁴ Gabon's crude is

⁴¹² E.U. imports are valued in Euros/metric tons not US\$ /barrels

⁴¹³ See 1.2.1 for detailed analysis of the importance of O&G to these economies

⁴¹⁴ All things being equal and assuming trade between GoG and US and EU are direct, this would ordinarily serve as basis for assessing certain taxes

estimated to have been undervalued by US\$ 165 millions, Nigeria's by US\$ 175 millions, Chad's by US\$ 400 millions and Equatorial Guinea's by US\$ 202 millions during the same period. It appears Cameroon and Chad suffered the most from undervaluation while Nigeria ironically experienced low levels of this form of mispricing notwithstanding that it exports more crude oil than other select GoG countries put together. Relative to production therefore, Cameroon lost more to undervaluation than Nigeria and most undervalued transactions were for crudes destined to the EU.

As concerns overvaluation no direct export of oil from Cameroon to the US was recorded as overvalued. However, use of tax haven intermediaries ensured that IOCs earned about US\$ 86.1 millions in overvaluation of crudes originating from Cameroon. As seen further in table 4-5 [infra] IOCs overvalued Gabon's crude by US\$ 330.70 millions; Chad's by US\$ 278, Eq. Guinea's by US\$ 523.40 millions and Nigeria's by US\$ 6,593.20 millions. Certain trends are observed if one analyzes these figures closely. Firstly, Nigeria topped the list of GoG economies affected by *overvaluation* while Cameroon suffered least. Secondly, IOCs mostly overvalued sales of GoG crudes to the US than to the EU. Conversely, more transactions were undervalued for sales to the EU than the US. Although we cannot on the basis of aggregate data alone explain these trends, factors like TP regulations, IOC headquarters and tax havens play significant roles in shaping these outcomes. Tax havens in particular appear to have played an indirect role in facilitating mispricing of transactions.

Table 4-3: Total Mispriced Values for GoG Crudes

United States (US)			European Union (E.U.)		
Import From	Am't Mispriced	% Imports	Import From	Am't Mispriced	% Imports
Undervalued			Undervalued		
Cameroon	\$18 mm	1.36%	Cameroon	\$296 mm	2.25%
Gabon	\$48 mm	0.23%	Gabon	\$117 mm	2.70%
Nigeria	\$62 mm	0.03%	Nigeria	\$113 mm	0.13%
Chad	\$288 mm	2.32%	Chad	\$112 mm	14.25%
Eq. Guinea	\$95 mm	0.89%	Eq. Guinea	\$107 mm	0.54%
Total for GoG	\$511 mm		Total for GoG	\$745 mm	
Overvalued			Overvalued		
Cameroon	-	-	Cameroon	\$86.1 mm	0.69%
Gabon	\$322 mm	1.51%	Gabon	\$8.7 mm	0.20%
Nigeria	\$4,957 mm	3.26%	Nigeria	\$1,636.2 mm	1.82%
Eq. Guinea	\$233 mm	2.19%	Eq. Guinea	\$290.4 mm	1.46%
Chad	\$278 mm	2.23%	Chad	-	-
Total for GoG	\$ 5,790 mm		Total for GoG	\$ 2,021.4 mm	

The Role of Tax Havens in Facilitating TPM

On the surface processed data conveys the impression that havens played little or no role in facilitating mispriced transactions. Only 17 of 16,360 EU records examined directly relate to deals

with tax havens, two of which were substantially undervalued but none of which concerned GoG crudes. However, this does not mean havens were not used as intermediaries when trading GoG crudes. **Firstly**, the published import data only shows the country of origin of the crude oil except in cases where this was not known thus rendering tax havens invisible in the data and masking their role as intermediaries in facilitating mispriced transactions. The EU and US data only reported crudes as originating from tax havens if their original source countries were unknown. Where the source country was known, transactions are reported as taking place between the country of origin (Nigeria, Cameroon) and the destination country (US, EU). Secondly, tax havens are used to facilitate re-invoicing of crude oils. Havens import crude oil from producing countries and re-export the same to destination countries. If IOCs arrange re-invoicing such that: (1) crude oil is underpriced when haven subsidiaries import from a producing country and (2) overpriced when re-exporting to a destination country, it is possible that the data would have cloaked the role of the haven by retaining only the export price invoiced by the GoG country and the import prices reported by the US or EU. This might explain why havens barely appear in the data used to determine mispricing's. Although mispricing of costs such as head office overheads, technical assistance and loans are not covered in this study, they are equally important issues of concern in the GoG.⁴¹⁵

4.3 Chapter Conclusion

It would be recalled that this chapter aimed from the outset to respond to the 2nd research question, that is, exploring evidence of the extent of use of TPM in the oil industry. In order to respond to this question we moved to examine both: (1) the mechanisms used by IOCs to manipulate transfer prices, and (2) available evidence substantiating claims that IOCs manipulate TP in the industry globally and within the GoG. Investigations into these issues inform the following conclusions.

On the mechanisms used by IOCs to manipulate TPs, it was noted that this could be hypothetically achieved by moving either income from high to low tax countries and/or allocating

⁴¹⁵ Economic stakeholders in other sectors have questioned TP policies pursued by MNE's operating in Africa, including for example the **brewery industry**. In a 2010 report by **ActionAid**, SABMiller was accused of avoiding over £20 millions in taxes every year from India, Ghana, Mozambique, Tanzania, South Africa and Zambia. It's Ghana subsidiary *Accra Brewery* sold about £29 millions worth of beer but reported operational losses for CIT purposes in only one of four years closing 2010. This was achieved by moving ownership of its beer brands and major procurements from these countries to a Dutch subsidiary and Mauritius subsidiary respectively, charging of exorbitant management fees by a Swiss based affiliate; and finally charging huge interests on heavy debts contracted with related companies. SABMiller has rejected allegations that it engaged in "aggressive tax planning in ... its operations". This objection notwithstanding, findings contained in the report highlight the fact that TPM is a concern to both hydrocarbons and other industries in Africa.

higher costs to high tax jurisdictions by shifting such costs from a low tax one. In addition, TPM schemes can be designed so that transactions are engaged directly between two related parties, or indirectly between three or more related parties via haven intermediaries. It was found that both income shifting (sale of crude oil) and cost allocations (technical assistance, royalty payments, financing) are avenues that can be exploited by IOCs for TPM purposes.

On whether IOCs manipulate TPs for tax purposes and the extent, if any, to which they do so, the literature reviewed establishes that there are genuine grounds for suspecting and possibly branding IOCs as “notorious abusers” of TP. A review of inferential evidence drawn from insights by tax experts, research reports by NGOs and importantly landmark cases support claims that IOCs are engaged in TPM. However, there is equally some case law and research evidence rebutting this proposition, thus indicating that the extent of abuse of TPs by IOCs cannot be considered as absolute. As concerns the GoG inferential and research-based evidences were presented that IOCs could, and have in some cases effectively mispriced intragroup transfers in the petroleum industry. In light of preceding analysis one could argue *that IOCs had and are engaged in transfer price manipulation both globally and in the GoG*. However, it is hard to determine the full extent of IOC deployment of TPM in their operations since companies generally treat as highly sensitive commercial data the information that is needed to make precise determinations on the issue. This notwithstanding, the body of evidence suggests that TPM in the oil industry is a major concern to governments in the GoG. There is as such an obvious need for tax authorities in the sub-region to closely monitor these schemes that serve to erode domestic tax bases at a time when oil revenues are badly needed to drive genuine economic transformation.

CHAPTER 5

PERSPECTIVES ON SELECT TRANSFER PRICING ANTI-AVOIDANCE REGIMES

In the preceding six decades the operational calculus of MNEs has changed constantly due to technological advances, growing international trade and the introduction of robust regulatory frameworks. This changing environment has placed enormous pressures on governments, which must regularly adapt domestic and international taxation regimes to constantly new dynamics in order to keep pace with and/or maintain the capacity to tax MNEs effectively. The inability to adapt quickly to these changes often results in states losing huge amounts of taxes to noncompliance practices like TPM. However, to MNEs pursuing these aggressive schemes the inability of states to adopt quickly translates itself into improved performance of divisions of related firms, increased corporate profitability and reduced liabilities vis-à-vis its global tax compliance obligations.⁴¹⁶ To prevent this happening, world leaders are presently considering a raft of measures aimed at tackling TPM. These range from measures as complex as reinforcing primary legislation with TP regulations, to actions as basic as strengthening capacity of tax officials to track these schemes. Trends show that the world's leading economies are reexamining policy on the issue, highlighting growing concern that TPM is a cross-border challenge that needs to be urgently addressed through concerted action. Indeed, TPM and OFCs were identified during the 2013 G8 and G20 submits held in the UK and Russia respectively as major targets in the global fight against tax avoidance.

However, it is proving hard to achieve global unanimity on the practical question of how best to tackle the problem. For instance, composition of the EU Commission's Joint Transfer Pricing Forum created to advise executives and state representatives on the subject has been heavily criticized.⁴¹⁷ Of its 18 members, independent non-governmental experts appointed to the panel were either drawn from *MNE's* or *Big Four* accountancy firms that respectively stand accused of manipulating TP to avoid taxes⁴¹⁸ or providing services intended to enable such abuse. This perspective is not widely shared. David Boubilil argues that far from betraying the EU's lack of

⁴¹⁶ Tang, R., *Current Trends and Corporate Cases in Transfer Pricing*, p.xix (2002)

⁴¹⁷ Leigh Phillips, "EU Tax-scram Body Stuffed with Tax Avoidance Experts" May 6, 2011

⁴¹⁸ Examples include the Royal Dutch Shell merger and Yukos cases discussed in 4.2.1.1.C and 4.2.2.A respectively

willingness to tackle the issue, the choice of panel members is justifiably the result of the fact that “apart from multinationals and the accounting firms, expertise in this area is very limited”. In Africa, there is uncertainty over what rules apply and the direction in which TP anti-avoidance regimes are moving, which doubts are ebbing as many governments take practical steps to tackle TPM. Trends on the continent indicate that policy is leaning towards seeking *state-level* rather than *collective* solutions to the issue. Consequently, some states have moved to reinforce existing anti-avoidance regimes by issuing TP regulations (*Kenya -2006, Nigeria and Ghana -2012*), while others are yet to (*Cameroon, Egypt*). Regulations adopted by each state differ in their approach, mix of options and degree of details inspired either by US and OECD guidelines on the subject.

We aim in this chapter to comparatively examine a variety of state-level approaches and mix of options deployed by select developed (USA, France) and developing (Nigeria, Cameroon) countries to regulate cross-border transactions with TP implications (5.2). However, it is important to note that many domestic regimes are built around supranational and sometimes national norms developed by the UN, OECD and US. Although it is our stated purpose to examine TPM as obtains in the petroleum industry, we must bear in mind that the subject of TP and its applicable rules are relevant in equal measure to all industries characterized by huge intrafirm transfers. What actually distinguishes O&G from other industries is the scale of transactions and the fact that hydrocarbons producing countries implement laws and fiscal regimes that are sometimes unique to the extractives industry.⁴¹⁹ First, let us begin by examining vital international taxation principles, standards and methods that are mostly adopted by states to develop their TP anti-avoidance regulations (5.1)

5.1 Transfer Pricing Principles, Standards and Methods

Hereinafter, we examine the Arms Length Standard (ALS) and Unitary Taxation Concept (UT), two competing standards on which TP regulations are or can be built (5.1.2). The five main methods used to determine transfer prices are also discussed, of which three are transactions based and two others profit based (5.1.3). Firstly, the section begins with a review of key principles of international taxation that underpin intrafirm pricings, including the jurisdiction to tax MNE’s on a source or residence basis, and canons of the international taxation system (5.1.1).

⁴¹⁹ On the question of how the O&G industry is unique, see Introduction to Chapter 3. Further, considering the importance of extractives to oil producing economies, it is worth questioning whether there isn’t wisdom in developing special TP rules that speak to and address characteristics of the industry (see Chapter 7 for more on this).

5.1.1 Principles for Taxing Intrafirm Transactions

Since the emergence of MNEs in the 1880's increased numbers of cross-border transfers have led to strong interdependence of the global economy. From a tax perspective, exercise of the jurisdiction to tax MNEs in any given country depends on whether governments treat them as "transparent" or "opaque" entities.⁴²⁰ If *transparent* then individuals that makeup the entity, such as partners in a partnership, become personally liable to tax in countries where they are tax resident. If *opaque* the entity is netted by tax in its country of residence. Should it occur that an entity is constituted under the laws of one country and does business in another, this is likely to result in double taxation if both treat it as *opaque*. The question thus arises as to which of these countries under international tax law has jurisdiction to tax profits earned by the entity (5.1.1.1). Regardless of which country exercises jurisdiction to tax, effectiveness of its anti-avoidance regime is likely to depend on whether its design incorporates certain principles of international taxation (5.1.1.2).

5.1.1.1 The Jurisdiction to Tax Under International Tax Law

It is important to note from the outset that the concepts of "associated enterprise" and "Jurisdiction to tax" are essential to ongoing TP debates. Hence, we briefly clarify their meanings as used in the international taxation discipline. An *associated enterprise* refers to one in which another or other enterprise(s) via use of intermediaries, participate either directly or indirectly in its management, control or capital. This often happens if one enterprise holds directly or indirectly, shares with at least a predetermined percentage of voting rights in both enterprises, or has advanced a loan to that other representing at least a predetermined percentage of the book value of the latter's total assets.⁴²¹ Considering, however, that subsidiaries or affiliates are distinct/separate legal entities from their parent companies it is argued that intragroup prices should be determined by having regard to those applied by independent firms under competitive market conditions regardless whether they are truly related or deemed as such. As concerns which of two countries avails the *jurisdiction to tax* MNEs, opinion varies on whether exercise of such a right reposes with the country in which the entity is resident (B), or that within whose territory profit is earned (A). If the problem of double taxation arises due to two or more countries laying conflicting claims to the right to tax same profits earned by an

⁴²⁰ Miller & Oats (2009), *supra* note 29 at p.28

⁴²¹ Nyah, Z., *Transfer Pricing in the Petroleum Industry*, (2009); Exceptionally unrelated entities may be deemed 'associated' for tax purposes due to their relationship.

entity,⁴²² what factors may justify giving priority to one's claim over another's? Broadly, what suitable frameworks have been adopted worldwide to coordinate country positions on the *residence* and *source* principles in ways that effectively reduce possibilities of double taxation, tax avoidance or tax evasion (C)?

A. Source-Based Taxation

There is consensus in international tax circles that the "source country" has the primary (but not exclusive) right to tax. This leaves the "residence country" with only a residual right to tax, the exercise of which is restricted by its responsibility to avoid double taxation and should modify its domestic rules if necessary. In effect, the *host* or *source* country within whose territory profits are earned has the right of first taxation of beneficiaries regardless of where such beneficiaries are resident for tax purposes. As such source-based taxation is premised on a nexus between the economic activity that produces the income targeted by tax and the host jurisdiction of these activities. In principle the exercise of this right does not preclude other jurisdictions from taxing on the *basis of residence* and this permits many countries to yet tax foreign sourced incomes. Many countries do tax MNEs on a residence basis suggesting that it is in practice a more attractive legal nexus over source-based taxation that is arguably now mostly treated as adjunct.⁴²³ From this angle it appears, the view prevails, that taxpayers owe economic allegiance to the country where they are most closely related, and not necessarily where income is earned.

B. Residence-Based Taxation

Residence taxation is based on a *home* or *residence* country's claim of right to tax owners of businesses that produce income. Residency is therefore the determining criterion in the taxation of an entity, nexus being existence of a relationship between taxpayer and the home jurisdiction so that the former's worldwide income may be taxed regardless of its source. What therefore is residence for tax purposes and are there any universal rules for determining it? A country's tax rules applied to natural and corporate residents may differ from those adopted by others. For example, while the US places emphasis on de jure control (*incorporation*), Canada and the UK lay emphasis on de facto control (seat of management). A country might also opt to tax worldwide incomes of residents before

⁴²² Eden (1998), *supra* note 3 at p.72

⁴²³ Krishna, V., The Fundamentals of Canadian Income Tax, p.70 (2002)

crediting against domestic tax liabilities income related taxes paid abroad (e.g. US), or tax only their domestic earnings by *exempting* all foreign incomes (e.g. France). A third variant exists whereby a *portion of foreign earnings* is taxed while specified others are exempted (passive investment income – as in Canada).

Taxation of Individuals

Three main approaches are presently used to determine the tax residence of individuals.⁴²⁴ The first and most common is the *time* (number of days) *spent in a country* within any given 12 months period or consecutive period of 183 days. For example, the jurisdiction to tax expatriates hired by IOCs can be determined on the basis of presence in a country for more than 183 days, or close socio-economic ties with that country. Since countries sometimes define residency differently this could result in a person being tax resident in more than one country so that “tie breaker” provisions are needed in double taxation treaties to assign residence.⁴²⁵ In principle this approach is statutory and often combined with the next. Secondly, residence may be determined according to a person’s connection with a specific country taking on characteristics of a personal attribute. This is mostly the result of case law and no criterion is retained as definitive in ascertaining tax residence. Lastly, residence might be determined on the basis of residence rules used for other civil law purposes, including citizenship status or right to work in the country.

Taxation of Companies -Legal & Economic Connection Approaches

Understanding of the concept of residence may slightly differ depending on whether one uses it for tax (*tax residence*) or other corporate (*corporate residence*) purposes including lawsuits. A corporate taxpayer can strictly speaking have only one tax residence, whereas the same company may be resident for litigation purposes in more than one jurisdiction. From the standpoint of taxation there exists two main approaches used to determine residence, namely legal and economic approaches. Nonetheless, tests used in countries to determine residence differ.

⁴²⁴ Thuronyi, V., *International Aspects of Income Tax* in *Tax Law Design and Drafting* Chap.18 (1998)

⁴²⁵ Miller & Oats (2009), *supra* note 29 at p.31-54. Ordinarily, one is deemed resident in a state on the basis of domicile/residence and if judged as resident in both, then tax residence is determined in accordance with Article 4 of OECD MDTC. First, he is deemed resident where he has a permanent home and if he has permanent homes in two states, he is resident in the place where he has his closest personal and economic interest (center of vital interests). If the PH and VI criteria fail, then he is resident in the place of habitual abode. If all three criteria fail he is deemed resident in the country where he is a national. Finally, where none of these ‘*tie breaker*’ provisos are capable of assigning tax residence, both contracting states shall determine residence by mutual agreement.

Legal Approach to Ascertaining Tax Residence

Tax residence as per this approach is essentially based on the legal form of the business. The **country of incorporation**, that is, where the entity is listed in the commercial register is used as the basis for ascertaining residence. Historically, this is the approach used by the UK and France. In the UK however, position seems to have shifted over time. In *Royal Mail Steam Packet v. Braham*⁴²⁶ the courts rejected 'place of incorporation' as being too easy and prone to manipulation, a view subsequently altered in *Gasque v. IRC*.⁴²⁷ Since 1988, the UK uses place of incorporation as default criterion to ascertain tax residence. There is a second approach.

Economic/Commercial Connection Approach

By this approach tax residence is determined on the basis of economic related factors including: the company's place of management, principal business location and residence of its shareholders. The *place of effective management* remains an important international test used to ascertain residence, the origins of which can be traced to the '*central management and control*' (CM&C) test developed by UK courts. Indeed CM&C was a major test for determining tax residence in the UK prior to readopting *incorporation* in 1988. Lord Loreburn argued in *De Beers Consolidated Mines Ltd v. Howe* that a "...company resides, for income tax purposes where its real business is carried on...and the real business is carried on where the central management and control actually abides."⁴²⁸ In spite of *De Beers* being managed from both South Africa and the UK, the court found it to be tax resident in the UK since "the Directors' meetings in London are the meetings where the real control is always exercised in practically all the important business of the company... operations." However, one must not confuse CM&C of a company with the day-to-day running of its operations. CM&C is to be determined using factors like the place where: (i) the company's governing body meets, (ii) decisions to carryout operations emanate, (iii) strategic control of the company is exercised, and/or (iv) place where key policies of the business are conceived and adopted instead of where they are implemented.⁴²⁹ The courts therefore settle for a 'pinnacle' test by which CM&C is deemed to exist at the highest level of the corporate entity.⁴³⁰

⁴²⁶ (1877), 2 App.Cas.381, at 386 (PC)

⁴²⁷ [1940] 2 KB 80; in this case, country of incorporation was accepted as a factor in determining tax residence

⁴²⁸ (1906), 5 TC 198, at 213 (HL)

⁴²⁹ *Miller & Oats* (2009), supra note 29 at p.63

⁴³⁰ *Union Corporation, Ltd. v. Commissioner of Inland Revenue* (1952), 34 TC 207, at 271 (CA)

This commercial connection approach is not restricted to the UK's CM&C test. Existing alternatives include the '*place of management*' test that is used to mean the place where policy is made, place of operational management or the legal head-office or where the company's Board of Directors convene. The OECD Model Tax Convention cites and defines the place of effective management as "the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made."⁴³¹ That is, the place where the most senior person or group of persons make decisions for the entity and where implementation is decided. Establishing tax residence via these tests is no task to be taken lightly since one must examine the relevant facts of each case. Also the concepts of *place of management* and *central management and control* differ in that the former places slightly more emphasis on the day-to-day running of a company's affairs. Lastly, *shareholder residence* is a valid criterion for ascertaining tax residence. Although rare to find, this approach is arguably an alternative to the others since it takes account of the economic impact of the company's financial health on the group and its shareholders as related entities. Canada uses this criterion.⁴³² If one resolves that corporations are mere aliases of their shareholders, it can be argued that the taxation of one is in fact taxation of the other. However, corporations and shareholders are at law and for income tax purposes separate legal entities with distinct tax residents,⁴³³ each being liable to tax in its own right.

C. The Double Taxation Problem

Double taxation designates *economic or juridical exposure* by a given taxpayer to taxation of same revenue streams or profits more than once. If tax is charged twice or multiple times on the same profits within a country's border, this amounts to *Economic Double Taxation*. However, if jurisdictional overlaps result in one or more countries exercising the right to tax same profits; or if legal persons earn profits in countries other than those in which they are tax resident, this amounts to *Juridical Double Taxation*. The absence of universal standards of jurisdictional entitlement on a "source" or "residence" basis creates significant problems for taxing authorities in both home and host countries. It often opens-up avenues for conflict between competing jurisdictions seeking a cut of profits transiting or ultimately lodged within their territory. For example, assume that a foreign subsidiary in Country X earns profits that it remits as dividend to its parent in Country Y. There are in

⁴³¹ Para 24 of the Commentary on OECD Model Tax Convention, July 2005 Condensed version

⁴³² § 250(4) of Canadian Income Tax Act (1970)

⁴³³ *Salomon v. Salomon & Co.*, [1897] AC 22 (HL)

principle three income taxes that can be collected on this operation. The host country, (Country X) might on basis of the source principle charge both the CIT and a withholding tax to the profits. Likewise, Country Y in which the parent is resident may charge CIT on remittances received.⁴³⁴ Hence, the same income is taxed twice in Country X and once in Y. Countries confronted by this problem apply either of three approaches to mitigate its effect.⁴³⁵ Under the *deduction approach* the country of residence taxes foreign incomes, but expenses taxes paid abroad. Foreign taxes are treated as an expense of doing business, and deducted as other costs would for tax purposes. The *exemption approach* is based on an entirely different philosophy. Here, the residence country fully exempts and does not tax foreign incomes (e.g. France). Finally, there is the *credit approach* by which foreign income is taxed in order to determine a resident's global tax liability. Income and related taxes paid in foreign countries are then credited against domestic tax liabilities (e.g. USA).

If the jurisdiction issue is handled poorly it is likely to lead to double taxation, and in turn push taxpayers to resort to international tax avoidance. In effect "corporate taxpayers [would seek to] ...derive all the economic, political, and legal benefits of residence in a country and [yet] arrange their international transactions so as to source their income in low-tax countries or tax havens."⁴³⁶

5.1.1.2 International Regulatory Principles

In Chapter 2.2.1 of this thesis, we discussed canons of a 'good tax system' that should be included in the design of domestic and/or international tax systems. These canons elaborated by Smith for domestic tax regimes have in part been redefined -under Musgrave's influence- to take account of their international context. She expanded two of Smiths' four canons of taxation namely equity (*Inter-nation, international taxpayer*) and neutrality (*capital export, import*) to accommodate their global peculiarities. To these, we added certainty (*international taxpayer and inter-nation*) and efficiency (*international system*). Efforts to set-up a system that integrates these principles requires that authorities select and include a suitable blend of taxes into the system (architecture), decide on the substantive aspects of each tax that is selected –*rate, base* (engineering) and prescribe robust mechanisms to enable practical implementation of the system (tax administration).⁴³⁷

⁴³⁴ Eden (1998), *supra* note 3 at p.74

⁴³⁵ Miller & Oats (2009), *supra* note 29 at p.71

⁴³⁶ Krishna, *supra* note 423 at p.70

⁴³⁷ Shoup, C., Public Finance, (Chicago: Aldine, 1969); Also see chapters 6 and 7 for further discussions on these issues

5.1.2 Review of Transfer Pricing Standards

Standards for adjusting TP first emerged in the US in 1928 when congress granted the treasury secretary powers to reallocate profits amongst related companies. During its early years of implementation, stakeholders commonly used the ‘percentage of turnover’ method for TP that is in effect similar to the **unitary concept** (*also formulary apportionment*) examined in 5.1.2.2. It was not until 1935 that the League of Nations in its Model Tax Convention endorsed the **arm’s-length standard** for use by parties engaged in related party transactions (5.1.2.1).

5.1.2.1 The Separate Entity Standard -Arm’s Length Standard

Understanding the ALS Concept

The ALS is widely regarded as an appropriate benchmark for ascertaining intrafirm transfer prices. Accordingly, related party transfers should be priced on similar basis as transactions between unrelated parties operating in competitive market settings.⁴³⁸ This might require MNEs to source arms-length prices (ALP) for comparable uncontrolled transactions. The ALP is a price “...which would have been agreed upon by unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market.”⁴³⁹ Enforcement of such a standard is contingent on taxing authorities finding identical transactions, which are sometimes hard to come by⁴⁴⁰ and presupposes (perhaps erroneously) that independent parties effectively use market prices. This is not always the case. Further, if one considers the interwoven nature of ownership structures in the world today it is hard to be sure that presumed ALPs sourced from presumed independent transactions are not themselves outcomes of other controlled transactions. These preoccupations aside, the ALS as provided in Articles 9 of the OECD and UN Model Tax Conventions underpins most, if not all, TP regimes in the world.⁴⁴¹

If properly applied the ALS technically prevents mispricing and artificial transfer of revenues abroad retaining as such taxable profits in the jurisdictions in which MNEs make these profits. It is applicable to all forms of intragroup transactions including tangibles and intangibles (goods and services -*technical and financial assistance, interest and patent royalties, managing and marketing*

⁴³⁸ Eden (1998), supra note 3 at p.26

⁴³⁹ See Article 9 of the 1977 Model Tax Convention and TP regulations issued in 1979.

⁴⁴⁰ GAO, *International Taxation: Transfer Pricing and Information on Non-Payment of Tax*, p.33 (1995)

⁴⁴¹ Eden (1998), supra note 3 at p.108; In Chap 5.2 we examine the ALS as applied in the US, France, Nigeria and Cameroon

fees).⁴⁴² In ascertaining the ALP one needs to ask the following questions including: What would the parties have done had they been unrelated? What would the negotiated price have been? And, did any independent parties engage in the same or identical activities under same or identical circumstances? Broadly, there exist two main approaches used to approximate ALPs. The first identifies comparable transactions by unrelated firms and uses prices derived therefrom to determine the ALP. Note that adjustments are allowed for product and functional differences. The second relies on prices charged in comparable transactions and circumstances between a related group member and independent party to estimate the ALP. Irrespective of the approach, tax authorities may reinstate into taxable basis profits accrued on account of mispricing schemes.⁴⁴³

Historical Development of the ALS

Historically, the ALS developed in three distinct stages. During the *First Stage* lasting from the 1920s through early 1960s, the Financial Committee of the League of Nations initiated technical meetings aimed at deciding whether MNE's should be taxed on the separate entity or integrated enterprise approaches. The meetings held in Mexico (1928) and London (1946) were precursors to UN and OECD Model Tax Conventions. The *Second Stage* ran from 1968 to 1993 and was triggered by the US Treasury's issuance of landmark Section 482 regulations in 1968. It sought to convince other countries to adopt both the separate entity approach and ALPs for intragroup transfers. The OECD endorsed this approach in both Article 9 of its 1977 Model Tax Convention and TP regulations issued in 1979. Accordingly, stakeholders were required to treat and price intragroup transfers as they would any other independent transaction. This strengthened the concepts of legal ownership, control of legal entities and provided legal basis for the fisc to reallocate profits in line with the ALS. Four methods were retained for this purpose namely CUP, C+, RP- and others. By 1983 Germany adopted TP guidelines and the OECD issued another report on the subject a year later. These publications endorsed a growing tendency to maintain ALS. The *Third Stage* began in 1993 and is ongoing. Landmarks include OECD's review of its 1979 and 1984 reports on TP culminating in the issuance of revised guidelines in 1995 that mirrored the US' revised s.482 regulations released in 1994. Both documents endorsed the ALS over UT.⁴⁴⁴

⁴⁴² Miller & Oats (2009), supra note 29 at p.306

⁴⁴³ Eden (1998), supra note 3 at pp.33-35

⁴⁴⁴ Eden (1998), supra note 3 at p.109

5.1.2.2 The Integrated Enterprise Standard -Unitary Taxation

Understanding the Unitary Approach

Unlike the ALS that allocates profit on a separate entity basis, UT attributes profits on an integrated entity basis by which account is taken of the contributions made by each related firm to the MNE's worldwide income.⁴⁴⁵ This is arguably a simpler standard to implement than ALS. UT entails consolidating, apportioning and taxing worldwide incomes of MNE businesses.⁴⁴⁶ Thus members of a group doing business in any given tax jurisdiction only pay taxes there, in proportion to their contribution to the groups' worldwide income. It also supposes availability of '*apportionment factors*' that would be used to determine related party contributions, including: employment, payroll, sales and stock of capital. Taxable profits are not determined by looking at separate accounts of subsidiaries, but by looking at the group's global account. Stakeholders identify *factors* referred to above and determine a formula to be used in apportioning profits between tax jurisdictions based on contributions of individual subsidiaries to a group's earnings.⁴⁴⁷ The percentage contribution of a subsidiary, however weighted using these *factors*; multiplied by the MNEs worldwide income would determine the amount of income to be taxed in jurisdictions where they each operate. UT's core advantage over ALS is its technical ability to eliminate platforms used within group's to implement TPM. Once one treats related firms operating in different countries as separate legal entities for tax purposes, it is possible to use intrafirm transfers to mask profit shifting. By applying the formulary approach however, it does not matter where the bulk of the profits end up since all divisions of the business are treated as one integrated unit and taxable incomes shared proportionately amongst divisions of the group on the basis of their respective contributions to its global results.

In terms of its practical implementation there is very limited evidence that governments are interested in UT on the global stage, although the EU's proposed '*Home State Taxation*' based on the proportion of surplus value produced in each state and Common Consolidated Corporation Tax Base is an example. There is however, growing evidence of its domestic appeal. Switzerland, Canada and US use *formulary apportionment* to share taxable profits between federated states. In the US, factors like ownership rights, payroll, sales, cost and profits constitute basis on which a group's combined income drawn from domestic operations can be allotted between states. In *Mobil Oil Corporation v.*

⁴⁴⁵ Also *integrated enterprise standard* or *global formulary apportionment*

⁴⁴⁶ Eden (1998), *supra* note 3 at p.313

⁴⁴⁷ Miller & Oats (2009), *supra* note 29 at p.346

Commissioner of Taxes,⁴⁴⁸ the Supreme Court held that Vermont's inclusion for tax purposes of dividends from Mobil's affiliates into its business income was appropriate. In *Exxon Corp. v. Wisconsin Department of Revenue*⁴⁴⁹ the court resolved that Exxon's treatment of its operational department as an independent profit center did not consider the companies integrated structure, and advantages enjoyed in terms of centralized management and information control. Keeping separate accounts and not reflecting earnings of these segments in single accounts was not enough to exclude such earnings from the reach of Wisconsin's taxation. Thus, tax authorities were right to treat vertically integrated divisions of the group as part of a unitary business. In both cases the court rejected attempts by companies to isolate and treat segments of the value chain as distinct businesses for tax purposes. Some federated states since have tried to push this a step further. Rather than limit imposition of state taxes to the share of profits earned in the US, it was extended to cover the state's contribution to the group's worldwide profit. This has been challenged in courts by MNEs (Colgate-Palmolive), which companies can now opt to file only US earnings for state taxation and not worldwide earnings (so-called 'waters edge').⁴⁵⁰

5.1.3 Transfer Pricing Methods

Intrafirm transactions are varied and comprise tangibles or intangibles including purchase, sale, leasing, borrowing, lending of goods, services and intangible assets.⁴⁵¹ Although there is a requirement in most countries that MNEs charge ALPs for intrafirm transactions, this is not always the case. Thus, US and OECD guidelines have been quite instrumental in shaping the ALS (5.1.2 *supra*), methods and TP policy (5.2 *infra*). In this subsection we review five methods habitually used to determine intrafirm prices, classified either as transactions (5.1.3.1) or profit-based (5.1.3.2) methods.⁴⁵² For consistency, we illustrate all five methods using examples discussed in chapter 4.1.1. The fisc and MNEs could sometimes disagree over what TP method to use, a concern resolved in the past by "imposing priority methods". Since 1994 however, reforms have tended to allow use of the "best method" following due analysis of parameters like business functions, contract terms, risks and economic conditions. Although this approach allows flexibility on the choice of methods, parties could disagree over what the *best method* is.

⁴⁴⁸ 445 U.S. 425 [1980]

⁴⁴⁹ 447 U.S. 207 [1980]

⁴⁵⁰ Miller & Oats (2009), *supra* note 29 at p.346

⁴⁵¹ Treas. Reg. § 1.482-4(b); Also Sections 4.2.1.1 [B] and 4.2.2.1 [B] *supra* for examples of intrafirm transactions

⁴⁵² Feinschreiber, R., *Transfer Pricing Methods –An Applications Guide*, p.3 (2004)

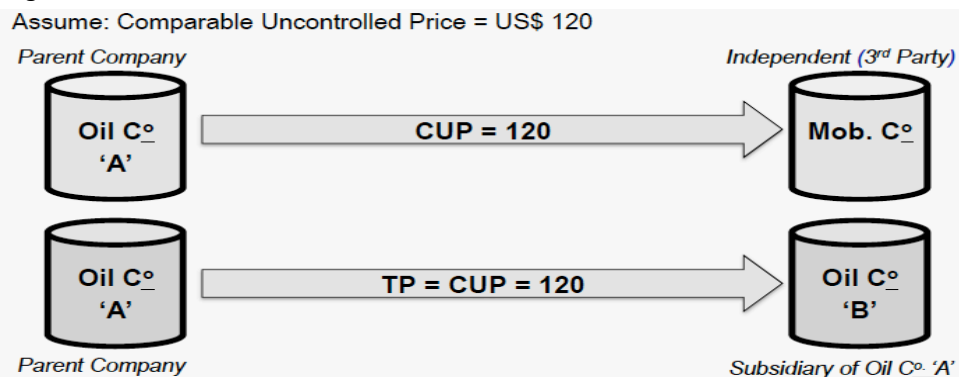
5.1.3.1 Traditional Transaction Based Methods (TTM)

Three key methods can be used to determine ALPs for intragroup transfers: comparable uncontrolled price, resale price, and cost plus methods. Methods create uncontrolled outcomes by aligning intrafirm prices to those charged for similar transfers by independent parties.⁴⁵³ Prior to introducing the “best method” these were default methods under OECD and US rules.⁴⁵⁴

A. Comparable Uncontrolled Price (CUP)

CUP is highly recommended for establishing ALPs and is applicable to standard, identical and fungible commodities like crude oil. Under this method the suitable TP is determined by comparing prices applied on intrafirm transactions, with those charged on similar independent transactions. Examples include those between (i) a group firm and independent third parties, or (ii) independent parties altogether. For example in diagram 5-1 below, Oil Co ‘A’ (a parent company) charges a price of US\$ 120 for sales of crude oil to Mob. Co. Independent an unrelated third party. This transaction and price could be used as comparable basis for similar transfers of crude oil from Oil Co ‘A’ to its related subsidiary and refinery Oil Co ‘B’. In exceptional cases however, prices exclusively charged on related party transactions might be allowed as ALPs. This is extremely rare, but speaks to the point that one could draw from direct or indirect data when analyzing CUP.

Figure 5-1: Illustration of CUP



However, this method poses practical implementation challenges. It is not easy to identify comparables since differences exist between seemingly identical transactions. In extractives for example, benchmark prices for commodities (e.g. *gold*, *crude oil*) are widely quoted on commodity exchanges. These benchmarks, it is argued, make it easy to compare intrafirm with uncontrolled

⁴⁵³ OECD Guidelines, Chap 2, paragraph 2:5 (2010)

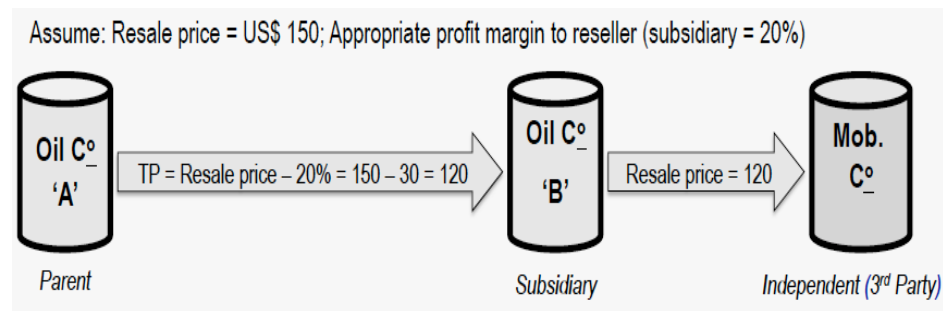
⁴⁵⁴ Eden (1998), supra note 3 at pp.37 & 110

prices. However, one must not lose sight of the fact that there might be technical and contract differences between transactions quoted on exchanges and non-quoted ones. The CUP is hence workable only if two conditions are satisfied, namely that: (1) differences in transactions are not of a nature to materially alter the presumed ALP, and (2) if differences exist, that they can be eliminated through adjustments.⁴⁵⁵ As concerns the transfer of intangibles and provided authorities have data on transfer of comparable intangibles under comparable circumstances, a suitable arms-length royalty can be determined using the Comparable Uncontrolled Transaction method. Intangibles are comparable if products or processes emanate from the same general industry.

B. Resale Price Minus (RPM)

In cases where ready-made transactions cannot be sourced on the open market, MNEs can use the resale price method (RPM) to establish TP. Resale prices are mostly used to determine profits earned by distributors, whilst cost plus is used for manufacturers.⁴⁵⁶ RPM basically identifies downstream ALPs and reverses them by working backwards to a point where the corporation's upstream transfer price is determined. The challenge is to ascertain the resale price that buyers (resellers) would eventually charge customers for a given product, less an appropriate gross margin in order to get the seller's transfer price. This presupposes that reliable data can be sourced, analyzed and that necessary price adjustments can be made to the figures.

Figure 5-2: Illustration of RPM



Lets suppose that Oil Co. 'A' transfers a barrel of crude oil to its wholly owned subsidiary Oil Co. 'B' which then resells the barrel to Mob. Co. Independent at the market price of US\$ 150, earning in the process a hypothetical *gross profit margin* of 20%. The appropriate price for intrafirm transfers of the barrel between Oil Co. 'A' and Oil Co. 'B' is US\$ 120 being the resale price minus gross margin

⁴⁵⁵ OECD Guidelines, Chap 2:6-7 (2010)

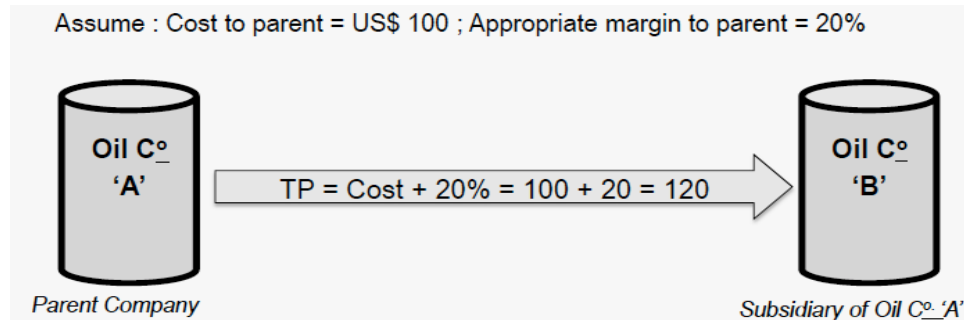
⁴⁵⁶ Feinschreiber (2004), supra note 452 at p.69

of US\$30 ($TP = Resale Price - Gross Margin$). As shown in this example, one may determine the applicable gross margin by examining uncontrolled transactions between (i) a related reseller and independent third party, or (ii) gross margins used in transactions between two or more unrelated parties. As with CUP there is need to establish comparability of transactions.⁴⁵⁷ Further, one observes that RPM closely resembles the netback pricing method developed in 1985.⁴⁵⁸

C. Cost Plus Method (CPM or C+)

Unlike RPM that seeks to determine intragroup transfer prices through the resale lens, CPM approaches the issue via the lens of producers. The suitable ALP is determined by adding up all **costs** involved in producing the commodity, plus an appropriate mark-up (profit margin) to reward the MNEs effort spent in doing so. Assuming that Oil Co. 'A' incurs total unit costs of US\$ 100 to produce a barrel of crude oil that is transferred to Oil Co. 'B' (its subsidiary) for an undisclosed price. If the applicable margin for similar quality crudes on the open market were 20%, the ALP would be US\$ 120. As with prior methods it is vital that identical data reflecting the full range of production costs is sourced, and comparability analysis/adjustments performed.

Figure 5-3: Illustration of CPM



The main challenge in applying CPM is getting the appropriate mark-up. In extractives, mark-ups differ depending on the: (1) extent to which fiscal terms capture economic rents; (2) the prospectivity of oil fields, and (3) degree of structural variations to transactions imposed by competing accounting systems.⁴⁵⁹ It is helpful to shop for comparable mark-ups used by the same supplier in uncontrolled transactions, or by independent enterprises in comparable transactions.⁴⁶⁰

⁴⁵⁷ OECD Guidelines, Chapter 2, paragraph 2:16 (2010); Feinschreiber (2004), supra note 452 at pp.70-78

⁴⁵⁸ Supra, see Chapter 3.1.2.1 [B] for an explanation of how the net-back pricing system works

⁴⁵⁹ Eden (1998), supra note 3 at p.234

⁴⁶⁰ OECD Guidelines, Chapter 2, paragraph 2:33 (2010)

5.1.3.2 Transactional Profit Based Methods

TPBM's focus on profits and are best used when transaction methods prove unhelpful. They are seldom used in the OECD⁴⁶¹ but are acceptable if consistent with the ALS/comparability conditions set in Art 9 of the MTC. The OECD retains only two profit-based methods as satisfying these standards, namely: (D) the profit-split, and (E) transactional net-margin methods.⁴⁶²

D. Transactional Net-Margins (TNM)

TNM for its part compares the **net-profit margin** from a controlled transaction with that obtained from a comparable uncontrolled transaction concluded by the company on arm's-length basis with an independent third party, or by entirely two independent parties. Depending on the facts and circumstances of each case, factors such as costs, sales or assets may be used as appropriate bases for the comparison. To achieve comparability the adjustment of net-margins must be considered when applying the method.⁴⁶³ Its main advantage over other methods is that net-margins are much less affected by transactional and/or functional differences between firms, as net-margins are likely to be same regardless of functions performed. Basing TP adjustments on net-margins eliminates the need for complex analyses of functional or transactional differences notably in cases where reliable data is hard to come by. However, determination of an arms-length net-margin is easily influenced by factors that may have little direct bearing on transactional prices or gross margins thus skewing basis for adjusting net-margins. Further, it is possible that MNEs may not have information on uncontrolled transactions at the time of applying the method.

E. Profit Split Method (PSM)

Under PSM, profits gotten from controlled transactions are split using a formula that reflects the respective contributory capacities of each associated enterprise in a group. The MNE: (1) estimates an arms-length return/profits,⁴⁶⁴ (2) compares the economic contribution each party makes to the venture, and (3) proceeds to split returns between venture parties in proportion to their contribution -often using as measure the ratio of operating profits to operating assets. Assuming as shown in diagram 4-4 that Oil Co 'A' produces and transfers a barrel of crude to Oil Co 'B' a trading

⁴⁶¹ Dahlberg, M., *Transfer Pricing: Using the Comparable Uncontrolled Price Method*, p.17 (2003)

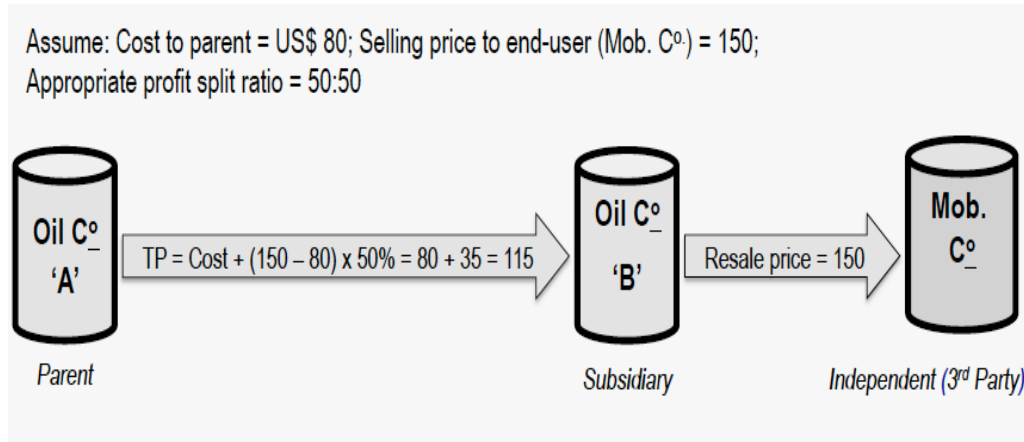
⁴⁶² OECD Guidelines, Chapter 3, paragraph 3:1 (2010)

⁴⁶³ OECD Guidelines, Chapter 3, paragraph 3:26 (2010)

⁴⁶⁴ OECD Guidelines, Chapter 3, paragraph 3:12 (2010)

subsidiary at a breakeven price of \$80, which on-sells to Mob. Co. Independent at the market price of US\$150. The groups operating profits is US\$ 70 (that is 150-80). If the ratio of operating assets between the *parent* and *subsidiary* companies is 50:50, then profit split will be \$35 each. The initial TP charged for transfers of crude from 'A' to 'B' will be increased to \$115 (that is 80+35). With PSM it is the ratio of operating assets that is typically used to split profits.

Figure 5-4: Illustration of PSM



Long before the US upgraded the status of PSM to a specific method in 1994, critics opposed adopting the method.⁴⁶⁵ The main reason is that it mainly relies on group data to compare with independent others raising concerns over objectivity. Issues to be addressed include what measures of profit should be used, how profits are to be split and what the target activities are.⁴⁶⁶ Proponents of the method argue that it is simpler to split gross profits than handle complexities that underpin the sourcing of comparables and adjusting intrafirm prices. It is most useful in situations where data on suitable *product* comparables (CUP) or *functional* comparables (C+, RP-) are unavailable. Therefore, it remains the method of last resort with the OECD advising that in order to avoid penalizing MNE's when applying profit methods the fisc should consider that it could not have reasonably foreseen circumstances when forecasting arms-length returns.⁴⁶⁷

⁴⁶⁵ Feinschreiber (2004), supra note 452 at p.191

⁴⁶⁶ Eden (1998), supra note 3 at p.47

⁴⁶⁷ OECD Guidelines, Chapter 3, Paragraph 3:11 (2010)

5.2 An Overview of Actual TP Anti-Avoidance Regimes in Four Select Countries

As explained earlier effectiveness is the perceptible gap or conceptual distance between a **given-regime-state** (actual attributes) and an **ideal-regime-state** (regime objectives).⁴⁶⁸ In this section we review *existing legal frameworks* for tackling TPM in four select countries, two of which are drawn from developed countries –US/France, and two others from developing O&G producing countries in the GoG -Nigeria/Cameroon. These frameworks are appraised in Chapter 6. It is worth noting that current TP rules being applied around the world are largely influenced by Article 9 of the OECD and UN Model Tax Conventions; examples being Art 57 and s. 19 of France and Cameroon Tax Codes respectively. Likewise regulatory approaches on the subject differ. For instance, many OECD countries have not published country specific TP regulations since the organization's Guidelines are *de facto* regulation (France).⁴⁶⁹ In the US however, a clearly different approach to regulating TPM is adopted notwithstanding OECD membership. The country has issued regulations that are in some respects different from and even drive thinking on TPM within the OECD. As concerns non-OECD countries trends show increased reinforcement of TP regimes via issuing domestic regulations inspired by the OECD and/or US. Nigeria is a fairly recent example (2012). In addition to the reasons for our choice of countries discussed earlier,⁴⁷⁰ it is worth noting that these select regimes in various ways embody key trends on regulating TPM. The US pursues a robust approach that is widely viewed as *Tight* (5.2.1). All three others actually pursue *Light* approaches. We hereinafter examine in each select country the four system attributes that constitute existing frameworks for tackling TPM. These are the ALS, D&D, Audits & Penalties, and Appeals.

5.2.1 Tight Approach to Regulating TPM: Case of the USA

TP regulations in the US are much more technical, rule-based and formalized compared to OECD guidelines.⁴⁷¹ This is due to the comprehensiveness of policy, legal and administrative frameworks that comprise the US system. Examples of legal instruments that comprise the US's transfer pricing regime include Section 482 of the *tax legislation* dealing with allocation of incomes

⁴⁶⁸ See Chapter 2.1.2 for details on this approach

⁴⁶⁹ Feinschreiber (2004), *supra* note 452 at p.206

⁴⁷⁰ *Supra*, see Chapters 1.3 on the *research problem*, and 2.2.1 on the *classification of system attributes*

⁴⁷¹ Levy, D. & Wright, D., *In the OECD & US It's the ALP That Matters: Comparison of New TP Regulations*, pp.28-44 *International Transfer Pricing 2* (1995). Brazil has a similar system.

and deductions of tangibles and intangibles; *Regulations* 1.482, the *1988 White Paper* on TP of intangibles; 2014 Manual for TP audits; *case law* that sometimes cause amendments to existing regulations; and *Bilateral Tax Treaties* often modeled along similar lines as the OECD's.

5.2.1.1 Jurisdictional Issues and the Applicable TP Standard

A. Jurisdiction to Tax Multinationals in the USA

What Amounts to US Tax Residence?

The US and other countries tax residents on their worldwide incomes although domestic rules for corporate residency differ between them.⁴⁷² Most countries have adopted the economic connection approach to ascertain jurisdiction to tax corporate residents while the US uses a purely formal and rigid approach. Indeed all companies organized under US or Federated State laws are treated as 'domestic', while those that are not so organized are deemed 'foreign'. This allows an avenue for corporations to engineer residence-based *corporate inversion* avoidance schemes. In essence, a US domestic company could create a company abroad –say Bermuda- and transfer its holdings of the US company to the latter, becoming foreign and non-US resident for tax purposes.

What is the US Approach to Taxing Multinationals?

In addition to the above, taxation of multinationals in the US can be categorized into two headings: foreign source income of US Multinationals and US income of foreign multinationals. In the first case a distinction is made between foreign branches (100% owned by a US parent) taxed as income is earned; and controlled foreign companies (CFC -more than 50% owned by US residents, but incorporated outside the US) for which a charge to tax is deferred until CFC incomes are remitted to the USA. US tax base therefore comprises US domestic income, accrued foreign branch profits, head office fees, interest payments remitted to US resident from its affiliates abroad, plus dividends that are grossed-up by the amount of foreign income tax.⁴⁷³ Since US inbound foreign incomes are taxed in the source country and in order to eliminate double taxation, the US offers unilateral relief in

⁴⁷² Miller & Oats (2009), *supra* note 29 at p.35; as concerns natural persons, citizens and resident aliens are taxable for their worldwide incomes irrespective of their duration of absence from the US, making it possible to be tax resident in two or more countries. By resident aliens, we refer to *green card holders*, and those who satisfy the *substantial presence test*, that is, doing 31 days a year, or 183 days in three consecutive years including any current year. For US tax purposes, individuals could have dual status aliens if they are present in the US for 31 consecutive days, or are present in the US for 75% of 31 days starting on the first of a 31 days period ending with last day of the tax year (5 days absence maybe disregarded as *de minimis*).

⁴⁷³ Eden (1998), *supra* note 3 at p.85

form of foreign tax credits for (1) withholding taxes on remitted incomes, head office payments and dividends, (2) foreign branch taxes, and (3) Foreign CITs on dividends. However, such credit may not exceed US tax liability. On the taxation of *US source incomes of foreign MNE's*, the US imposes a basic Federal CIT of 34%, sometimes accompanied by state income taxes of between 0 - 12% that are deductible from the Federal CIT. If remittances are made abroad to foreign MNE's, US charges 30% withholding tax that may drop to as low as 5% if terms are agreed in Bilateral Tax Treaties.⁴⁷⁴

B. The Arms-Length Standard: s. 482 and Related Provisions

Historical Overview of Section 482

As far back as 1917, the US Treasury Secretary could for tax purposes exercise authority via *correlative adjustments* to reallocate incomes and deductions between associated parties. However, it was not until 1928 that US Congress first introduced TP legislation granting IRS authority under s.482 to adjust related party accounts. During this period s.482 aimed to curb tax evasion by related firms (particularly foreign subsidiaries) that improperly used TP to 'milk' or 'manipulate' the accounts of US based parent corporations. These powers were construed broadly, so that by 1935 it became necessary for the US Treasury to clarify circumstances and basis (ALS) under which the Commissioner would exercise authority to reallocate incomes. One can argue that there was logically no real need of developing a robust overall departmental approach to dealing with the problem given that the provision was mostly applied to intrafirm transactions taking place within the US. This perhaps explains the light-handed manner in which the US government initially treated the regulation of related party transactions. By the 1960's however, US firms rapidly expanded their operations abroad turning TP into a major international tax issue and risk. From IRS's perspective, shifting taxable incomes between federated states in the US was one thing, but moving US taxable income abroad was altogether something else.⁴⁷⁵ This also probably marked the point at which the approach to tackling TPM changed from a **light** to a **tight** one. This new trade dynamics was also followed by IRS's issuance of landmark TP Treasury regulations in 1968,⁴⁷⁶ designed to respond to the growing international tax planning industry and intended to guide MNE's on IRS's application of s.482. This was followed by an increase in the number of tax audits with common positions. Section 482

⁴⁷⁴ Eden (1998), supra note 3 at pp.84-85

⁴⁷⁵ In the first case, tax would still be collected in the US albeit on reduced basis; whereas the second development altogether shifted otherwise chargeable incomes beyond the reach of US taxation

⁴⁷⁶ Eden (1998), supra note 3 at p.29

remained unchanged until 1985 when as a result of difficulties experienced in its enforcement to intangibles, congress added a sentence addressing this concern. The US' regulatory framework was further improved in 1986, by linking in s.1059A TP used for customs purposes with those used for tax purposes. Further updates to this regulation occurred in 1994 when IRS issued mandatory general principles addressing substantive and procedural issues.

Allocation of Income and Cost Deductions Under s.482

The US transfer pricing anti-avoidance regulations are built on **section 482** of the Income Tax Code that states as follows:

“In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the US, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be **commensurate with the income** attributable to the intangible.”

The enforcement modalities of s.482 are detailed and reinforced in Treas. Reg. 1.482, by which intragroup transfers must take place at arms-length. Reg. 1.482 operationalizes IRS's authority to adjust MNE accounts and imposes penalties on transactions that are not so reflected. The overarching reason behind the Secretary invoking s.482 to reallocate MNE incomes is the need to place controlled taxpayers on a parity with uncontrolled ones by preventing tax evasion/avoidance, and ensuring that intragroup firms report their true taxable incomes. It is important to note that US courts have over the years interpreted s.482 broadly to cover almost: (i) any enterprise exercising control *-be it general or specific*, or (ii) any transactions whether they have or lack a business purpose and/or motivated by tax considerations.⁴⁷⁷

⁴⁷⁷ Eden (1998), supra note 3 at p.384

Arm's-Length Standard Applied to Tangibles

Effective compliance with s.482 and related regulations is predicated on MNEs carrying-out “substantive analysis”⁴⁷⁸ on three main issues, including applying the best method rule,⁴⁷⁹ undertaking thorough comparability analysis,⁴⁸⁰ and that transfer prices fall within the ALR.⁴⁸¹

The Best Method Rule: Under this rule the taxpayer selects the best method, being the method judged as providing the *most reliable measure* of ALPs and for which IRS may expressly request that the taxpayer substantiates its choice of method. Related firms should thus use as benchmarks, same or identical transactions, undertaken in same or identical circumstances by unrelated firms. Practically however, such a standard is hard to implement since it is rare to find same or identical transactions and rather easy to find comparables. To make up for this limitation the US allows MNEs to use comparable transactions in comparable circumstances. Selection of the best method should thus be guided by two main factors: analyzing the extent of comparability between controlled and uncontrolled transactions; and vetting the quality of economic data and assumptions used to do so. Best methods require comparable data to itself be *complete, accurate* and reliable with little or no transactional sensitivities. If data permits the MNE to ‘identify and quantify’ factors that otherwise affect the result, then it may be deemed complete and accurate.

Comparability Analysis: In determining ALPs, it is advisable that MNEs use transactions as comparables only after running appropriate analyses. Transactions are *comparable* if analyses of both controlled and uncontrolled transactions show them to be “sufficiently similar”. That is, factors in both transactions susceptible to impact prices or profits are taken into account, including: (i) doing functional analysis -*functions performed, resources used or associated with the function: e.g. production, R&D, marketing, distribution*; (ii) looking at contractual terms -*consideration charged or paid to taxpayer, sales, scope and terms of warranty, payment terms*; (iii) examining risks borne by each related party -*market, cost, demand, price fluctuations, R&D, financial, product liability, general business risks*; (iv) reviewing economic conditions in which firms operate -*similar geographic and size of markets, location specific costs, factors of production, extent of competition in each market*; and (v)

⁴⁷⁸ By performing *substantive analysis* the MNE is able to select an appropriate TP method prior to engaging in target transactions, and also preserves these analyses in contemporaneous (written) documentation so as to avoid penalties in the event of TP audit, so-called documentation requirements

⁴⁷⁹ Treas. Reg. § 1.482-1(c)

⁴⁸⁰ Treas. Reg. § 1.482-1(d)

⁴⁸¹ Treas. Reg. §§ 1.482-1(c), 1.482-1(d) and 1.482-1(e); The ALS is discussed in Chapter 5.1.2.1 [Supra]

property or services -*compare property/service transferred, intangibles taken into account*. These factors highlighted are not of equal weight as different factors are given more weight in different circumstances by different methods. If transactions compared are judged to be sufficiently similar, then adjustments are made to prices of controlled transactions in line with commercial, economic practice, or statistical analysis.⁴⁸²

Arms Length Range (ALR):⁴⁸³ Treas. Reg. 1.482 identifies three main approaches to be used in determining ALP.⁴⁸⁴ Firstly, there might be only one arms-length amount so that there is no need to seek a range *per se*. Secondly, it might arise that a series of arms-length amounts exist so that it is necessary to determine an ALR. Lastly, transactions might not be so comparable thus imposing the need for an ALR to vet results. Taxpayers fully benefit from ALR if: (1) information on comparable transactions are “sufficiently complete”, (2) an MNE can identify “all material differences” inherent in these transactions, (3) if each identifiable difference has a definite and reasonable effect on operational prices or profits; and (4) each difference can be eliminated through adjustments meant to even existing gaps. If the transaction does not permit one to fully establish the ALR, a truncated range (that is interquartile range or other statistical technic) may apply to fix the applicable range.⁴⁸⁵

Arm’s-Length Standard Applied to Intangibles

Determination of TPs for intangibles has proven controversial in the US and globally. Prior to introducing changes to s.482 in 1985 there was no clear obligation under US taxation that the transfer of intangibles should be treated as sales or distribution, and accounted for at fair market values. This is because s.482 ordinarily netted the sale of technology, whereas transfers that did not take the form of sales were tax-free (s.351). Corporations often used this loophole to avoid paying US taxes on transfers of intangibles, by declaring R&D expenses in the US and transferring ownership of intangibles abroad without adequately compensating the US developer. The effect is that incomes for patents and licenses were then declared in other countries instead of the US. Post *Eli Lilly and Company v. Commissioner*,⁴⁸⁶ Congress introduced s.936 (h) effectively converting foreign tax exemptions to foreign tax credits for qualified possession source investment incomes, meaning that IRS could attribute to the US parent intangible incomes earned by possessions corporations under

⁴⁸² Treas. Reg. § 1.482-1(d)(2)

⁴⁸³ No adjustments of transfer prices may be carried out for transactions that fall within the ALR

⁴⁸⁴ Treas. Reg. § 1.482-1(c)

⁴⁸⁵ Treas. Reg. § 1.482-1(e)(2)(iii)(B)

⁴⁸⁶ 87 T.C. 996(1985)

what became known as the “Dole Rule”.⁴⁸⁷ The court in *Eli Lilly* confirmed that IRS could use the profit split method to adjust transfer of intangibles like R&D and royalties.

As concerns the allocation of R&D costs the US in s.861 and its accompanying regulation, has designed a system that moves from allowing complete deduction of R&D costs, to one that shares R&D costs with affiliates of the developing group. This approach has nonetheless met with disapproval from tax authorities around the world that tend to disallow deduction of R&D costs unilaterally allocated by US tax authorities, sometimes leading to double taxation. Allocation of Imputed Royalty for intangible transfers is also important. It would be recalled that s.351 permitted MNEs to *transfer intangibles tax free* provided the transfer was not motivated by tax avoidance, which loophole was blocked with the introduction of s.367 (d). Going forward, US firms transferring intangibles abroad are required to receive or report as having received from its foreign affiliates arms-length payments. Payments should reflect royalties imputable over the life of the intangible asset regardless of the nature of transfer or type of intangible using the “**commensurate with income**” approach introduced by s.1231 (e) and later incorporated into ss. 482 and 367(d)(2)(A).

5.2.1.2 TP Compliance, Adversarial and Appeals Procedures

C. TP Compliance Requirements: Documentation & Disclosures

Notwithstanding increasing gross receipts of foreign owned US corporations, IRS reports that the amount of taxable income filed by these companies in the US is rather dropping. A similar conclusion is drawn for US owned corporations so that huge amounts in taxes are lost to foreign tax authorities. In order to reverse this trend, IRS has reinforced the US compliance regime with increased documentation and reporting requirements. New developments include a mandatory charge to prepare and retain specified documentation, and also to file specified reports with IRS.⁴⁸⁸ These requirements have been criticized as being heavy handed with IRS itself estimating that MNEs would require about 1.5 million man-hours a year to fulfill compliance obligations.⁴⁸⁹ While these rules were initially intended to apply to foreign owned US-based companies, they have since been extended to include all US incorporated firms (domestic or foreign owned).

⁴⁸⁷ That is, foreign affiliate that holds US developed but transferred intangibles. S. 936 was replaced by s. 30.A which itself phased out in 2005.

⁴⁸⁸ Feinschreiber (2004), supra note 452 at p.57

⁴⁸⁹ Feinschreiber (2004), supra note 452 at p.200

TP Documentation Requirements

Section 6038A of US tax law imposes on MNEs the duty to prepare and retain specified TP documentation. The list of documents to be prepared is comprehensive with regulations providing a safe harbor of approximately 100 records to be kept to avoid attracting non-compliance penalties. To benefit from s.6038A's safe harbor reprieve, six essential components are needed. Taxpayers must keep: (i) original entry books and transaction records (*general ledger, sales journal, purchase orders, cash receipts and disbursement books, bank statements, work papers, purchase invoices, sales contracts*); (ii) profit and loss statements (*filing consolidated statements comprising the US reporting corporations figures plus all related party figures -parent + overseas affiliates*);⁴⁹⁰ (iii) pricing documents; (iv) foreign country and third party filings; (v) ownership and capital structure records; and (vi) records of loans, services, and other non-sale transactions. IRS can also request that a taxpayer provide documents purportedly held by a foreign parent or other subsidiary, which taxpayer may not invoke lack of control over related foreign party or missing documents as grounds for non-compliance. Further, the Pacific Association of Tax Administrators (PATA)⁴⁹¹ has stepped in to harmonize position on the issue in an effort to limit the economic impact on MNEs of different tax authorities imposing varied documentation obligations. In 2003 it published a standardized TP documentation package⁴⁹² that could insulate taxpayers operating in member states from domestic documentation penalties. Although the PATA package is comprehensive, corporations can only truly avoid documentation penalties if they identify and also conform to domestic requirements.

TP Reporting Requirements

Under US law MNEs have a duty to file annual corporate income tax (CIT) returns. In addition to regular CIT reporting requirements, foreign owned US based corporations, affiliates, and foreign parents have an annual responsibility to file TP information using **Form 5472**.⁴⁹³ The "reporting corporation" is netted if it has foreign shareholding amounting to 25% or more. The *form* allows for reporting of each intragroup transaction so that simple aggregation of data is insufficient. Let's assume that France's Total SA owns two subsidiaries in the US and two others in the UK. If transactions take place between the French parent, its US subsidiaries and those in the UK, then

⁴⁹⁰ Treas. Reg. § 1.6038A-3(c)(2)(ii)

⁴⁹¹ Members of the PATA include Australia, Canada, Japan and US

⁴⁹² <http://www.irs.gov/businesses/international/article/0,,id=156266,00.html> [Last visited: February 3, 2014]

⁴⁹³ Therefore Form 5472 is an information and not a tax return

each of the US subsidiaries will be required to file with IRS three Form 5472's, for a total of six. Further to the above, reports must be filed in or translated into English and the US dollars used as mandated currency for determining US tax amounts.⁴⁹⁴ Although reporting companies are required to spontaneously file documentation, IRS might specifically request them to further provide already existing or yet to be prepared records. Broadly, mega companies are required to file records if either or all of six triggering mechanisms are met. Feinschreiber notes that reporting is mandatory based on: (i) type of transaction - \$50,000; (ii) related party gross payments of \$5 millions; (iii) US gross receipts of \$10 millions; (iv) Gross receipts of \$20 millions; (v) if it constitutes a significant industry segment of \$25 millions; and (vi) if the high profit test threshold of \$100 millions is met. Further, **s.6038A** allows companies a safe harbor to approximate values if figures represent within 75% to 125% of an amount to be determined by IRS and/or the courts. Taxpayers may successfully challenge the extent of documentation requests by IRS if good cause is shown.

D. TP Adversarial Procedures: Audit and Penalties

TP Audits or Examinations

Tax audits are important to ensure effectiveness of any tax regime *-including TP*. In the US the Examination Division of IRS is charged with auditing corporate accounts within three years of tax returns being filed. During audits the examiner identifies and investigates revenue, expenditure and asset related issues for a given or specified number of tax years. The aim is for TP auditors to go behind the reporting corporation's books to establish ownerships and values in line with the firm's value chain, to identify value added functions at each level, and to determine whether the information that it filed accurately reflects intragroup flows of tangibles and intangibles. US tax auditors have traditionally used *functional analysis* (grounded in microeconomics) to determine the basis of s.482 allocations. In reviewing MNE accounts, certain practical questions arise.⁴⁹⁵ What transactions were done? What economically significant functions were involved? Who performed each function? How were these functions accomplished? Were there valuable intangibles used in performing the function? Why were transactions structured the way they were? Where and when did transactions occur and which entities were involved? And, what were the economic risks borne by each of the parties?

⁴⁹⁴ Feinschreiber (2004), *supra* note 452 at p.57

⁴⁹⁵ Fuller, J., *US Tax Review*, pp. 241-7 Tax Notes International (July 25,1994b)

The Pre Audit Compliance Phase

There has been a general shift in orientation towards TP examinations in the US. Prior to release of the 1994 revised regulations, IRS would first challenge the reporting corporations transfer price as noncompliant with the ALS, and then move to determine another that it believed to reflect the proper ALP. This approach had two shortcomings being that taxpayers were not bound to substantiate their choice of method; and IRS's selected methods were frequently challenged and sometimes defeated in the courts. These weaknesses are mitigated under present regulations since taxpayers now use *best methods* to determine ALPs, provided it is backed by *contemporaneous documentation* prepared in advance of transactions to *substantiate the choice of method*.⁴⁹⁶ This new approach has three main advantages. IRS may now: (i) accept at first instance TPs filed by taxpayers if it falls within an accepted range of ALPs, (ii) move the range of acceptable ALPs and/or trim the TP range as circumstances dictate, and (iii) exercise authority to extensively impose penalties on the reporting corporations choice of method if found to be deficient. Thus, once a taxpayer opts for and uses a specific method, it is precluded from later challenging IRS's adjustments by proposing another method. One could argue that this represents a profound shift in position from the time when taxpayers were not required to substantiate their method and could therefore maneuver the system by choosing another TP once IRS challenged the first method.

Orientation of TP Audits

Transfer pricing audits are now thorough and could lead to allocations in cases of non-compliance. IRS examiners can also requests from both US-owned or Foreign US corporations "principal"⁴⁹⁷ and "background documents"⁴⁹⁸ which must be provided within 30 days in order to avoid the penalty regime. TP auditor examine whether the amounts charged by MNEs for target transactions are based on arms-length considerations.⁴⁹⁹ Examiners are guided by the criteria discussed in Section 5.2.1.1.B namely applying the *best method rule*, *comparability analysis* and the *arms-length range*. Data analyzed by examiners could come from taxpayers wishing to use the CUP (*direct evidence*), or benchmarks sourced from public exchanges or quotations (*indirect evidence*). In practice however, examiners in the US often apply comparable profit methods using techniques like:

⁴⁹⁶ Treas. Reg. § 1.6662-6(d)(2)(iii)

⁴⁹⁷ Treas. Reg. § 1.6662-6(d)(2)(iii)(B)

⁴⁹⁸ Treas. Reg. § 1.6662-6(d)(2)(iii)(C)

⁴⁹⁹ Treas. Reg. §1.482-3(b)(2)(ii)(A)

ratio of operating profits to sales, gross profits to sales, and operating profits to operating assets.⁵⁰⁰ IRS's approach is underpinned by broadly worded powers granted the Commissioner, which in theory and practice gives him/her a significant degree of discretion in the exercise thereof. In cases where authority is exercised, the burden of proof rests with the taxpayer to show that the Commissioner acted unreasonably, in an arbitrary manner or without jurisdiction.⁵⁰¹

Transfer Pricing Sanctions or Penalties

The existence, or not, of a robust penalty regime is important in determining a company's TP compliance policy. In tackling TP the US through s.6662 operates a robust and complex penalty regime that is distinct from penalties applied in other contexts.

Penalties on Foreign Source Incomes of US MNEs

US multinationals are subject to mainly two types of penalties for TP adjustments. These are (i) transactional penalties, and (ii) net s.482 adjustment penalties.

Transactional Penalty: IRS has authority to impose two main levels of transactional penalties that further contain four subcategories:⁵⁰² Substantial valuation misstatements attract a 20% penalty charge on principal tax recalls if the taxpayer unnecessarily uses high or low valuations; and Gross valuation misstatements for which a 40% penalty charge is imposed on principal tax recalls if the taxpayer uses extremely high or low valuations for transactions examined. *Substantial Valuation Misstatement (SVM):* High Valuation: If the transfer price filed in Form 5472 is equal to or more than 200% of the price determined by IRS under s.482 authority, then an SVM **penalty of 20%** is applicable to any property paid for, use thereof, or for services concerned. The same penalty rate is applied for Low Valuations, that is, if the transfer price filed is less than or does not exceed 50% of the price determined by IRS in exercise of its s.482 authority. There is also *Gross Valuation Misstatement (GVM)*. High Valuation exists when the TP for property or services (or for use thereof) as reported in the taxpayers return equals or exceeds 400% of that determined by IRS under s.482 authority. Low Valuation occurs when a taxpayer files a price judged by IRS to be 25% lower than what should have been filed. In both cases a GVM penalty of 40% applies.

⁵⁰⁰ Feinschreiber (2004), supra note 452 at p.52

⁵⁰¹ Cole, R., *Allocation of income and deductions in Sale Transactions between Related Entities and Competent Authority Procedures as a Solution to TP Disputes –US Experience*, Special Seminar on Issues in International TP: Texts of Seminal Papers, p.12 (1987)

⁵⁰² Treas. Reg. §1.6662-6(b)

Net-Section 482 Adjustment Penalty: Unlike the transactions penalty that is imposed on a *transaction-by-transaction* basis, net-section 482 adjustment penalties are imposed on aggregate basis. The penalty is charge on net differences obtained by IRS adjustments under s.482, that is, if positive adjustments exceed negative adjustments.⁵⁰³ The system is designed to account for (i) income increases resulting from s.482 allocations, and (ii) income decreases attributable to collateral adjustments.⁵⁰⁴ Penalties would apply if either of two net s.482 adjustments were effected, namely: (i) Substantial Valuation Adjustments -SVA, or (ii) Gross Valuation Adjustments -GVA. *Substantial Valuation Adjustment* penalties apply if IRS's net-section 482 adjustments exceed either of *two thresholds*, notably if the net adjustment amounts to \$5 millions, or accounts for 10% of the reporting corporations gross receipts. Equally, *Gross Valuation Adjustment* penalties apply if either of two thresholds (\$20 millions, or 20% of gross receipts) is exceeded following net s.482 adjustments. As with other penalty regimes discussed above, net s.482 penalties are avoidable. To benefit from this reprieve, reporting corporations need to demonstrate reasonable cause and good faith vis-à-vis transactional penalties, and/or compliance with documentation requirements.

Penalties on US Source Incomes of Foreign MNEs

Controlled Foreign Companies operating in the US are subject to three main types of TP penalties: (i) initial, (ii) additional, and (iii) noncompliance penalties.

Initial Penalty: This is basically charged on foreign owned US based corporations that do not record, maintain or comply with reporting requirements imposed by s.6038A. Initial fines are imposed in cases where information filed is “substantially incomplete” including failures to: (i) file information return Form 5472 within stipulated timeline and in the manner prescribed by regulation, (ii) maintain or causing another party to fail to maintain records under existing rules, and (iii) provide IRS within prescribed timeframe with records kept outside the US. IRS may impose an annual penalty charge of \$10,000 per failure to file Form 5472.

Additional Penalty: In situations where IRS formally writes to the reporting company notifying failure to comply with s.482 obligations and provided failure continues for another 90 days following notification, IRS may impose an additional \$10,000 per 30 days delay (whereby a fraction of the 30 days will be treated as an entire 30-day period).

⁵⁰³ Treas. Reg. §1.6662-6(b)

⁵⁰⁴ Feinschreiber (2004), supra note 452 at p.7

Non-compliance Penalty: If a reporting corporation does not provide the information requested,⁵⁰⁵ IRS may reject all deductions claimed and/or file criminal charges against the failing corporation in certain circumstances. Likewise, IRS can press criminal charges if the reporting corporation is determined to have filed false or fraudulent tax returns. It is important to note that s.482 penalties are applied separately, independently and concomitantly. Penalties can be avoided if the reporting corporation shows reasonable cause for its action or inaction and that it had substantially complied with its compliance responsibilities. Further, relieve is granted if proof is shown that the company acted in good faith, that noncompliance was the result of honest misunderstanding and that facts/circumstances of its case militate against penalty.⁵⁰⁶

E. TP Dispute Resolution Mechanisms

Settlement of transfer pricing disputes in the US is broadly handled through the **traditional** (i) and/or **alternative** dispute resolution mechanisms (ii).

Traditional Dispute Settlement Mechanisms in the US

Administrative Phase: This is the main mechanism used to resolve quarrels between IRS and taxpayers. In principle, if an MNE disagrees with s.482 reallocations to its income or cost by examiners following a TP audit it could file a dispute with IRS's Appeals Division. The purpose of this approach is to preempt disputes progressing into litigation without prior consideration except it is necessary. The appeals phase has been successful in vetting between 80-90% of all disputes arising from tax audits with only about 20% of TP disputes ever making it to the litigation.⁵⁰⁷

Litigation Phase: Reporting corporations that are dissatisfied with the Appeals Division's decision in their dispute against IRS's international examiners, reserve the right of further appeal to the Tax Courts for further review. It is worth noting that the burden of proof with respect to these suits rests on the taxpayer to show that IRS's determination is *arbitrary* and *capricious*. These suits are lengthy and very costly to IRS and taxpayers, sometimes lasting up to 10 years and going all the way up to the US Supreme Court as with the *Aramco Advantage Cases* discussed in Chapter 4.2.1.1 [*supra*].

⁵⁰⁵ Treas. Reg. §1.6038 A-4 (a)(1)

⁵⁰⁶ Feinschreiber (2004), *supra* note 452 at p.59; Miller & Oats (2009), note 29 at p.335

⁵⁰⁷ Wrappe (1993), *supra* note 205 at p.1581

Mutual Agreement Procedure Phase: IRS's International Division is the designated competent authority charged with managing tax disputes filed under the MAP. The MAP is used to resolve disputes of a transnational nature, provided the US has a Double Taxation Treaty with the third party state. Considering that many MNEs have the US as country of incorporation (home), it is the US' tactical disposition during negotiation of these treaties to seek to place limitations on the ability of co-contracting states to impose withholdings taxes for remittances made to the US (royalties, dividends, head office fees, technical assistance fees).

Alternative Disputes Resolution in the US

Advanced Pricing Agreement: Sometimes described as a "one stop shopping method",⁵⁰⁸ APAs are advantageous in providing a platform for: (i) reducing *-upfront-* administrative costs otherwise spent by IRS and taxpayers in resolving TP disputes, and (ii) enhancing tax compliance within a cooperative and non-adversarial framework. APAs are *Unilateral* if entered into between IRS and the MNE, or *Bilateral* if concluded between IRS, US taxpayers, and foreign taxpayer, and other competent tax authority. Since IRS negotiates and mutually agrees with taxpayers on methods to be applied to specific transactions over a given period of time, APAs are pre-transactional mechanisms to preempt disputes. And where disputes actually occur, APAs are an agreed platform for their eventual resolution. From this angle they constitute a "safe harbor". Finalizing an APA requires IRS and taxpayers to: (i) agree on the relevant facts and circumstances, (ii) agree on the applicable method after the MNE provides documents supporting its proposal, and (iii) contribute to the APA Ruling that confirms the acceptable TP and ALR of acceptable prices. APA requests in the US are filed against payment of administrative fees (\$25,000 -1996, presently \$50,000) and are set to run for a 3 years period with taxpayers expected to file yearly updates on the economics and vital facts underpinning the agreement. TP audits still target MNEs with whom IRS has APA's during which they are expected to demonstrate: (i) *bona fide* compliance with terms and conditions of APA rulings, (ii) continuous validity of material representations made to IRS, (iii) the accuracy of data and analysis underpinning the method chosen, (iv) continuous validity of critical assumptions, and (v) uninterrupted application of TP methods and critical assumptions. The APA ruling can be revoked 'for cause' and taxes, interests and penalties recalled if IRS establishes misrepresentation of material facts or non-

⁵⁰⁸ As described by Robert Ackerman who headed IRS's APA Program; See Tax Notes International p. 390 (1993) cited in Eden (1998), supra note 3 at p.474

respect of terms and conditions in ruling. There is also a possibility to amend the ruling in cases where critical assumptions underpinning the APA change.

Binding Arbitration under Tax Court Rule 124: This rule was adopted in 1990 to give disputing parties a possibility to resolve some of their differences via domestic arbitration instead of litigation. Its aim was to reduce the number of tax cases (transfer pricing) that got to litigation on the basis of issues of fact alone (not issues of law). Benefit can only be taken of Rule 124 if arbitration is engaged before trial or litigation commences. Arbitration under Rule 124 is both voluntary and binding as parties are given the latitude to reach agreement on precise facts to be submitted for arbitration and the procedures to be used in resolving the matter. At least one TP dispute has been successfully decided using this procedure: *Apple Arbitration Affair*. In this case both parties agreed to use the baseball (pendulum) arbitration approach by which they each submitted a single number to a panel of arbitrators that was not allowed authority to change or in any manner alter the numbers submitted to it for a ruling. The panel upheld IRS's figure and rejected Apples'.⁵⁰⁹

5.2.2 Light Approaches to Regulating TPM: The Cases of Nigeria, France and Cameroon

Evidence in support of long-standing claims that developing countries are losing billions of dollars in tax revenues to TPM is increasingly coming to light; and governments in Africa are taking proactive steps to tackle the issue.⁵¹⁰ Some are adopting new and arguably light TP rules –e.g. South Africa, Kenya, Uganda, *Nigeria*, Ghana, Benin and Zambia; (ii) building the capacity of state officials, (iii) increasing attempts at information exchange, and (iv) improving MNE compliance monitoring. In comparison to France that is also widely seen as implementing light regulations, the present state of progress on the issue in Africa is arguably very modest as uncertainties still grip TP anti-avoidance regimes (including GoG oil producing countries). Of the select GoG countries Nigeria has distinguished itself by issuing domestic TP regulations, raising doubts as to whether this signals a shift in policy toward the tight approach or a mere strategic re-posturing to reinforce its *light approach* (5.2.2.1). Unlike Nigeria many other oil-producing countries in the GoG (including Cameroon) are yet to issue specific regulations. Nonetheless, tax laws in these countries contain some form of general

⁵⁰⁹ Eden (1998), supra note 3 at p.477;

⁵¹⁰ Tax Administrations are increasingly reviewing practices in the areas of management, technical assistance fees, interests on loans, and broadly declining income taxes and royalties as possible areas for tax recalls.

anti-avoidance provision that upholds the ALS. France' legal TP framework differ from Cameroons' in that whilst both have similarly worded general anti-avoidance rules, the former enjoys direct benefit of OECD membership and recourse to OECD TP guidelines (5.2.2.2).

5.2.2.1 Federal Republic of Nigeria: A Light Approach Reinforced by Fairly New Regulations

In this subsection, we provide an overview of the Nigerian TP anti-avoidance regime that led us in Chapter 1.2 to describe the country's approach as light. Although the country continues to retain its moderate approach, its TP regime was reinforced in 2012 when the Federal Inland Revenue Service (FIRS) issued the first *Income Tax (TP) Regulation No.1, 2012*. Regulation No.1 harmonizes rules applicable to the ALS in various Nigerian income tax laws; aim being to reduce inconsistencies and criticisms of the manner in which FIRS's auditors applied the country's broadly worded TP provisions. Its benefits include reducing revenues lost to TPM, improving compliance with the ALS, reinforcing and broadly mastering the range of international MNEs that are tax resident in the country.⁵¹¹ It is hoped that this new capacity will also strengthen the country's economic potential. Implementation of Regulation No.1 in the oil sector is complex considering the panoply of state institutions charged with managing *components* of income generated and likely to be affected by mispricing practices of IOCs.⁵¹² The key question that arises is whether these departments can coordinate action to ensure seamless enforcement of Nigeria's TP regulations. Further, it is not clear if Regulation No.1 is a statement of policy intent to shift the country's TP policy towards tighter regulation, or simply reinforcement of Nigeria's otherwise light approach.

A. The Jurisdiction to Tax in Nigeria: Case of IOCs

Corporations doing business in Nigeria are liable to income related taxes whether they are resident or not in the country. A corporation is resident for tax purposes if incorporated in Nigeria. Residents are liable to a CIT charge of 30% on profits accruing in, derived from, brought into or received in Nigeria in respect of legitimate trade. This nets all the earnings of resident firms on both domestic and foreign operations. Regulation No.1 identifies certain corporations deemed to be tax

⁵¹¹ FIRS, *Transfer Pricing: E-Discussion*, available at <http://www.firs.gov.ng> [Last visited: August 23, 2013]

⁵¹² NEITI Handbook, p.21 (2011). Notably: the Ministry's Department of Petroleum Resources (DPR) that collects royalty and data, FIRS's Petroleum and International Tax Department (PITD) that assesses and collects the Petroleum Profits and other direct taxes from JV's and PSC's; Nigeria National Petroleum Corporation (NNPC) has two agencies that play equally significant roles in the determination of taxes within the sector, that is, Crude Oil Marketing Department (COMD) and National Petroleum Investment Management Service (NAPIMS).

resident in Nigeria including those referred to in ss. 13(2)(d), 18(2)(b) and 22(2)(b) of the Company Income Tax Act, 2004; and Section 15(2) of the Petroleum Profit Tax Act, 2004. Typically, connected taxable persons such as permanent establishments are treated as resident in Nigeria. PEs include entities, companies, subsidiaries, associates, partnerships, joint ventures, trusts or associations created for the purpose of doing business. As per s. 15(2) of the PPTA transactions are deemed to be artificial or fictitious if they take place between:

“...Persons **one** of whom has **control** over the **other** or between persons **both** of whom are **controlled** by some other person which, in the opinion of the Board, have not been made on the terms which might fairly have been expected to have been made by independent persons engaged in the same or similar activities dealing with one another at arm's length.”

FIRS can exercise jurisdiction to adjust prices if one party participates directly or indirectly in the management, control or capital of the other, or when both parties involved in the transaction have a common source of control, management or shareholdings.⁵¹³ In principle, non-resident corporations are liable to tax only for portions of income or profit sourced in Nigeria. This is consistent with the purport of s. 13(2) of CITA. Corporations operating in Nigeria through permanent enterprises (PE) that engage in transactions with the head office or related branches are treated for tax purposes as separate legal entities. Non-resident companies thus fall liable to Nigeria's income tax if they: (i) have a fixed base in Nigeria where business or trade is carried out, (ii) habitually or customarily operate a business authorizing and controlling a dependent agent in Nigeria, (iii) operate a business that involves a single turnkey project or installations, and (iv) operate business with a person in Nigeria that is judged by FIRS not to have taken place on an arms-length basis.

B. The Arms-Length Standard in Nigeria

Historical Overview of Nigeria's TP Regulations

Like many others in Africa, Nigeria's tax laws contain broadly worded TP anti-avoidance provisions. In order to operationalize these provisions, the UN sub-committee on Capacity Building and German Ministry of Economic Cooperation and Development (GIZ) in 2011 agreed to support the establishment of TP frameworks in countries with no prior experience on the issue. Nigeria, Egypt and Pakistan were selected as pilot countries for the project. In Nigeria FIRS's management

⁵¹³ For purposes of the regulation, control shall be understood to mean the power to govern a company's operations, finances or to influence policy with a view to drawing benefits from such operations

constituted a technical committee to lead consultations on the issue. This culminated in September 2012 in the adoption of Regulation N^o.1 to provide practical guidelines on the implementation of TP provisions. Further, administrative frameworks for operationalizing these regulations were set-up in Nigeria's Two Large Taxpayers Offices⁵¹⁴ and capacity building events were organized to train relevant FIRS personnel and taxpayer's on the implementation of TP rules in Nigeria.⁵¹⁵

Section 15 of the PPT Act, ALS and Regulations

There are primarily three relevant provisions in different Nigerian tax laws granting FIRS authority to reallocate incomes for intragroup transfers in line with the ALS. These are: (i) s.17 of the PIT Act CAP P8; (ii) s.22 of the Companies Income Tax Act CAP C21, Laws of the Federation of Nigeria (as amended in 2007), and (iii) s.15 of the Petroleum Profit Tax Act, CAP.P13, Laws of the Federation of Nigeria, 2004. Although Regulation N^o.1 does not expressly refer to provisions in Nigeria's Capital Gains Act, FIRS is expected to apply its principles to capital gains adjustments. Note that both the content and purport of these provisions are similar so we base our present analysis on s. 15 (1) alone:

"Where the Board is of the opinion that any disposition is not in fact given effect to or that any transaction which reduces or would reduce the amount of any tax payable is artificial or fictitious, the Board may disregard any such disposition or direct that such adjustments shall be made as respects liability to tax as the Board considers appropriate so as to counteract the reduction of liability to tax effected, or reduction which would otherwise be effected, by the transaction and the companies concerned shall be assessable accordingly. In this subsection, the expression "**disposition**" includes any trust, grant, covenant, agreement or arrangement"

Embedded in this provision is the presumption that related party transactions are to be treated as artificial or fictitious. Adherence to the ALS in s.15 (1) is reinforced by stipulations of Clause 10.1 of Nigeria's Model Production Sharing Contract for the 2005 bid round (extract):

"...it is the intent of the Parties that such **prices** shall reflect the **true market value** based on **arm's length transactions** for the sale of the new Crude Oil."

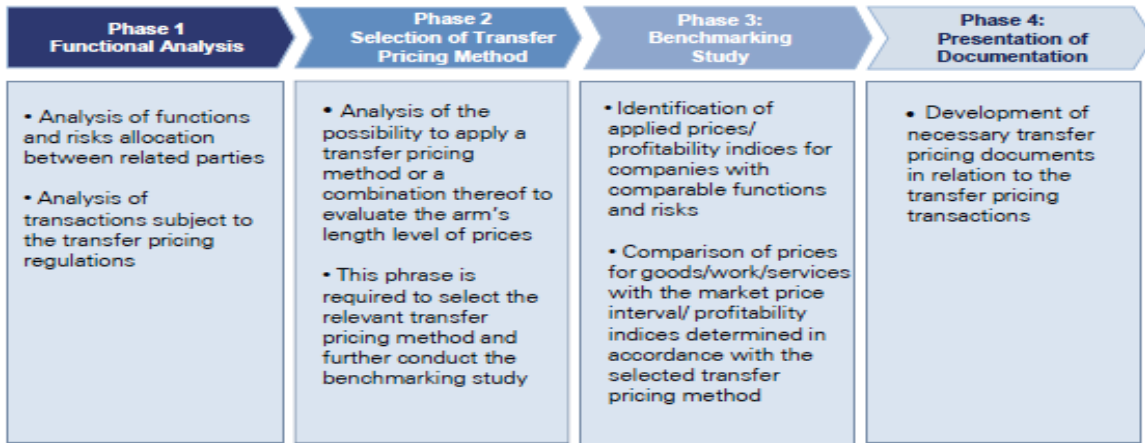
⁵¹⁴ The first LTU handles taxation of Oil & Gas and the second handles Non-Oil Taxation

⁵¹⁵ Bamidele, J., *TP Regulations Implementation in Nigeria*, (presentation 2011) available at

<http://www.taxresearch.org.uk/Blog/2012/06/29/tjns-helsinki-transfer-pricing-conference-the-papers/> [Last visited: October 2013]

These anti-avoidance provisions, clauses and the accompanying regulations grant FIRS effective authority to combat underinvoicing and overinvoicing by charging tax on taxable bases that are reflective of the level of economic activities realized by IOCs in Nigeria, and consistent with the country’s statutory and contractual stipulations. The accompanying regulation provides certainty vis-à-vis the applicable TP framework and reduces risk of economic double taxation that has so often been cited as a serious challenge to MNEs operating in Africa. It creates a level playing field for DOCs and IOCs and provides the necessary legal framework for redressing undue competitive advantages gained through tax avoidance. Implementation of the ALS in Nigeria requires analysis of the: comparability of transactions, methods, safe harbor and compliance issues pertaining to documentation and reporting. These are variously highlighted in the following flow diagram.

Table 5-1: TP Regulation No.1 Compliance Process



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ALS Safe Harbor: It is not clear whether Regulation N^o.1 provides a safe harbor to connected firms for certain types of operations notably: (i) if prices are charged in accordance with statutory provisions -rates of technical and management fees as approved by National Office for Technology Acquisition and Promotion; and (ii) if related party prices were validated by FIRS or other regulatory authority - NOTAP, Nigerian customs service, the Central Bank of Nigeria.⁵¹⁶ Both could constitute safe harbors if FIRS decides to exempt such transactions from being scrutinized for documentation compliance and possible substantive adjustments. However, it still reserves the right to scrutinize these transactions, for instance, in case of foreign exchange rate shortfalls.⁵¹⁷

⁵¹⁶ This is an issue requiring clarity as it could affect effective implementation of the new regulations

⁵¹⁷ Deloitte, *Transfer Pricing Regulations Berth in Nigeria*, p.3 October 2012 at www.deloitte.com [Visited: Aug. 16 2013]

Comparability Factors: Transactions between related parties must be engaged in accordance with the ALS, failing which FIRS could make arms-length adjustments by sourcing similar transactions on the open market. Therefore, related party transactions should be priced under comparable circumstances, that is, similar or identical to transactions between independent persons carrying on business under sufficiently comparable conditions. Considering that public data on private company transactions on the African continent is scarce, getting suitable African benchmarks in TP cases is a major challenge. One could compensate this lacuna by shopping for external benchmarks and making appropriate adjustments. Comparability factors retained by Nigeria are similar to those used by the US and discussed in subsection 5.2.1.1(B) supra.

Applicable Methods: Regulation N^o.1 retains same methods as the OECD and UN [see 5.1.3 supra]. Other methods are approved by FIRS with a possibility to use improvised methods provided proof is shown that the method so chosen produces outcomes that are consistent with uncontrolled transactions, and that it is impossible to get any sound result by applying the 5 listed methods. For example, MNEs can use as base comparable analysis on prior transactions that have close economic characteristics as those examined (Reg. 9). Nigeria requires that MNEs apply the most appropriate method to circumstances of the case having regard to the: (i) strengths and weaknesses of methods, (ii) analysis of transactions -risks, functions, assets, (iii) reasons for choice of method, and (iv) the degree of comparability and reliability of assumptions. These methods are applicable to both transactions of a tangible and intangible nature.⁵¹⁸ To reinforce the applicable framework, Reg. N^o.1 authorizes FIRS to use UN and OECD documents including Art.9 of DTC, OECD TP guidelines approved for publication in July 22, 2010, and UN Practical Manual on TP. Should these documents contradict Nigeria's regulations on specific issues, then the latter prevails.

C. TP Compliance: Documentation & Disclosure Requirements

The regulation enjoins company's resident and doing business in Nigeria to keep and report information on related party transactions. This compliance framework, it is hoped, enables proper monitoring, implementation and enforcement of TP regulations.

Documentation Requirements: Documentation should be prepared in English and provided in hard or electronic formats that ease FIRS' verification of the MNEs choice of method. If documents are

⁵¹⁸ Tangibles -sale or purchase of goods and services, lease of tangible assets, and financial; Intangibles -sale or purchase or lease of intangible assets -goodwill, patents, intangible deals that affect or are incidental to profit and loss.

kept in another language, FIRS may serve a written notice on the taxpayer directing it to produce certified English versions. Documents required include ledgers, journals, cashbooks, cheques, invoices, stock list, all other books of account and data related to transactions with related parties. As concerns TP documentation should contain:⁵¹⁹ (i) a brief description of the MNE's organizational structure -*domestic and foreign*, (ii) details of all controlled or related party transactions -*broader disclosure following Nigeria's migration to IFRS*, (iii) an overview of relevant transactions and analysis of economic factors impacting products, services or intangible pricings, (iv) methods used to determine the ALP, (v) reasons for selecting a method, and (vi) information about comparable uncontrolled transactions available to and used by taxpayer to determine TP. As indicated earlier it is advisable that taxpayers examine the OECD and UN guidelines when deciding documents to prepare since standards set by these bodies are quite helpful complements. Related firms should factor into their analyses the complexity and volume of transactions when preparing TP documentation. Documents should be ready prior to the statutory deadline for filing TP returns and should be retained for at least 6 years from the date of relevant return entries.

Reporting Requirements: Under the Nigerian tax system taxpayers are expected to file annual tax returns no later than 6 months following close of the tax year. TP documentation is to be filed together with annual tax returns in disclosure forms provided by FIRS for this purpose. Reporting should be done annually without necessarily receiving requests from FIRS to do so. In cases where FIRS expressly writes to taxpayers requesting information, the latter must provide it within 21 days of the request. However FIRS may grant extra days if taxpayers can show reasonable cause.

D. Adversarial Procedures: Audits & Applicable Penalties

Transfer Pricing Audits: As concerns transfer pricing audits, the burden of proof rests with the taxpayers to show that documentation provided and methods used in transactions are not significantly or materially different from comparable transactions used by unrelated parties. In other words, that '*sufficient information*' has been provided to justify its transfer price. A necessary first step to satisfying this onus is that the taxpayer keeps and files documents in a manner consistent with the regulation. FIRS's release of Regulation N^o.1 thus provides a common source of reference for both tax authorities and taxpayers during TP audits. Once international tax examiners serve the taxpayer with a notice of TP reassessments, it has 30 days within which to send its objections to the Decision

⁵¹⁹ Deloitte (2012), supra note 517 at p.4

Review Panel (hereinafter the Panel).⁵²⁰ The Panel for its part has 90 days (3 months) from the date an objection is received to make a determination of the amount to be issued as formal assessment to the taxpayer in view of the facts before it. In order to reach this decision the panel examines the reassessments issued, the basis on which reassessments were made, objections of the taxpayer, and evidence presented to it by the parties. If the taxpayer *fails to raise formal objections* within 30 days of the notice being served, the Panel forthwith issues formal assessments in line with initial adjustments and assessments. This procedure is consistent with administrative tax appeals processes detailed in the FIRS Establishment Act.⁵²¹

Transfer Pricing Penalties: Nigeria does not have a penalty regime unique to noncompliance with TP rules. Rather the applicable penalty regime is that prescribed by the relevant taxing Act on the basis of which reassessments are made. For example, taxpayers in breach of s.15 of the PPTA are charged penalties detailed in that Act. If the taxpayer fails deadlines with respect to payment of installments a 5% penalty is charged on the principal tax due. Failure to pay the penalty results in the taxpayer being served with a demand note enjoining it to make payment forthwith. If the debt is not settled within one month of receiving the *note*, the taxpayer is guilty of an offence. As concerns offences for which specific penalties are not prescribed, a fine of ₦10,000 (US\$ 63.07) applies.⁵²² This is grossed-up by ₦2,000 (US\$ 12.6) for each and every day of delay during which such offence continues, or failure to file returns or deliver accounts continues. Failure to pay these fines may result in imprisonment of up to six months. Where taxpayers are found to have prepared incorrect accounts (omitting or understating profits, royalties, expenditures),⁵²³ they fall liable to a fine of ₦1,000 (US\$6.3) plus double the amount of underpaid tax, provided FIRS issues reassessments within 6 months of the taxpayer filing such a return.⁵²⁴ If a taxpayer makes false statements or representations, or forges or aids and abets tax fraud, such is guilty of an offence and is liable to a fine of ₦1,000 (US\$6.3) and treble the amount of tax evaded, or imprisonment for 6 months; with possibility of both imprisonment and fine. Further, failures to withhold at source, deduct or to remit taxes withheld within 30 days may result in FIRS charging penalties of up to 200% of the tax that was

⁵²⁰ The Panel is a specialized body created to assist in finalization of TP Adjustments). The Panel is composed of: The Head of TP department at FIRS, and two others of the Service with at least the rank of Deputy Director.

⁵²¹ Deloitte (2012), supra note 517 at p.5

⁵²² <http://www.xe.com/currencyconverter/convert/?Amount=10000&From=NGN&To=USD>. The US Dollars (USD) to Nigeria Naira (NGN) exchange rate as at November 6, 2013 stood at 1.00 USD=158.554 NGN. All US Dollars equivalence of Naira amounts quoted in this sub-section are dated as indicated above.

⁵²³ s. 52(1) of PPTA

⁵²⁴ s. 52(2) of PPTA

not withheld or remitted plus interest at the prevailing commercial interest rate. For corporate bodies, principal officers (directors, secretary or other) may be criminally liable unless they can show that the contravention took place without their knowledge or connivance.

E. Transfer Pricing Disputes: Settlement Mechanisms

Section 15 (3) of the PPTA gives taxpayers the legal right to contest tax recalls issued by FIRS including taxes resulting from transfer pricing adjustments. Accordingly proviso (3) states:

“Nothing in this section shall prevent the decision of the Board in the exercise of any discretion given to the Board by this section from being questioned in an appeal against an assessment in accordance with Part VIII of this Act and on the hearing of any such appeal the appropriate Appeal Commissioners or the Court may confirm or vary any such decision including any directions made under this section.”

As seen in this proviso, Nigeria’s tax law provides both traditional and alternative dispute resolution mechanisms if the taxpayer opts to appeal tax reassessments.

Traditional Disputes Resolution

Administrative Appeal Phase: The appeals process for PPT tax recalls is detailed in Part VII of the PPTA. Should the taxpayer remain unsatisfied by the Panels decision on TP assessments, it may lodge an administrative appeal with the competent *Appeals Commissioner* within 30 days of receiving the final assessment after notifying the Panel that it would do so.⁵²⁵ The Commissioner might still consider an appeal after 30 days and not exceeding a total of 60 days if the taxpayer shows cause that it was not possible within the statutory deadline to file notice of appeal (sickness or absence from Nigeria). Under pain of being rejected, the Notice of Appeal should contain details of the official number of reassessment, the accounting period covered, amount, date on which appellant was served, precise grounds of appeal and a valid return address through which notices and decisions of the Appeals Commissioner will be served.⁵²⁶ Appeals are heard *in camera*.

Tax Litigation Phase: Taxpayers dissatisfied with the decision of an Appeals Commissioner may within 30 days of receiving notice of the decision file an appeal against assessments with the Federal High Court (FHC). Appeal can also be filed if FIRS’s Board fails to appoint an appropriate Commissioner to decide taxpayer’s objections within 30 days. FIRS might itself file an appeal to the

⁵²⁵ s. 41 (1) of PPTA

⁵²⁶ s. 41 (2) of PPTA

FHC against a Commissioners decision within 30 days. This deadline can be extended by another 30 days provided reasonable cause is shown as to why appeal was not filed within 30 days of the decision.⁵²⁷ The enforcement of assessments can be stayed until determination of appeal, provided that portions of taxes not disputed are paid forthwith by taxpayers.⁵²⁸ As a rule the onus to prove excessive taxes is on the appellant (taxpayer) and the court can on the basis of evidence before it confirm, reduce, increase or annul assessments. Unless the judge otherwise directs, appeal in the FHC is held *in camera*. Further appeal of the FHC's decision by either the taxpayer or FIRS is to the Federal Court of Appeal for sums that are equal to, or upwards of ₦1000 (US\$ 6.3).

Mutual Agreement Procedure (MAP): If TP assessments are issued by a country that Nigeria has a Double Taxation Treaty with, and provided a connected person requests that FIRS review the arm's-length basis applied, it may effect corresponding adjustments to taxes payable in Nigeria in order to avoid double taxation. It is still murky whether FIRS would agree to carryout secondary adjustments for indirect taxes such as VAT or duties, or whether it would retain as binding on itself transactions and prices that have been validated by other regulatory agencies in Nigeria.

Alternative Disputes Resolution

Related taxable persons looking to engage certain transactions may request an Advance Pricing Agreement (APA) with FIRS to establish the appropriate set of conditions for complying with ALS. The request should specify all controlled transactions to be included in the APA and analyze functions to be performed, the assets employed and risks to be borne by related parties. Applicants should determine both comparability factors and critical assumptions on which future operations would be based, plus select and propose the most appropriate TP method. Provided an administrative fee of ₦5,000,000 (US\$ 31,555) is paid, FIRS may negotiate an APA for annual cumulative amounts of at least ₦250 millions (US\$ 1.6 million) in deductible costs or revenues. Data (*trade secrets, other commercial information*) put at FIRS' disposal within the APA process are treated as highly confidential. It could accept, modify or reject the request filed under sub-regulation 1 and specify the basis for its acceptance, modification or rejection of the request. Countries likely to be concerned by proposed transactions should be identified to determine whether the APA sought would be unilateral or bilateral. By agreeing to or modifying the proposed APA, FIRS engages not to

⁵²⁷ s. 41 of PPTA

⁵²⁸ s. 44 of PPTA. A similar measure referred to as respite of payment is provided for in s. M121 of Cameroons CTC.

reassess transactions covered by the agreement for periods not exceeding 3 years if these are consistent with terms agreed. Nonetheless, FIRS could cancel if the taxpayer fails to comply with essential terms of the agreement, is in material breach of any critical assumption, or if there is a change in tax laws that materially impacts the APA. Importantly, FIRS can cancel if its decision to issue a ruling was based on misrepresented facts, mistakes or omissions by taxpayer. Likewise, connected taxable persons may file notice to cancel if there is a material change in the circumstances on which the APA request was made, or relevance thereof put into question as a result of a significant change in the structure of a controlled transaction. Effective *termination of the APA* takes place from the date specified in FIRS' notice of cancellation (Para. 8.a and 8.c), from the date that the material breach occurs (Para. 8.b), and in certain cases retrospectively from the date that the APA was entered into (Para. 8.d) or the date specified in the notice of cancellation (Para 9).

The effectiveness of Nigeria's TP regime in tackling TPM will be analyzed in Chapter 6.

5.2.2.2 France and Cameroon: Similar Regulatory Approaches

France and Cameroon operate moderate and quite similar systems of TP anti-avoidance although there are growing differences in the details of system attributes adopted in both countries. Cameroon's TP regime is largely based on general anti-avoidance rules that are progressively being reinforced by specific ones intended to tackle TP. However, this regime cannot be described as specific since TP provisions are broadly worded without a comprehensive regulatory framework to clarify stakeholders on the precise scope and modalities for its implementation. It is questionable whether the system provides adequate tools to permit tax authorities enforce TP rules in Cameroon and other African countries operating similar regimes. Like Cameroon, France's regime comprises general and on certain issues specific rules designed to facilitate timely recalls of unpaid taxes. It nonetheless has the advantage that the French Tax Authority (FTA) applies OECD transfer pricing guidelines directly during tax audits and other related procedures.⁵²⁹ For example, TP rules in France and in as many as 30 OECD member countries are clearly built around the ALS defined in The Guidelines. Indeed, many OECD countries have fairly similar rules dealing with TPM since The Guidelines is part of the legal corpus of domestically applicable rules. In the following subsection we comparatively present existing system attributes in both countries.

⁵²⁹ Reference to OECD principles is made in regulation of 23 July 1998 and also on APA and TP documentation.

A. Jurisdictions to Tax in France and Cameroon

EU countries with the exception of France mostly tax the worldwide profits of home companies. By applying the *principle of territoriality* France only taxes profits earned by enterprises within its borders.⁵³⁰ Thus, it has opted for a predominantly source-based system that exempts foreign incomes from its jurisdiction to tax, instead of the residence-based system where worldwide profits are taxed and foreign taxes credited against domestic liability to avoid double taxation. There is however an exception to territoriality in France. Within meaning of Art 223A-223Q of the FTC, the Minister for Economy may authorize certain French companies to apply the consolidated profits regime whereby in addition to French source profits, those of affiliates operated abroad are included for tax computation purposes. Excepting consolidation, Cameroon's jurisdiction to tax is largely influenced by the French system. Jurisdiction is based on territoriality and the "company tax shall be established... for all taxable transactions in Cameroon" within meaning of s.14 of CTC. Likewise, "Transactions carried out in Cameroon ...shall be liable to VAT even when the residence or head-office of the real taxpayer is situated outside Cameroon" as per s. 129(1) of CTC.

Technically, *legal or economic residence* in Cameroon or France mainly serves to reinforce source-based taxation. As an example, s.14 of CTC nets companies "at its registered office or, ...at the place of its principal establishment." The phrase "registered office" is consistent with 'place of incorporation' examined in 5.1.1.1.B [supra]. However, the concept of "principal establishment" raises interpretational difficulties. Is it akin to the concept of 'permanent establishment' developed in Art.5 of OECD's Model Tax Convention?⁵³¹ Or, is it the 'place of management' or 'principal business location'? Whatever it's meaning one may presume that Cameroon applies the same unilateral double taxation relief system (exemption) as France. From this perspective, it is technically hard to see how *legal or economic residence* mentioned in statutes could be interpreted as granting taxing authorities jurisdiction to also tax foreign-source incomes for Cameroon resident companies. Requirements under s. M19 (a)(2) of the Manual of Tax Procedures (CTC) for large taxpayers resident in

⁵³⁰ This means carrying on regular business in France as: (i) an autonomous establishment, (ii) through representatives, or (iii) as part of operations forming a complete business cycle

⁵³¹ A *permanent establishment* is defined by Article 5 of OECD Model Tax Treaty as a fixed place of business through which an enterprise wholly or partly carries on business, comprising: the place of management, branch; office; factory; workshop; and mine, oil or gas well, a quarry or other place of extraction of natural resources. It encompasses building sites, construction, assembly and installation projects, furnishing of services, and consultancy services, if these last for more than twelve months within any twelve-month period. Nevertheless, use of facilities for storage only, or processing by another enterprise, or solely for collecting information and purchasing goods, or carrying other activity of an auxiliary character would not amount to operating a permanent establishment in that state.

Cameroon to automatically produce documents on controlled operations during tax audits serve to reinforce the allocation of incomes and costs on a source basis.⁵³²

The jurisdiction to tax companies operating in Cameroon's O&G sector is exercised by a number of government institutions and departments. As noted hereafter these institutions variously assess and collect at least four types of fiscal revenues enumerated in the Petroleum Code: (i) Surface Rentals, (ii) signature and production bonuses, and (iii) ad-valorem Royalty from Concessions or PSCs,⁵³³ (iv) state's share of Profit Oil, and (v) the Corporate Income Tax and other direct taxes. In this regard, CIT is assessed on the net-taxable results of both exploration and production operations,⁵³⁴ and together with fixed fees and surface rentals are collected by the Taxation Directorate (DGI) through its Large Taxpayers Unit. Likewise, royalty, bonuses and profit oil are assessed and collected in cash or kind by the National Hydrocarbons Cooperation (SNH). If received in kind SNH's Commercial Department is responsible for marketing the crude oil on both the international and domestic markets (off-takes by SONARA).⁵³⁵

B. The Arms-Length Standard in France and Cameroon: Art. 57 and s. 19 of Respective Tax Codes

Historical Evolution of the ALS in Both Countries

In France, the fisc relies on Art.57 of the FTC to tackle schemes designed to indirectly transfer profits abroad. Alternatively, tax authorities may rely on the general anti-avoidance doctrine of '*acte anormal de gestion*' contained in Art.39 of FTC to disallow tax deductions if these expenses are not engaged in accordance with normal acts of management, are incurred not necessarily in the interest or for the benefit of the business.⁵³⁶ Whilst Art.57 is applicable mainly in cross-border TP cases, Art.39 may apply to all tax avoidance cases. France's approach to regulating TPM is arguably light considering that FTA only issued its first regulation/main doctrine in May of 1973 and has since released no formal commentary on OECD guidelines. However, FTA has finalized and published

⁵³² If they are (i) more than 25% owned directly or indirectly by foreign established or incorporated entities, or (ii) that are themselves directly or indirectly owners by more than 25% of a legal entity domiciled out of Cameroon

⁵³³ s. 92(2) of Cameroon's Petroleum Code

⁵³⁴ s. 94 of CPC

⁵³⁵ http://www.snh.cm/index.php?option=com_content&view=article&id=77%3AAla-dco&catid=51%3Acorganigramme&Itemid=63&lang=en [Last visited on October 2, 2013]

⁵³⁶ This consecrates the principle in French taxation that deduction of expenses are allowed only to the extent that they are incurred for the benefit of business or within framework of normal commercial management. The tax authorities are required to show that the transaction was underpinned by a deliberate attempt to shift profits from one taxpayer to the other and covers domestic and international transactions and is applied to corporations and branches alike

commentary on the interpretation of TP legislation in France following amendments to Art. 57 CGI aimed at transactions with tax havens. Furthermore, regulations were published on APA procedures (bilateral -1999, unilateral -2005), the MAP in 2006, and a series of commentaries on TP cases issued over the years. According to Art. 57 of the French Tax Code:

“To determine the income tax owed by companies that either **depend on** or **control** enterprises outside **France**, any profits transferred to those enterprises indirectly via increases or decreases in purchase or selling prices, or by any other means, shall be **added back into the taxable income** shown in the companies' accounts. The same procedure shall apply to companies that **depend on an enterprise** or a **group that also controls enterprises** outside **France**.

The relationship of dependence or control need not be established if the transfer is to enterprises in a foreign State or territory outside France that has a preferential tax regime within the meaning of Section 238A paragraph 2.

In the event of non-response to a request under Section L.13 B of the Tax Procedure Manual, the administration shall determine the taxable income to which the request refers on the basis of elements in its possession, and pursuant to the adversarial procedure set forth in Sections L.57 to L.61 of the Manual.⁵³⁷

In the absence of the specific elements needed to perform the corrections stipulated in the first, second and third paragraphs, taxable profit shall be determined by **means of comparison** with the profit of **similar enterprises doing business normally**”

Likewise, s.19 of CTC is strongly inspired by Art.57 of FTC and if the evolution of France's TP anti-avoidance regime is arguably moderate, Cameroons' has been even more so. Despite the fact that the illicit transfer of profits abroad is historically targeted in s.19, it was not until 2007 that the fisc started developing an appropriate legal framework to facilitate effective implementation of the provision. Piecemeal reforms include the introduction of s. M19 *bis* protocols to be used during General Tax Audits to formally request intragroup information and documentation.⁵³⁸ In 2012, further reforms were added to s. M19 *bis* intended to compel controlled *companies* to provide information and documentation to tax auditors at the start of the audit exercise (s. M19 bis (2)). More reforms on thin capitalization, technical assistance and TP related issues are being considered.

As concerns the purport of s.19 of CTC, it reproduces verbatim paragraph one of Art. 57

⁵³⁷ These provisions apply to audits undertaken as from the effective date of Act N° 96-314 of 12 April 1996 published in the Journal Officiel de la République Française of 13 April 1996.

⁵³⁸ Circular N° 004/MINEFI/DGT/LC/L of 25th Jan 2007 to specify the methods of application of the fiscal provisions of the 2007 Finance Law

[supra], omits paragraphs two and three, and words paragraph four slightly differently emphasizing that taxable profits should be assessed by comparison with those of “similar undertakings operating in Cameroon.” Statutory emphasis is on using comparables drawn specifically from within Cameroons borders. This can be contrasted with France’ version (*doing business normally*). Although there is noticeable inclination towards retaining for TP reassessment purposes French comparables, France’ version allows FTA to draw comparables from outside of France by using for example pan-European benchmarks. In both countries the burden to prove dependence rests with tax authorities. Reassessments are possible only if subordination or dependence is shown to exist between parties, and that failure to adhere to ALS resulted in the indirect transfer of taxable profits abroad.⁵³⁹ However, there is a presumption of dependency in France if the transaction takes place with entities based in tax havens.⁵⁴⁰ No such presumption exists under Cameroon tax law.

Further, FTA may accept on the basis of Art. L13 B ‘any method’ prescribed by the OECD guidelines provided it is consistent with the ALS and backed by sound economics, accounting and methodology. This position is consistent with that adopted by Cameroon in that although statute does not cite a specific method, Circular N°. 004 of 2007 indicates that the DGI would accept “any method put forward by the enterprise...” provided it is accompanied by supporting documentation under s. M19 bis.⁵⁴¹ One could argue that such a standard, namely “any Method” does not necessarily amount to the “best Method” that is currently applied in the US and Nigeria. It may not also satisfy OECD recommendations that stakeholders “select one method that is apt to provide the best estimation of an arm’s length price”. In practice however, it seems that the understanding and application of the “any method” standard by FTA is akin to the “Best Method” with theoretical preference being given to traditional transactions over transactional profit methods. However, there are no explicit ALR provisions in these domestic legal frameworks. Nonetheless, safe harbors exist on certain cost deductions (*interest -thin capitalization*, payment of technical assistance fees).⁵⁴²

⁵³⁹ Guionnet-Moalic, C., *Are French Anti-Avoidance Rules More Favorable or Less Favorable to Corporate Taxpayers?* Tax Planning Int’l Special Report: Tax Planning & Anti-Avoidance Legislation, September 2009

⁵⁴⁰ That is, entities benefiting from privileged tax treatment within meaning of s. 238 A of the French Tax Code. Under present rules, this implies countries that charge taxes representing less than 50% of what France charges

⁵⁴¹ Although this position is similar to France’s the latter imposes a much more robust standard for large taxpayers

⁵⁴² Cf. s. 212(1) of French Tax Code

The ALS in Cameroon's Petroleum Industry: s.94 of the Petroleum Code

The basis for applying ss. 19 and M.19 bis to circumstances of the hydrocarbons (O&G) sector is embedded in s.94 of Cameroon's Petroleum Code (CPC).⁵⁴³ Considering that valuation of crudes impact revenues the state gets in royalty, profit oil, income taxes and possibly signature bonuses, Cameroons crude oil should be sold on the basis of "dated international market prices" (*Prix courant du Marché International*). If the corporation pays royalty in kind as a proportion of production, it must value these payments and report the same as a component of proceeds for CIT purposes. Likewise, s. 95(a) provides similar exigencies for CIT allowable expenses such as payments for services, overheads, personnel and related expenses. If these payments are made to foreign or domestic affiliates of the field operator, prices charged should reflect those normally charged by independent parties for similar transactions under competitive market settings. This also applies to financial transactions with s.95(c) laying the basis for Cameroon's DGI to develop regulations to tackle Thin Cap and other interest schemes.⁵⁴⁴

On the issue of valuing hydrocarbons, Cameroon has issued guidelines for determining the ALP in ss. 90-94 of Decree N^o.2000/465.⁵⁴⁵ The value of hydrocarbons produced is the going price on the international commodity markets,⁵⁴⁶ quoted in dollars or other convertible currency as agreed by the parties. The international market price shall be FOB at the contractually agreed delivery point and should be comparable to prices charged for sale of hydrocarbons of similar quality with necessary adjustments to account for transactional peculiarities. The price for natural gas is effectively the US\$/BCF price agreed in the sales contract provided the transaction takes place between independent parties. If sale takes place between related parties or joint ventures or paid in another currency that is not easily convertible into FCFA, parties shall adopt an ALP that is applicable to similar transactions on the basis of Barrels of Oil Equivalent (BOE). International market prices are negotiated between the state and contract/license party every three months (quarterly) by averaging 'Dated Brent' quotations or other reference crudes as published on *Platt's Crude Oil Marketwire*, plus or minus crude differentials. The settled price is applicable upon publication by the Minister in charge of prices.

⁵⁴³ Law N^o. 99/013 of 22 Dec 1999 bearing the Petroleum Code

⁵⁴⁴ However, according to s. 7(B) of CTC amounts paid as interests to service debts may not exceed rates set by the Central Bank (BEAC) topped-up by two points

⁵⁴⁵ Decree N^o. 2000/465 of 30 June 2000 Establishing Modalities for the Application of Law N^o. 99/013 of 22 Dec 1999 bearing the Petroleum Code

⁵⁴⁶ s. 90 of Decree N^o 2000/465 (Cameroon)

C. TP Compliance Requirements: Documentation and Disclosures

Documentation Requirements in Both Countries

In both countries there is responsibility that related parties *prima facie* prepare and file accounting documents.⁵⁴⁷ In Cameroon for example documents should be kept for a minimum of 10 years during which period the *fisc* might exercise the right to investigate.⁵⁴⁸ In the event that accounts are computerized, they must be prepared in line with procedures that ensure reliability and security.⁵⁴⁹ In such circumstances and in accordance with s. M8 the *fisc* may seek technical assistance from experts to conduct tests on the equipment used by the enterprise with a view to probing the accounting system, information, data and processes directly or indirectly used to produce accounting and/or tax results or to draft mandatory documents as provided in the Tax Code. Also to probe documents relating to the analyses, programming and execution of processes. Documentation requirements in Cameroon are therefore broad and not TP specific.

France for its part has made substantial progress on the issue of TP documentation by introducing Art L.13 AA.⁵⁵⁰ Though unique in that it applies only to taxpayers of the Large Tax Unit from Jan 2010, this signifies a milestone in what is otherwise a light approach to tackling TPM. In essence, incorporated companies, permanent establishments and other entities doing business in France are netted provided: **(a)** turnovers or gross assets on balance sheet exceed €400 millions - *approximately US\$ 520 millions*, **(b)** more than 50% of capital or voting rights of the entity in (a) is held directly or indirectly by a given party, **(c)** more than 50% of capital or voting rights of a given entity is held by the entity in (a), **(d)** a tax ruling grants benefit to entity under the Worldwide Tax Consolidation Regime, and **(e)** Part of French tax group in which at least one of the legal entities in the group meet at least one of conditions in (a), (b), (c) or (d). The new rules enjoin MNE's to keep formal and compulsory TP documentation that permits the FTA to get a clear sense of the economic, legal, financial and fiscal environment of its intrafirm policies. It is doubtful, whether this section nets foreign parents keeping accounts under GAAP rules that sometimes differ from French accounting rules (e.g. Salaries affect gross profits in the former, but not the latter).

⁵⁴⁷ For example s. M4 of CTC

⁵⁴⁸ s. M5 of CTC

⁵⁴⁹ As per conditions provided in s. 22 of the OHADA Uniform Act to Organize and Harmonize Corporate Accounting.

⁵⁵⁰ This new documentation requirement was introduced by s. 14 of the 2009 Amended Finance Bill that was codified as Art L.13 AA and L.13 AB. Further, Administrative Guidelines N° 4 A-10-10 of 23 December 2010 *relating to documentation requirements in matters of Transfer Pricing* were later issued to clarify Art L.13 AA and AB

Compliance with new documentation rules entails adopting a two-pronged approach. First, provide a group level general description easily drawn from the group masterfile, and a second describing French specific fact patterns drawn from local file. These documents should contain general information on the group including (i) a description of its activities, (ii) identifying legal, operational structures and relationships between firms engaged in transactions, (iii) description of functions performed and risks borne by each group member, (iv) identification of intangible assets owned by the company -*patents, trademarks, trade names, know-how*; and (v) a broad description of its TP policy. In addition to keeping the above, FTA examiners may during audits request more specific information relating to description of activities including changes carried out during the years audited; operations carried out with related parties (nature and amount of flows –global flows per category with interest in royalties); list of cost sharing agreements, APA's and rulings affecting the company's results; TP policy and basis for selecting a specific method; analysis of comparability factors used to select the method applied; and other relevant documents. Further, Art L.13 AB imposes an additional obligation for French companies to provide financial statements of related entities operating in countries classified as non-cooperative.

Reporting Requirements in Both Countries

Cameroon is long on general reporting requirements but short on requirements specific to transfer pricing. There is obligation under s. M2 of the CTC to file, within deadlines, tax returns and mandatory documentation using official forms provided by the DGI. Failure to do so results in the fisc issuing a notice reminding taxpayers to comply.⁵⁵¹ Other provisions in the tax code are partially relevant to documenting intrafirm transactions. For instance, s. 18(1) of CTC obliges firms to file returns of revenues derived from their business ventures and to furnish documents mandated by the OHADA Accounting system. Further, s.101 requires taxpayers to annually file a list of *sales per client* and *purchases per supplier* (detailing amounts) before the 15th of March with the competent tax authority. This includes all payments in excess of 250,000 Fcfa (US\$ 518) made as commissions, rebates, fees, charges, copyright or inventors royalties or other remuneration, which should contain full business names of the purchaser, full business names of the seller, the amounts per nature of transaction and period covered by the payments.⁵⁵²

⁵⁵¹ s. M.3 of Manual of Tax Procedures

⁵⁵² s. 102 of CTC

During tax audits disclosure is imperative if auditors request information and documentation on cross-border transactions within meaning of s. M19 (a)(1).⁵⁵³ This standard finds equivalence in Art. L.13 B of FTA now applied mainly to Small and Medium Businesses (SMB's). This is nonetheless moderate compared to Art. L13 AA & AB applied to Large Businesses, which provision, Cameroon's tax law has no equivalence for. Under s. M19 (a)(1) requests may be made on the first day or within 30 days of commencing audits. The DGI may not oblige compliance before a month and the taxpayer may not request deferral beyond two months. Documents are either filed in English or French in both countries, although France can insist that they be wholly or partly translated into French. Failure to reply exposes the company to risk of administrative assessments by which the *fisc* directly assesses taxes on the bases of elements at its disposal, in line with adversarial or arbitrary procedures provided for in ss. M23 and M28 of the MTP. Recourse to s. M19 (a)(1) and Art L.13 B is neither compulsory nor systematic and only used when the auditor is not provided with adequate information during audit. Further, requests can only be made during general audits and the taxpayer is under no obligation to provide response if exercised within context of desk controls. In conclusion, France has upgraded its D&R requirements for large businesses while Cameroon applies for a similar category of taxpayers, standards that are now only applied to SMB's in France.

D. Adversarial Procedures: Audits & Applicable Penalties

Transfer Pricing Audits

Two main procedures are used in both countries to examine taxpayer accounts, namely “**desk examinations**” and “**tax audits**”. The former is an in-office review of returns and therefore not a technically suited procedure for adjusting transfer prices. Tax audits are the default procedure for examining TP.⁵⁵⁴ *General Tax Audits* consists of examining all taxes for periods not spent under *statutes of limitation*. In Cameroon the *fisc* may only exercise its right to examine accounts within four years of the tax falling due, without possibility to extend this limitation even in TP cases.⁵⁵⁵ This

⁵⁵³ Information that can be requested includes nature of intercompany transaction, pricing method used, activities of related foreign enterprises, tax treatment of intercompany transactions,

⁵⁵⁴ There are at least three main types of field examinations historically used in both jurisdictions: General, Partial and Punctual Audits to be carried out by tax officials with at least the rank of *Inspector of Taxes*. Punctual Audits entail examining accounts vis-à-vis a select number of taxes and can only cover a period short of a year. This is not ideal for TP examinations. *Partial Audits* typically may cover a single tax for a non-spent period (e.g. CIT, VAT) or examine all taxes for a single year. This -like the *General Tax Audit*- is a useful procedure for examining TPM although Cameroon reserves use of the Partial Audit procedure only for validating VAT refunds.

⁵⁵⁵ s. M34 of the CTC. However, there is a second school that will argue there is an implied possibility to extend audit (even on TPM matters) beyond the statutorily barred period under exceptions provided for Section M.16 by which the *Fisc*

position differs considerably from France' that provides a three (3) years statute of limitation, with possibility under Art L.188 A to extend to five (5) years if the FTA requests for information from a foreign Tax Administration before expiration of the initial statute of limitation. The extension ends in the year following that in which a response is received. In principle site visits during general audits in Cameroon may not run for more than three (3) months excepting TP where it might last for up to six (6) months. In France, there is no time limit for completing site investigations built into the law. Following notification by the FTA of intended adjustments the taxpayer has one month within which to object or accept adjustments. Auditors would then finalize and issue tax recalls or absence thereof within two months of receiving taxpayer's objections to, acceptance of, or lack of response to notice. France's audit system slightly differs from Cameroons in that prior to FTA issuing a notice of collection (*Avis de Mise en Recouvrement*), taxpayers may raise objections with a review panel - Commission Départementale- that issues a non-binding ruling on technical (not legal) issues.

In principle, the burden of proof rests with the *fisc* during tax audits to establish that the taxpayer failed to comply with its obligations. In at least one case however, the 'burden' shifts to the taxpayer when as a result of non-cooperation tax authorities are compelled to adopt administrative assessments.⁵⁵⁶ In France especially, the 'burden' also shifts to the taxpayer if transfer of profits take place with related parties incorporated in a tax haven. The question as to who bears the 'burden of proof' in these cases was clarified in 2008 by judgment (*arrêt*) of the Administrative Court of Appeal (*Cour Administrative d'Appel -CAA*) of Paris. The ruling confirms that *onus* rests with the FTA and not the taxpayers even in matters of transfer pricing, although practice shows that the *onus* is borne by taxpayers once the *fisc* presumes illicit transfer of profits. France has nevertheless been devoting substantial amounts of resources to TP investigations, with all 30 sector audit teams of the *Direction des Vérifications Nationale et Internationale* (DVNI) receiving assistance from tax inspectors of the 30th Brigade specialized in transfer pricing.⁵⁵⁷ The DVNI is known to source comparables from databases like InfoGreffé, Bureau Van Dijk's Diane and Amadeus. As concerns resources devoted to auditing

is allowed possibility to go one or more years back beyond the statutorily barred period if deficit is carried forward into the non-barred period and expensed.

⁵⁵⁶ Cf. s. M29 of CTC. Under the Arbitrary Assessment Procedure, tax authorities could on the basis of facts available to them and by comparison with other companies or person's operating in same sector as the noncompliant taxpayer, use best judgment to ascertain its tax liability. Notification is forthwith served on the taxpayer accompanied by an enforceable tax bill. In this case, the burden of proof shifts from the Tax Administration to the taxpayer to demonstrate that assessments and debts issued by *fisc* are unfounded or exaggerated.

⁵⁵⁷ Competent to audit companies (industry) with turnover or €152.4 millions (US\$...) or service companies with turnover of €76.2 millions (US\$...)

host affiliates of foreign MNE's, sector audit teams within the Large Taxpayers Unit (LTU) in Cameroon are responsible for handling this.⁵⁵⁸

Transfer Pricing Penalties

There are no penalties specific to TP under Cameroon's tax Law although examiners may charge two types of generic penalties for noncompliance: *fiscal* and *penal*. Fiscal penalties are charged for noncompliance with obligations to file returns and/or tax collection. In cases where a taxpayer *omits or files inadequate and/or inaccurate* returns the taxing authority shall charge as penalties either 30% if good faith is proven, 100% for bad faith or 150% in case of evasion without prejudice to criminal sanctions.⁵⁵⁹ This is topped by interest of up to 1.5% of principal tax recall per month of deferral to a maximum of 50%. However, in cases where the *taxpayer fails to file returns* and the DGI engages administrative assessments to enforce compliance, the chargeable penalty is 100% or 150% in case of additional offence.⁵⁶⁰ Further, returns that are filed after compliance deadlines are subject to a penalty charge of 10% per month of delay up to 30%. France, like Cameroon applies generic noncompliance penalties. For example the rates of 40% and 80% would apply depending on whether good faith or bad faith is established. But, fairly reduced interests of 0.40% per month and 4.8% per annum are applied for late payments compared to 1.5% and 18% respectively charged in Cameroon. Another significant difference is that France has now introduced penalties specific to transfer pricing (Art. 1735 *Ter.*). Thus, if a taxpayer following a formal request by auditors fails to, or provides incomplete documentation that results in TP adjustments being made this attracts a maximum fine of 5% of the amount transferred abroad with a minimum of €10,000 (US\$ 13,584.94) per year audited. If the company audited fails to or provides incomplete documentation the analysis of which does not result in reassessments, there is nonetheless a noncompliance fine of €10,000 charged per year audited.⁵⁶¹ None of these penalties are deductible expenses for CIT computation purposes. Art. 1735 *Ter.* is therefore a major veering away from France's historic approach of imposing generic (not specific) penalties.

⁵⁵⁸ For taxpayers with annual revenues of 3 billion Fcfa (US\$6.06 million) or more; Until December 2013 this was set at 1 billion Fcfa

⁵⁵⁹ s. M96 of CTC

⁵⁶⁰ s. M97 of CTC

⁵⁶¹ s. 1735-II of FTC

In addition to tax penalties discussed above the FTA can request a warrant from a judge to search premises of taxpayers suspected of tax fraud.⁵⁶² Likewise DGI can introduce criminal proceedings against a taxpayer who “evades fraudulently or attempts to evade fraudulently” the issue, payment or repayment of taxes as detailed in the Tax Code. The same applies to taxpayers who expressly refuse to file returns, conceal part of taxable amounts, organize its bankruptcy or obtain VAT refund through fraudulent means. Penal sanctions include: imprisonment of from 1 to 5 years or a fine of between 500,000 to 5,000,000 Fcfa (US\$ 10,355).⁵⁶³ The DGI can also seek an award of temporal prohibition of up to five (5) years from the exercise of commercial, industrial or other professional activity in Cameroon. The statute of limitation for taxing authorities to introduce criminal proceedings is four (4) years. Valid preoccupations might be raised regarding effectiveness of these penalties in terms of tackling TPM, an issue we return to in greater detail in Chapter 6.

E. TP Dispute Settlement Mechanisms

Traditional Dispute Resolution

Administrative Phase: Appeals primarily concern objections by taxpayers against erroneous assessments, computations or collection of taxes. In Cameroon, firms seeking grant of a right arising from a law or regulation must file appeal at most 90 days of receiving formal notification of a tax recall bill or having certain knowledge of the levy.⁵⁶⁴ The competent tax authorities have 30 days to notify taxpayer of their decision to uphold or reject appeal, with competence to relief up to 30 millions Fcfa (US\$ 62,134). If unsatisfied with the decision, it can appeal further to the Director General of Taxation within 30 days who shall respond within 60 days of it being filed, with competence to write-off 100 million FCFA (US\$ 207,116).⁵⁶⁵ Final administrative appeal goes to the Minister of Finance, who notifies his decision within 90 days. Within meaning of s. M124 silence by the *fisc* to respond to the taxpayers appeal amounts to rejection, a position akin to France’s requiring that response is given within 6 months of receiving the pre-litigation appeal. Thereafter, leave is granted taxpayers in both countries to proceed to litigation if dissatisfaction persists.

⁵⁶² s. L16 B of FTC

⁵⁶³ s. M107 of CTC

⁵⁶⁴ s. M116 of GTC. There are admissibility conditions attached to filing appeals, including mention of taxes, tax years of issue, place of assessment, reasons for the appeal, and proof of payment of the undisputed part of debt

⁵⁶⁵ This procedure was shortened in 2014. Appeals of amounts of up to 50 million Fcfa are handled by the regional chiefs while amounts falling in-between 50–100 millions are handled by the Director general. Further appeal from both levels goes directly to the Minister in Charge of Finance

Litigation Phase: Taxpayers may challenge taxes in the Administrative Courts (AC) within 60 days of receiving or failing to receive notice of the Minister's decision.⁵⁶⁶ In both countries AC's (*Tribunal Administratif*) stand competent to decide cases pertaining to direct, indirect and allied taxes, principle being that registration, stamps and trusteeship are to be litigated and handled in Judicial Courts. In contrast to the administrative phase, where silence of the *fisc* is interpreted as rejection, failure by the Minister to respond to the courts notification within 60 days amounts to acquiescing to facts stated in the taxpayers petition.⁵⁶⁷ Courts may appoint experts to assist in proceedings.⁵⁶⁸ There are limitations placed on probing accounts of affiliates or branches established abroad and foreign accounts might not be invoked in litigation with the *fisc* unless they show profits or losses made by the same subsidiary or branch.⁵⁶⁹ Further appeal goes to the Appeals Court (*Cour Administrative d'Appel - France*) and Administrative Bench of the Supreme Court (*Conseil d'Etat*).

Mutual Agreement Procedure: With only four International Tax Treaties to its credit (*France, Canada, Tunisia, and CEMAC*) as at end of December 2014, inter-nation tax disputes and the MAP are infrequent in Cameroon. It is however a much useful procedure to taxpayers in France seeking redress against double taxation within meaning of Art. L.189 A. Once the MAP is engaged FTA suspends collection of taxes contained in reassessment notices, which deferral only holds until end of the third month following the date on which taxpayers are notified of the outcome of the MAP.⁵⁷⁰

Alternative Disputes Resolution (ADR)

Unlike other select countries Cameroon has only restrictively oriented policy towards ADR's. Indeed, little is being done to suggest that legislation in this area is being strengthened. Nonetheless, there exists two ADR's in Cameroon: international arbitration for major oil disputes⁵⁷¹ and tax transactions –*compromise/settlement*- provided for in the Tax Code. Firstly, s.115 of CPC allows contract parties to make recourse to *international conciliation* and *arbitration* for contractual breaches, excepting technical issues that are primarily resolved by applicable regulation. Whether or not

⁵⁶⁶ s. M126 of CTC

⁵⁶⁷ s. M133 of CTC. The taxpayer is deemed to have acquiesced after 1 month if he does not respond to the tax authorities reply to his petition.

⁵⁶⁸ s. M134 of CTC

⁵⁶⁹ s. 19 of CTC

⁵⁷⁰ Since February 2006, France has new MAP regulations that provide guidance with respect to the scope, conditions and implementation of MAP. This takes into account the EU Joint Transfer Pricing Forums' code of conduct vis-à-vis implementation of the EU Arbitration Convention

⁵⁷¹ s. 115 (2) of CPC; Also see Cameroons 1964 and 1978 mining laws that allow the same possibility

domestic tax matters can be referred to arbitral jurisdictions is not clear. Secondly, s. M125 allows parties the option to negotiate a total or partial *tax settlement* prior to issuing the tax bill or during the entire dispute process. Settlement is possible on condition that the taxpayer agrees to refrain from filing any further complaint, withdraws existing complaints and pays all related outstanding taxes. There is as yet no record evidencing settlement in TP disputes.

In France, Art. L.80 B 7th codifies basis for concluding bilateral and unilateral APA's with taxpayers.⁵⁷² Prior to introducing unilateral APA's in 2004, only bilateral APA's were available to taxpayers. Bilateral APA's are open to taxpayers from countries with which France has signed a tax treaty with a section equivalent to Art.25 (3) of OECD's MTT. APA requests can be filed in France and/or treaty party state and may cover all or part of the group's transactions. All major documents needed to facilitate the negotiation process are normally listed during preliminary meetings. Following an in-depth review, a non-retrospective ruling is issued detailing the parties, transactions, TP methods elected, underlying assumptions, revision formula's and procedures, date and duration of the APA (3-5 years) and content of annual report to be filed by the taxpayer. Unilateral APAs may be negotiated with taxpayers in cases where a treaty does not contain MAP procedures, if such a procedure exists but the foreign competent authority is unwilling to engage in APA negotiations, and where the taxpayer seeks an APA on simple issues like management fees. The APA procedure in France has been criticized for its lack of appeal with MNEs.

5.3 CHAPTER CONCLUSION

In the foregoing sections we have examined the conceptual underpinnings of TP regimes - *principles, standards, methods* (5.1), and explored actual attributes of TP anti-avoidance in four select countries - *jurisdiction to tax, ALS, compliance, adversarial, dispute resolution mechanisms* (5.2). We therefore draw the following conclusions on the overview of existing TP regime designs.

As concerns conceptual underpinnings, we establish as follows:

On the jurisdiction to tax MNEs we note that two competing concepts may be used to justify the right to tax. These are source-based and residence-based approaches. Opinion varies if the right to tax reposes with the country in which an entity is *resident* (country of residence), or that within

⁵⁷² Administrative Guidelines 4 A-8-99 N°. 171 of 17 September 1999 relating to Bilateral; and Guidelines 4 A-11-05 N°. 110 of 24 June 2005 on Section L.80 B 7th on Unilateral Transfer Pricing APA procedures

whose borders it *earns income* (source country). We conclude that the source country has the *right of first taxation* even if business entities operating in its borders are not tax resident there. France for example taxes all domestic earnings, whilst exempting from its taxable base incomes earned abroad. From this perspective, the country of residence⁵⁷³ only has a residual right to tax incomes of entities that are earned or remitted from abroad. If indeed it moves to tax foreign incomes, it is likely that this would result in double taxation and it thus has the responsibility to eliminate this possibility by granting relief in forms of tax credits (US) or tax deductions.

On the applicable transfer pricing standard, we find that there are two competing approaches, namely the separate entity (Arm's-Length Standard -ALS) and the integrated entity (Unitary Taxation - UT) approaches. Review of the *given-regime-state* in all four countries strongly reveals that the ALS has been retained over UT, notably as far as the international taxation regime is concerned. But, far from being jettisoned UT is used domestically in the USA, Switzerland, and is now gaining inroads into the EU system by way of formulary apportionment. On the question of transfer pricing methods, we find that there are five main methods used by MNEs to determine TP (CUP, CPM, RPM, PSM, TNMM). In principle the world is moving away from imposing statutory preferences of any single method over others. The *actual-regime-state* allows taxpayers to apply the 'best method rule' stated in the US and Nigerian regulations. However, France and Cameroon use a rather different standard namely "any method" to guide MNEs selection of TP methods, raising doubts on whether this creates a different and somewhat lesser exigency than the 'best method' rule mentioned above. As concerns choice of method it was observed that in practice, tax examiners in both the US and France prefer applying profit based methods, notable the TNMM.

As concerns given-regime-state (actual attributes) of select TP regimes:

Arm's-Length Standard: Authority granted IRS under s.482 in US tax law was discussed in the chapter as broadly covering: (i) any enterprise exercising control or (ii) any transactions –tangible or intangible- whether they have or lack business purpose and/or not motivated by tax considerations. Further, design of Treas. Reg. 1.482 is highly detailed, robustly built and one can as such conclude that the US maintains a very tight approach to regulating TP. Nigeria's s.15 PPTA and Clause 10.1 of its 2005 Model PSC adopt the ALS but maintain a light approach to regulating the problem. This notwithstanding, it's issuance in 2012 of new regulations raises anxiety as to whether the country is

⁵⁷³ 'Residence' is based either on *de jure* control (*incorporation*) or *de facto* control (seat of management)

signaling a shift towards the tighter approach. France and Cameroon adopt the ALS in Art.57 and s.19 of their respective tax codes. Whilst France allows the *fisc* to draw comparables from outside its borders (pan-European benchmarks), comparables in Cameroon can only be drawn from within the country's borders within meaning of present rules.

Documentation and Disclosures: We find that US law mandates MNE's to prepare and retain TP specific documentation, and also to file these documents with IRS. These requirements are criticized as being heavy handed with IRS itself estimating that MNE's would require about 1.5 million man-hours a year to fulfill compliance obligations. France by introducing Art L.13 AA and L.13 AB seems to be improving response to tackling TP from the documentation angle. Although both apply only to taxpayers of the Large Tax Unit, this signifies a milestone in what is otherwise a light-handed approach to regulating these schemes. As concerns *Audits and Penalties* we conclude that the US has protocols for IRS to carry out TP specific audits and also to apply penalty regimes specific to TP. As a rule, IRS may allow as deductible expenses for income tax purposes payments made in settlement of TP penalties. Like the US, Nigeria has introduced TP audits although it does not apply a penalty regime specific to the TPM issue. France and Cameroon do not have any legal provisions allowing for audits specific to TP. Unlike Cameroon however that does not apply exclusive penalties to TP, Art. 1735 Ter of France's Tax Code has introduced TP penalties for noncompliance with documentation requests. While TP penalties are deductible expenses for CIT computation in the US, they do not qualify for deduction in the other three select countries.

Disputes resolution Mechanisms: We conclude that in addition to the US offering a full spectrum of traditional and alternative disputes resolution mechanisms (administrative appeals, litigation, MAP, APA) it distinguishes itself from other select countries in that it has setup a *binding domestic arbitration mechanism*. France and Nigeria also offer all conventional disputes resolution mechanisms listed above. However, Cameroon trails in terms of options for disputes resolution as it offers a weak and possibly limited ADR framework. There is a major distinction between the US and Nigeria regimes on the one hand, and France and Cameroon on the other as relates to the burden of proof in TP cases. Whilst the burden rests with the taxpayer in countries with an Anglo-Saxon tradition, it primarily rests with tax administrations (*fisc*) in countries with a French tradition to establish during audits and disputes that the taxpayer failed to comply with its obligations.

CHAPTER 6

EFFECTIVENESS OF SELECT GOG TRANSFER PRICING REGIMES: A QUALITATIVE APPRAISAL

Chapters 4 and 5 respectively examined evidence of TPM by IOCs and the actual-state of anti-avoidance regimes designed to tackle the practice in four select countries. Firstly, the evidence shows that the risk to GoG governments of IOCs manipulating transfer prices is substantial.⁵⁷⁴ Secondly, while the architecture of actual TP regimes in GoG select countries can be described as ideal (see chapter 2.2) the *engineering* and *administration* of these regimes are not necessarily effective. This view is underpinned by evidence that some courts in Africa have proven reluctant to uphold TP adjustments that are based on generally worded anti-avoidance provisions,⁵⁷⁵ thus raising concern as to the effectiveness of these regimes from the standpoints of their engineering and administration: *Unilever Kenya Ltd. v Commissioner of Income Tax*.⁵⁷⁶

It would be recalled that effectiveness was described in chapter 2.2 as the “*perceptible gap or distance between the actual-regime-state and an ideal-regime-state*,”⁵⁷⁷ and that as far as TP regimes are concerned this could be judged from the perspectives of their architecture, engineering and administration. It was further noted that while the first two perspectives overlap and are sometimes confused, they are indeed different. **Architecture** mainly deals with the framework design, that is, the actual *composition and arrangement* of concepts comprising the regime (the “**what**”). **Engineering** for its part, relates to “**how**” the draftsman using either of two main *policy approaches* (light or tight) populates the architectural framework with *detailed anti-avoidance rules* designed to tackle TPM. As part of the architecture of TP regimes for example, architects would *include* concepts like audits and penalties in order to ensure detection and remediation. Building on this framework, the engineer’s task is to select from the light or tight policy approaches actual rules to be used in

⁵⁷⁴ As corroborated by *ex post facto* and *hypothetical* evidences discussed in Chapter 5 [supra]

⁵⁷⁵ Which is characteristic of the light approach to engineering anti-avoidance regimes

⁵⁷⁶ (2005) Income Tax Appeal N° 753 of 2003. In this case, Visram J., of the Nairobi High Court ruled against the Kenya Revenue Authority’s (KRA) reliance on broadly worded TP rules contained in Section 18(3) of the Income Tax Act to adjust TP. Without adopting appropriate legislation and guidelines, the Kenya court reasoned that KRA could not successfully rely on such broadly worded provisions to challenge methods used by Unilever.

⁵⁷⁷ Using the analytical framework developed in Chapter 2, effectiveness is assessed on the basis of how well the objectives of a given system track (or is likely to track) against certain preset ideals. This might entail occasionally using *ex-post facto* and/or *hypothetical MAS* evidences to test this

populating these concepts. If the light approach were used, rules pertaining to TP audits and penalties would be nonspecific (general) in nature.⁵⁷⁸ If the policy approach used were however tight, then very specific rules would be introduced for TP audits and penalties.

Further, it would be recalled that in chapters 2.2 and 5.2, we respectively presented the ideal architecture for tackling TP (what) and how this framework is actually populated in the GoG. Given that earlier discussions showed actual architectural frameworks in the GoG to be largely effective,⁵⁷⁹ time and space are no longer allocated to assessing these regimes from this perspective. The problem, resides in ‘how’ well GoG regimes are actually engineered and administered to respond to cases of TPM. Thus, focus in this chapter is on judging effectiveness of TP regimes from two angles.

As noted earlier, the depth of detail that goes into engineering and administering TP regimes largely depends on whether policymakers adopt the tight or light approaches in tackling TPM. The effectiveness of either approach depends on the context in which it is applied and the engineer’s ability to shrewdly use specific or nonspecific anti-avoidance rules to achieve system objectives. In practice both sets of rules are mixed in varying proportions so that countries with a tight approach tend to have more specific rules, while those with a light approach mostly adopt nonspecific ones. Regardless of the approach adopted the ultimate aim is to create a system that effectively tackles TPM by facilitating detection and remediation of TP schemes, or that ideally deters noncompliance. In certain contexts, factors might intervene to make otherwise *light* anti-avoidance regimes effective in cases where *tight* ones would not. Likewise, adopting tight rules might prove effective in contexts where light ones would not. Therefore, the main challenge posed by *context* is that one has to select a suitable blend of nonspecific and specific rules that respond to TPM effectively.

In this chapter, we analyze the strengths and weaknesses of TP regimes in Cameroon and Nigeria compared to those in France and the US. We examine shortcomings of the light approach adopted by GoG countries in their engineering and administering of TP regimes; as well as their ability to detect, remedy and ultimately deter TPM. Views on the effectiveness or otherwise of these regimes are expressed in two main sections. Firstly, effectiveness of select GoG regimes is reviewed from the perspective of their engineering (6.1). This is followed by a review of effectiveness from the standpoint of the administering of these regimes (6.2). Lastly, the chapter concludes with remarks on whether actual TP regimes in the GoG are effective or defective (6.3).

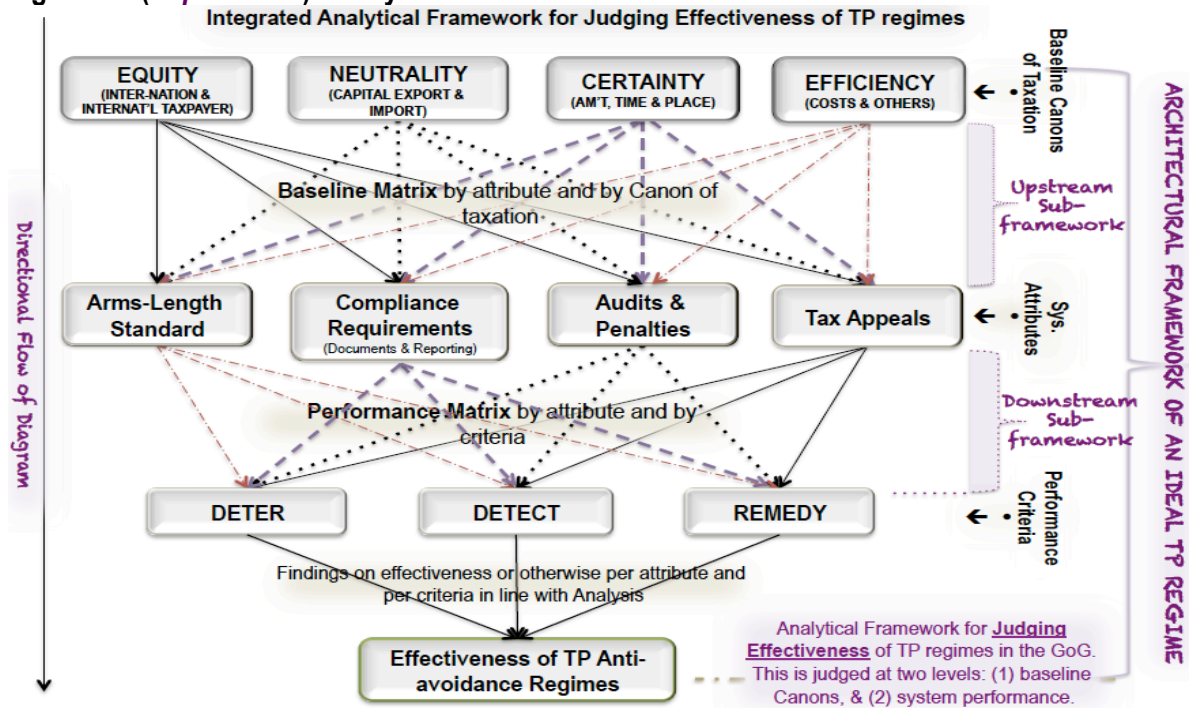
⁵⁷⁸ That is the same or similar as those applied to most or all other avoidance schemes

⁵⁷⁹ Excepting instruments like *safe harbors*, APAs that are yet to be incorporated into mainstream preemption framework

6.1 ENGINEERING EFFECTIVE TP REGIMES IN THE GOG

As discussed in chapter 2 the ideal architectural framework for judging effective TP regimes comprises three layers of concepts namely, a **top** layer (baseline canons of a good tax system), a middle layer (system attributes) and a bottom layer (performance criteria). As shown in figure 2-2 [reproduced below], these three layers of concepts that were grouped into an integrated analytical framework are hereinafter split into two main sub-frameworks within which the effectiveness of TP regimes in the GoG would be assessed. For the purpose of convenience, the first part is described as the upstream sub-framework, and the second as the downstream sub-framework. This logic is embedded in the architectural design proposed in figure 2-2 and hereinafter used as basis for analyzing the effectiveness of TP regimes from an engineering standpoint.

Figure 2-2 (*Reproduced*): Analytical Framework of the Research

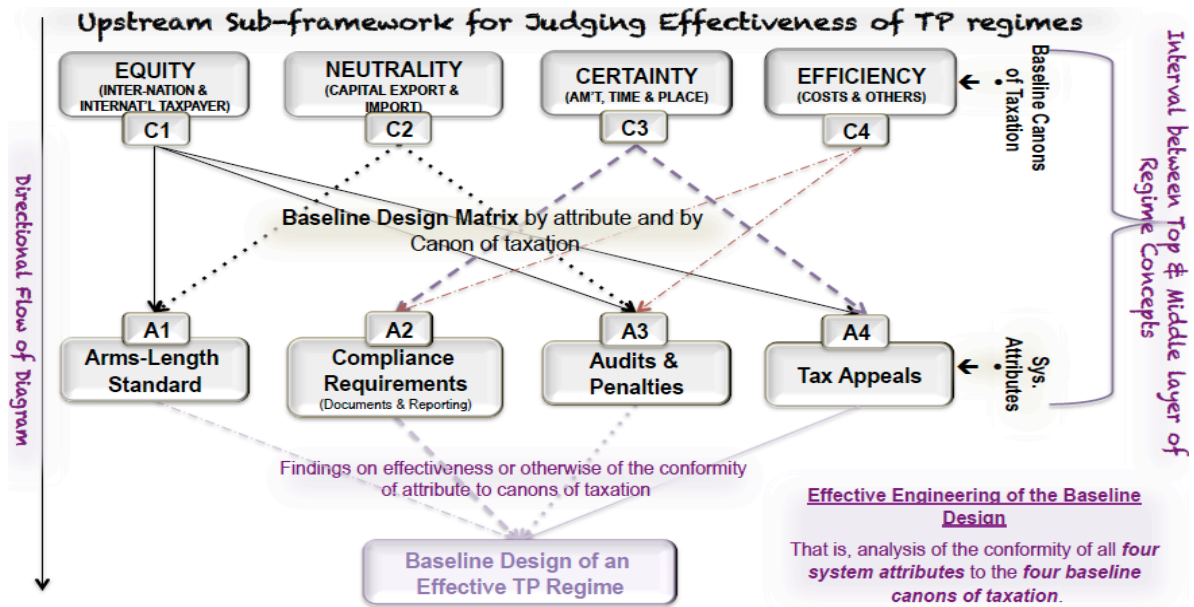


In assessing effective engineering of TP regimes in the GoG, section 6.1 is organized as follows. Firstly, the upstream sub-framework analyzes how well *system attributes* are designed to conform to the baseline canons of a “good tax system” (6.1.1). For its part, the downstream sub-framework examines how effectively *system attributes* are engineered to achieve a *select number of performance criteria* namely detect, remedy or deter TPM (6.1.2).

6.1.1 UPSTREAM SUB-FRAMEWORK: INTERVAL BETWEEN CANONS AND ATTRIBUTES

As indicated earlier [chapter 2], the upstream sub-framework comprises the interval of interactions between the top layer of concepts (*baseline canons of equity, neutrality, certainty and efficiency*) on the one hand and the middle layer of concepts (*system attributes of ALS, compliance, adversarial, appeals*) on the other. This sub-framework is presented in figure 6-1 below.

Figure 6-1: Upstream sub-framework for judging Effectiveness of Baseline Design



This interval as shown in the figure above assesses how well attributes of the anti-avoidance regime are engineered to conform to canons of the broader tax system. Focus is on analyzing the effectiveness of TP anti-avoidance regimes in terms of engineering of the matrix between canons of taxation and actual system attributes using as the proposed yardstick for this analysis the “*perceptible gap between the actual-regime-state and an ideal-regime-state.*” Within the upstream sub-framework therefore, engineering of the interval between the *baseline canons* and *system attributes* would be judged effective, if no (or minor) gaps are identified to exist in terms of conforming actual system attributes to the canons of taxation (codes A and C respectively).

As one reads through these analyses, two important points should be noted. Firstly, it is impracticable to exhaustively analyze interconnections between each canon and attributes. Secondly, it is practically impossible to engineer a system that flawlessly conforms actual attributes to all canons. Thus In judging effectiveness of these regimes, we only discuss key defects in the system.

6.1.1.1 Engineering Attributes A1, A3 and A4 to Conform to the Canon of Equity (C1)

It is the system engineer's task to create rules and procedures that conform the ALS (A1), audits and penalties (A3) and tax appeals (A4) to the baseline canon of equity (C1) as shown in figure 6-1 [supra]. For example, TP regime engineers in the US and France respectively adopt the **ALS** in s. 482 and Art. 57 as the standard on which to build transfer pricing rules and procedures. Likewise, engineers of TP regimes in both Nigeria (s.15 of the PPTA) and Cameroon (s.19 of the GTC) adopt the ALS. While the precise rules and procedures deployed by each select country in their effort to implement the standard sometimes differ, the choice of ALS is certainly significant in ensuring that attributes of TP regimes are engineered to conform to the canon of equity. By allowing for tax computation purposes only transfer prices that could have been used by independent parties in similar circumstances, ALS indeed places intrafirm transactions on a par with independent ones, thus eliminating tax related inequities that could arise between domestic and international firms as a result of MNEs using intragroup transfers to create undue tax advantages for themselves.

A similar argument can be made regarding the engineering of adversarial procedures *notably* audits, penalties and appeals.⁵⁸⁰ To equitably allocate IOC profits in a manner that reflects the true contribution and earnings of each group member, engineers need to load attributes A3 and A4 with tools to ensure that 'host' and 'home' countries can effectively adjust intrafirm TPs when needed. Again, GoG countries populate these attributes with rules and procedures that enhance the canon of equity. Although the approach to engineering attributes might differ between countries, it can be argued that the adoption of ALS by these TP regimes (i), and the construction of TP rules and procedures around this standard (ii); render the baseline design matrix that links canon C1 to attributes A1, A3 and A4 effective from an engineering standpoint.

6.1.1.2 Engineering Attributes A1 and A3 to Conform to the Canon of Neutrality (C2)

It is also important that attributes of the anti-avoidance regime notably the ALS (A1), and audits & penalties (A3) conform to the canon of neutrality (C2). In Nigeria and Cameroon for example, neutrality of oil taxation systems is mainly achieved by loading them with few top-end instruments and more bottom-end ones designed to capture economic rent.⁵⁸¹ These fiscal instruments include *bid*,

⁵⁸⁰ Except that the answer to the further question of whether these attributes **actually** achieve *taxpayer and inter-nation* equity depend largely on their effective implementation.

⁵⁸¹ Garnaut & Ross (1975), supra note 91. High tax rates can be imposed provided they take the form of fiscal instruments (Bids, BT, PPT) designed to capture economic rent

signature or production bonuses, ad-valorem royalties and petroleum income taxes;⁵⁸² most of which instruments are designed to take account of actual prices at which crudes are transferred or sold in order to ascertain oil sector revenues. For tax computation purposes therefore, ALS rules prescribed by engineers as basis for ascertaining crude prices are vital in ensuring effective system neutrality.

To an extent, using the ALS (A1) to ensure price parity between related and non-related parties enhances neutrality of the system. By adopting the standard as common bases for valuing crudes transferred to related parties or sold to independent third parties, ALS eliminates the incentive for group members to use intrafirm pricings as a means of reducing their tax liability. Failure to engineer ALS effectively is likely to result in related parties paying less tax than unrelated competitors engaged in similar operations. If this leaves loopholes in the system that can be exploited to avoid tax, this could overtime create a non-neutral effect potentially changing the calculus of investors who from a tax perspective are likely to view investments as being more advantageous if structured as a group and disadvantageous if it were to adopt a non-group structure. Likewise, the engineering of effective audit procedures and penalties (A3) to cause *or force* MNEs to comply with the arm's-length standard is vital to efforts aimed at ensuring that these companies take a rather neutral approach in their determination of intrafirm TPs for tax computation purposes.

Therefore, on the issue of whether the engineering of attributes A1 and A3 conform to the canon of neutrality, it can be argued that the *choice of ALS* and the fact of using it as basis for *engineering adversarial rules* enhance neutrality (C2) of TP regimes in both Nigeria and Cameroon.

6.1.1.3 Engineering Attributes A2, A3 and A4 to Conform to the Canon of Certainty (C3)

In figure 6-1 it is further observed that the upstream sub-framework would be effective if the engineer conforms compliance (A2), adversarial (A3) and appeal (A4) procedures to the baseline canon of certainty (C3). Compliance is made certain if system engineers populate this attribute with clear documentation and reporting rules clarifying the rights and duties of taxpayers. This includes clarity about the documents and timing of filing mandatory information, the applicable TP methods, the party to bear the burden of proof and rules delineating what data sources can be consulted for comparators. For example, as seen in chapter 5.2.1 the US's s.482 regime clarifies the level of documentation required and filing schedules for TP compliance purposes. This degree of clarity greatly enhances compliance with the regime. For companies with whom IRS has concluded APAs,

⁵⁸² Where income is the net-taxable income, that is, tax base + total revenues – total tax deductions.

the degree of certainty and predictability of steps that would be taken by the fisc is even greater. Certainty can be achieved by obliging third parties that assist IOCs in planning or implementing TPM schemes to disclose such schemes to the fisc. This approach is adopted in the UK. Similar arguments apply to attributes A3 and A4, where certainty of audit and penalty, as well as appeal procedures are needed. It is important that taxpayers know the *triggers of* and *precise rules* that apply to tax audits and penalties and procedures on how they can appeal process outcomes.

Both Cameroon and Nigeria adopt D&R obligations, audits and penalties, and appeal procedures as basis for conforming attributes A2, A3 and A4 to the principle of certainty (C3). In the former country, this includes generic (exceptionally specific) rules/procedures on documentation and reporting for TP purposes [cf. chapter 5.2.2.2]. In the latter, documentation and reporting procedures for TP have been consolidated in Reg.Nº1. Likewise, rules pertaining to attributes A4 are engineered so that appeals move from the administrative phase all the way up to the courts in both countries. The fact of obliging and ensuring that taxpayers report intrafirm transfers and defining clear appeal procedures to be used in contesting reassessments, ensures some degree of certainty to the regime and this diminishes the likelihood of tax authorities engaging in random and unpredictable adversarial processes. There is however in these countries no mandatory requirement that third parties disclose details of their dealings with IOCs that might result in tax avoidance.

Although there are procedural differences between both Nigeria and Cameroon,⁵⁸³ it is worth pointing out that attributes A2, A3 and A4 of these anti-avoidance regimes significantly conform to canon C3. Therefore, it is observed that as far as the engineering of **actual-regime-attributes** to conform to the canon of certainty in the GoG is concerned, this design criterion is significantly achieved since there isn't much of a **perceptible gap** between **the actual** and **ideal attributes**.

6.1.1.4 Engineering Attributes A2 and A3 to Conform to the Canon of Efficiency (C4)

Finally, effectiveness of the regime is equally achieved by conforming attributes A2 and A3 to the canon of efficiency as illustrated in figure 6-1. In the GoG where material, financial and human resources are especially scarce, the deployment of resources in a random and ill-considered manner during compliance (A2) and audits (A3) is likely to create inefficiencies in the regime. For instance, it is certain that the detection and adjustment of TPM during audits hugely depends on the availability and timing of obtaining viable information. The engineer could compel IOCs to keep and provide

⁵⁸³ For example many TP regimes in the GoG do not oblige systematic documentation, reporting or disclosures of TP information whereas Nigeria since 2012 adopts this approach

information to the fisc at two main levels. An option could be taken to mandate information reporting during the compliance phase (A2), or shifted further down the line to be done only during audits (A3). Another option might be to split the obligation such that part of the information is reported at the compliance phase and another during audits (twin option). While these options are capable of achieving efficiency it is observable that selection of the **twin option, which is** engineered to compel IOCs to provide the bulk of this information upfront, is more likely to prove efficient. Engineering attribute A2 to draw as much information on intrafirm transaction from IOCs, allows enough time for tax officials involved in the process of implementing attribute A3 to assess and investigate risks of TPM. Analysis of such information filed upfront ensures that available resources are not wasted trying to investigate taxpayers that pose little or no risk of TPM.

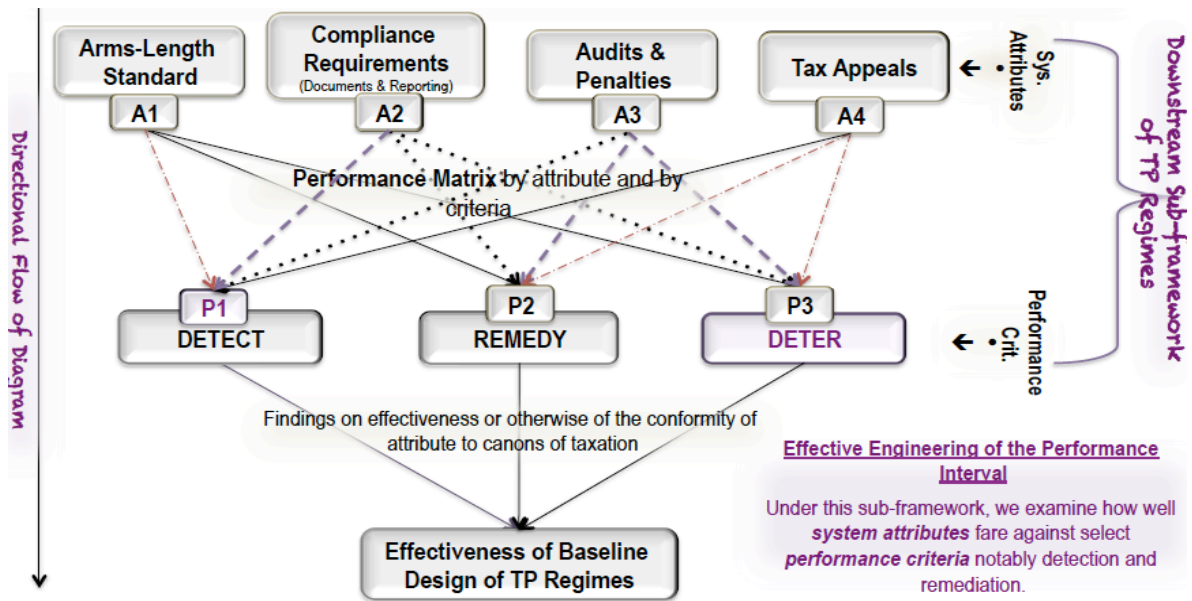
Until fairly recently however, actual engineering of TP regimes in select GoG countries did not make filing of TP information during the compliance phase mandatory. Two main inefficiencies are bound to arise under this system. Firstly, if the need arises to investigate TP practices of IOCs during audits it is doubtful whether auditors could do so properly given the relatively short timeframe allowed them by statute to close audits. The effect has arguably been that few, if any, tax audits have resulted in TP adjustments. Secondly, efficiency requires that auditors produce a tax yield, which exceeds whatever resources are spent in carrying out the exercise. In context where tax audits are engineered to pressure auditors into producing quick and/or immediate results, logic suggests that this invariably pushes them to focus more on adjusting less complex issues, relegating to second place schemes like TPM that are by nature complex and certainly require a huge amount of effort and time to prove wrongdoing or noncompliance with the legislation.

It can be argued that the **actual** engineering of attributes A2 and A3 of TP regimes in the GoG were conceived to conform these attributes to the canon of efficiency (C4). As noted in the preceding paragraph however, actual audit frameworks in these countries might not necessarily provide ideal platforms for auditors to efficiently recall all taxes owed the state by noncompliant IOCs. Therefore, it is not certain that the engineering of anti-avoidance attributes A2 and A3 actually achieve efficiency of the regime given a **perceptible gap** between the **actual** and otherwise **ideal outcomes** of these attributes, with inherent engineering lapses accounting for these inefficiencies.

6.1.2 DOWNSTREAM SUB-FRAMEWORK –INTERVAL BETWEEN ATTRIBUTES AND PERFORMANCE CRITERIA

As shown in figure 6-2 infra, the downstream sub-framework for assessing effectiveness of TP regimes in the GoG covers the interval between the middle layer of concepts or system attributes on the one hand (*ALS, Compliance, adversarial, appeals*), and the bottom layer of concepts or performance criteria (*detect, remedy, deter*) on the other (respectively coded as A and C).

Figure 6-2: Downstream Sub-framework for Judging Effective Performance

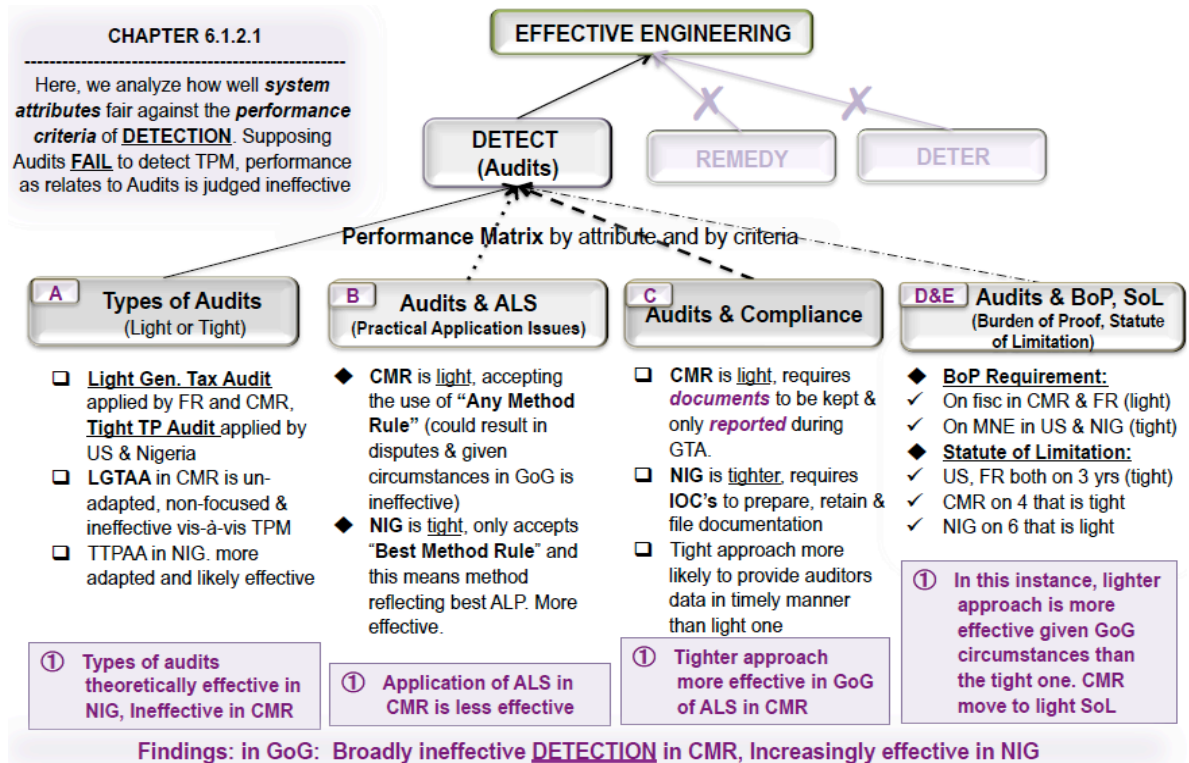


In judging effectiveness of these regimes under this *sub-framework*, focus is on analyzing the performance matrix to ascertain whether engineers incorporate into system attributes rules that are capable of attaining system performance objectives. As with the first sub-framework, the proposed yardstick for assessing effectiveness of TP anti-avoidance regimes is the “*perceptible gap between the actual-regime-state and an ideal-regime-state.*” Ideally, attributes of the regime would be loaded with a variety of tight or light rules and procedures engineered to detect, remedy or deter TP abuses. Engineering as per this sub-framework is judged on the basis of whether existing anti-avoidance rules adopted by GoG countries, be they specific or generic, actually provide authorities with the tools needed to detect (6.1.2.1), remedy (6.1.2.2) or deter potential abusers from engaging in TPM (6.1.2.3). Engineering is effective if there is no (or little) perceptible gap between the ideal and actual regime states, and defective if such a gap is judged to exist and is significant.

6.1.2.1 DETECTING TPM– Matrix Between Audits and Other Attributes

The ability to create anti-avoidance regimes that effectively detect TPM largely depends on whether the engineer in given circumstances, adopts a tight (specific) or light (nonspecific) approach in its selection of rules, notably with respect to audits and other attributes. Given that *self-assessment* has replaced the *roll* as the default compliance system, audits have grown into a significant and highly important platform via which schemes contrived to avoid taxes can be detected. Therefore, the need to assess actual tax audits is top on the list of critical issues to consider when judging effective engineering of anti-avoidance regimes. This is mainly explained by the fact that other performances objectives like remediation and deterrence largely depend on effective detection to themselves prove effective. On the basis of each country’s context therefore, the tools and protocols to use during audits in the detection of TPM should be engineered to optimize the chances that tax authorities charged with the enforcement of these regimes would actually spot cases of abuse. Hereinafter, five key aspects of tax audits likely to impact effective detection of TPM schemes are examined. These include the *types* of audits, practical application of the ALS, documentation and disclosures, the burden of proof, and statute of limitations.

Figure 6-3: Effective Engineering of Detection Mechanisms



A. Types of Transfer Pricing Audits

Governments often adopt either of two main approaches to audit MNEs, that is, the light or tight approaches. The light approach has traditionally dominated engineering of tax audit frameworks around the world. It adopts the view that efforts to tackle TPM and all other tax avoidance schemes should be treated equally, such that rules engineered for general tax audits would also be used to investigate TPM. For purposes of this study, this is referred to as the *Light General Tax Audit Approach (LGTA)*. However, host and home governments now regard TPM as the greatest single challenge they face in taxing MNEs effectively and as fresh evidence emerges in the GoG that MNEs are eroding domestic tax bases via the illicit transfer of profits abroad, consensus is building in these countries of the need of special audit frameworks engineered to specifically respond to complex TPM schemes. This is the *Tight Transfer Pricing Audit Approach (TTPAA)*.

Under the LGTA, governments essentially load the anti-avoidance regime with rules that are nonspecific to the issue of TPM; thus applying to TPM within the framework of GTAs, primarily the same set of rules applied to other avoidance schemes. For example, both Cameroon and France operate GTAs that are light on substantive and procedural issues specific to TPM. Although these regimes are engineered to facilitate detection of most tax avoidance schemes, the effectiveness of this approach depends on the context in which the rules apply. In France where comparable data is relatively easy to source and ample time is given to the FTA to investigate the issue, GTAs have proven to be effective probably as a result of the favorable context in which France's light rules apply.

However in the GoG where the context is not as favorable, engineering of audit rules along the lines of LGTA has proven to be un-adapted, non-focused and clearly ineffective for detecting complex TPM schemes. For example, s. M19 (a)(1) of the CTC only allows auditors to investigate TPM after serving a formal request for information and documentation on intrafirm transactions,⁵⁸⁴ if evidence is had *during audits* to support the presumption that profits have been indirectly transferred abroad. This approach from a detection standpoint has two main defects. Firstly, since requests are only addressed to taxpayers within the framework of general audits and not other forms of control, this restrictive formulation limits its usefulness as a tool for detecting TPM effectively. Secondly, this artificially creates a dearth of information otherwise needed to undertake pre-audit risk analyses and to prepare audit focus points. Apparently, these shortcomings are already pushing GoG countries to

⁵⁸⁴ The is needed to investigate the nature of intragroup relations, transactions carried out by these undertakings, pricing methods used and elements to justify the same, and the tax treatment given to these operations.

reform actual LGTAA frameworks by adopting some elements of the *tight* approach to now allow TP specific investigations. Nigeria, Ghana and Kenya have already done so.⁵⁸⁵

B. Practical Application of the ALS During Audits

Secondly, it is vital that system engineers delineate clearly what practices would be deemed as amounting to TPM since the ability to detect it depends on the extent of clarity on this issue. The absence of clarity could result in disagreements between parties over the acceptable ALP, the applicable methods and how such methods are to be selected. In reality, disagreement on the choice of TP methods accounts for a major part of disputes. If clear rules are not set to guide determination of intrafirm prices, it is likely that methods used by IOCs would always be looked at with suspicion by tax authorities given that the former have better access to market data than the latter. Besides, how does one in the absence of clear ALS rules proceed to adjust TP if the audited company via its global reach stands better informed of market prices than the fisc purporting to correct its intragroup operations? And, can the fisc validly reject TP methods used by IOCs in GoG countries if some of these regulations adopt a *light approach*, expressly allowing the use of “any method” in determining TP *without clarifying its meaning*? Is not the *tight* and more determinate ‘best method’ rule that has been adopted by some GoG countries like Nigeria a more appropriate response to the challenge?

The technical gap between Cameroon’s officially cited rule (any method) and that of Nigeria (best method) is quite wide. Indeed according to Circular N^o. 004 that stipulates practical modalities for determining TP, “any method put forward by the enterprise... is receivable” in Cameroon provided it is backed by documentation. One could argue that the “any method” rule is significantly different from and possibly less enabling of effective TPM detection when compared to the “best method” rule applied in the US and Nigeria. Since taxpayers can use ‘any method’ to fix intrafirm prices without being obliged to a greater standard of fairness, there is room for IOCs to adopt methods that suit their objectives but do not necessarily represent the appropriate price considering the given set of circumstances. This lack of clarity in the standard creates grounds for the fisc and IOCs to disagree on the applicable method. Although different in nature, ambiguities in the US transfer pricing system prior to introducing the ‘*best method*’ rule in 1994 resulted in many disputes. Before, IRS would prescribe the order of methods to be used so that taxpayers were not required to substantiate their choice of method. The burden was therefore IRS’s to prove TPM. Under, the “best method” rule

⁵⁸⁵ The advantages of such a move are discussed in Chapter 7.2.2.2

however, areas of ambiguity have been minimized with the responsibility for choosing a method handed over to MNEs, guided by an obligation to apply the most appropriate method in doing so.

It is not clear on the other hand that in applying the 'any method' rule risk of TPM is minimized. This lack of clarity concerning the rules to use in determining ALP as concerns the sale of crude oil, is certainly not eased by heavy reliance in the GoG on benchmarks for intrafirm transfer purposes. For example, s.94 of Cameroon's petroleum code requires valuation to be done on an arm's length basis using dated international prices (FOB 'Dated Brent') quoted on Platt's Crude Oil Marketwire.⁵⁸⁶ While a welcome relief, this ties effective determination of ALP during audits to the *reliability* of Platts' and other referenced prices. Although these are hypothetically useful sources of arms-length data, they are in practice only useful indicators of trends and cannot be unreservedly relied on considering multiple accusations that oil traders have historically and as recently as 2013 continue to manipulate data fed into databanks like Platts.⁵⁸⁷ If reference prices are themselves manipulated, it is doubtful how useful they are to Nigeria, Gabon and Chad in assisting tax auditors to detect oil mispricing effectively. Further, it is not uncommon to find technical contradictions embedded in rules engineered to ease the sourcing comparables so that while s.94 of Cameroon's CPC endorses the use of foreign comparables drawn from Platt's, the wordings of ss.19 and M19 CTC endorse the use of domestic comparables only sourced from similar undertakings in Cameroon. This engineering contradiction poses interpretational difficulties by creating uncertainty whether auditors are statutorily required to apply the position in the Oil Code (as an exception) or stick to the Tax Code since rules governing audits with possible TP implications are elaborated in the latter law.

Without adequate clarity of the guiding principles to use when selecting TP methods and applying ALS, legitimate questions arise as to how effectively TP regimes are engineered to enable detection of TPM using ALS during audits.⁵⁸⁸

C. Role of Compliance in Facilitating Effective Detection of TPM

Effective detection begins with the availability of information and as with audits tax authorities have adopted two main approaches in ensuring that MNEs prepare and report relevant information to the fisc. Under the *tight* procedure details of intrafirm transfers are to be mandatorily reported in advance of audits (US, Nigeria). Under the *light* approach however, MNEs are expected to report this

⁵⁸⁶ See, Chapter 5.2.2.2.B

⁵⁸⁷ *Oil Traders Claim Crude Prices Fixed*, The Guardian, November 6, 2013

⁵⁸⁸ Notably those countries that apply the 'any method' rule discussed above

information only during audits and often, but not exclusively, after auditors make a formal request for them to do so (France, Cameroon). Notwithstanding the approach used, the objective is to engineer rigorous *documentation* and *reporting* rules that ensure MNEs provide essential information needed to detect TPM during audits. What technically distinguishes procedures in one country from another are rules on the scope of data and the time of filing such data; and the extent to which either approach proves effective is a result system engineers adapting rules to context in which they apply.

The detection of TPM during tax audits is ideally achieved if engineers include a requirement that MNEs keep robust documentation of intrafirm transfers, without which the ability of auditors to source and analyze information useful in detecting TPM would be seriously hampered. For example, the scope of domestic and international documentation secured under s.6038A rules in the US partly explains the high levels of success registered by IRS in detecting TPM. As per US rules MNEs are required to prepare TP specific records and to report the same under specific reporting procedures if they are to avoid noncompliance penalties. These include details on parent-affiliate activities, non-sale transactions -*loans, services*, ownership and capital structure of the business, and documents backing TP/tax policies in the US, and other financial returns filed in foreign or third party countries. Like the US, Nigeria now requires MNEs to keep specific records on related party transactions in order to facilitate FIRS's monitoring efforts, including briefs on the MNEs structure, controlled transactions, the relevant economic analysis, methods, reasons for selecting them and information on comparable uncontrolled transactions. Further, Reg N^o 1 allows the FIRS to supplement domestic documentation rules by drawing on OECD and UN recommendations on the subject. While Nigeria's documentation rules are not as tight as the US's, it is nonetheless more far-reaching than rules that are actually applied in Cameroon.⁵⁸⁹

For its part reporting ensures that MNEs actually provide the fisc with information needed to investigate intrafirm transfer prices effectively. Engineers face a dilemma in designing reporting rules since excessive reporting is likely to result in needless burdening of the compliance system, while weak reporting makes the auditors already difficult task of detecting TPM even harder. Therefore, an appropriate balance should be found between causing MNEs to report TP information, and ensuring that the reporting sub-regime is not unnecessarily burdened. Under the *tightly* engineered US model, MNEs (parent, each US subsidiary) with foreign holdings of 25% or more are mandated to file annual documentation specific to their intrafirm operations using Form 5472. These reports are mandatory

⁵⁸⁹ Clearly short on documentation rules specific to the TPM issue

and should reflect each intragroup transaction as opposed to a mere aggregation of data.⁵⁹⁰ IRS can during audits *request* that the MNE provide further specific information already prepared, to be prepared, or purportedly held by a foreign corporation (affiliate or parent), to which US residents may not invoke lack of control over a foreign party as grounds for not providing the information requested.

Although auditors in Cameroon can request TP information from MNEs, it is evident that the technical scope of exercise of this power falls short of the US's. Under s. M19 (a)(1) of Cameroons tax law, the fisc mainly requests detailed documents and information on intragroup relations and transfers within the framework of general tax audits, whereas IRS has broad powers to obtain this information at anytime prior to and not only during audits. Unlike IRS, the fisc in GoG countries cannot oblige taxpayers through requests to provide information on foreign group members. Further, mandatory annual reporting was until recently not imposed in the GoG and this remains the case in many oil rich countries that have taken only timid steps to shift position on the issue. **Nigeria, Ghana and Kenya** have recently imposed mandatory reporting of TP alongside mainstream filing obligations indicating a shift in policy away from the *light* to a *tighter* approach. Cameroon has slightly upgraded its position by mandating MNEs that file taxes at the LTU to prepare and present TP documentation upon commencement or as further requested by auditors during general tax audits.

Although requests formulated during audits are designed to obtain as much information as is needed to ease detection of TPM,⁵⁹¹ it is doubtful whether engineering GoG rules to mandate that MNEs report information on intrafirm pricings primarily during tax audits is supportive of this effort. This is explained by the fact that auditors are understood under such a system to request information mainly in cases where reason exists to suspect the illicit transfer of profits abroad. This considerably weakens the capacity of the fisc to effectively detect TPM prior to and even during audits given that this *light* approach exponentially increases the need for, and amount of effort to be spent by auditors in sourcing vital information. Logic suggests that the detection of breaches would be more effective if the system is engineered to allow the collection of TP data ahead of commencing audits so that auditors have enough time to analyze and identify transactions to be investigated. Therefore, defective engineering of the timing and scope of information that auditors can statutorily access under actual rules adversely affect the effectiveness of GTAs in detecting TPM.

⁵⁹⁰ Thresholds at which reporting becomes mandatory for mega corporations as based on: (1) type of transactions \$50,000 and more, (2) Related gross payments of \$5m, (3) US gross receipts of \$10m, (4) Gross receipts excluding penalty of \$20m, (5) Significant industry segment \$25m, and (6) if the High profit threshold of \$100,000 is met

⁵⁹¹ That is, the territory concerned, undertakings, company or groups referred to, and the amounts transferred

D Importance of the ‘Burden of Proof’ in Detecting TPM

During audits statute might impose on either party the onus to justify its choice of method. Taxpayers might be expected to justify transfer prices, or the fisc adjustments it proposes to prices used by MNEs. The *burden of proof* as this obligation is known, is essential in detecting TPM and there are two opposing schools on which party should bear the burden. Proponents of the *tight approach* rest the onus of proving compliance with TP regulations on the filing party, whereas those in favor of the light approach rest the onus on the fisc.

There is, in principle, an understanding amongst tax experts in countries operating self-assessment tax systems that the burden of proof primarily rests with the fisc that challenges a taxpayer’s return.⁵⁹² However, there are circumstances where proponents of the tight approach argue that it might be necessary to exceptional shift the burden from the fisc to taxpayers to better respond to complex avoidance schemes. In the US where engineering is tight, the onus to proof as concerns TPM now rests with taxpayers. However, before introducing the Best Method Rule in 1994 a dissatisfied IRS would challenge the reporting corporation’s choice of TP method and select another that it deemed to be appropriate. Under this approach the onus was on IRS to substantiate objections to the method used. Taxpayers could as such challenge and easily defeat IRS’s objection by simply varying their initial method. Current US rules address this defect by imposing on taxpayers a duty to select the best method, substantiated with contemporaneous documentation that is prepared in advance of engaging the transaction. Once a method is chosen by an MNE, it is precluded from challenging IRS’s adjustments by varying its initial position.⁵⁹³ Therefore, it rests with taxpayers to show that the exercise by IRS of authority under s.482 is unreasonable, arbitrary or without jurisdiction given the circumstances. A similar approach is now used in Nigeria where *onus* is on the taxpayer to prove its choice of method not to be at odds with the ALS. Shifting the onus on taxpayers pushes them to provide the fisc with the scope of information needed to vet TP policies.

In Cameroon (like France) where the approach is light, the conventional position adopted for avoidance schemes including the onus to prove *de jure* or *de facto* dependence for TP purposes is on the fisc.⁵⁹⁴ It proceeds to make reassessments under s.19 (Art.57 in France) only if it shows: (i) the

⁵⁹² See ss. M19 bis and M23 of CTC; Also Evidence Act Cap E14 Laws of the Federation of Nigeria 2004 applies in terms of the burden of proof.

⁵⁹³ In practice IRS examiners are noted to prefer comparable profit as opposed to traditional transactional methods.

⁵⁹⁴ *De jure* dependence is easily proved if a (i) French PE is directly controlled through its share capital or voting rights by Foreign entity, or (ii) indirectly controlled through common management. *De facto* control can be established on the basis

existence of subordination or dependence between parties, and (ii) that they failed to apply the ALS resulting in the indirect transfer of taxable profits abroad.⁵⁹⁵ Nonetheless, the onus is sometimes exceptionally shifted to taxpayers as a means to ensure effective detection of TPM even in countries that adopt the light approach. There is at least one example of this under French tax law. In cases where transactions take place between a French company and entities based in havens, dependency is presumed and the FTA discharged of the onus to prove dependency.⁵⁹⁶ In Cameroon, the law is mute on the presumption of dependency and onus is wholly the DGI's to prove control except in instances where the MNE fails to provide TP documentation following a formal request by auditors. This light approach to engineering TP regimes raises concern regarding its effectiveness, especially as it is clear that significant contextual differences in which Cameroon and France apply TP rules exist. France has a vast network of tax and information exchange treaties and necessary resources to handle complex audits, placing it in a fairly strong position when sourcing comparables, adjusting TPs and defending its position. This cannot be said of Cameroon that underperforms on all three issues. In spite of its advantage, France's willingness to shift onus to MNE's in cases where it cannot readily source information underpins the need to adopt tighter TPM rules in the GoG. By shifting the onus to taxpayers as Nigeria has done, governments in the GoG can truly mitigate the impact of their apparent lack of access to comparable data.

E. Statute of Limitation and Timeframe for TP Audits

Lastly, the engineer needs to incorporate into the system design *timeframes* that allow auditors enough time to detect TPM effectively. Timeframes include **statutes of limitation** within which tax audits must be initiated and **statutory durations** in which to complete these audits.

Statute of Limitation for TP Documentation and Audits:

Statutes of limitation can be engineered using either the *tight* or *light* approaches with some countries opting to apply nonspecific statutes to all anti-avoidance schemes including TPM, while others create and apply specific statutes to TPM. As concerns this issue it is interesting to note that developed countries seem to apply relatively tight statutes compared to emerging and developing

of a commercial relationship that exists between two or more entities engaged in transactions. For example if a distributor uses staff and equipment provided by a French subsidiary of a foreign firm with shared management

⁵⁹⁵ Guionnet-Moalic (2009), *supra* note 539

⁵⁹⁶ Entities benefiting from privileged tax treatment within meaning of s. 238 A of the French Tax Code. That is countries charging on such profits taxes that represent less than 50% of what France would have charged

ones. In the US, Belgium and France for example, a generic 3 years statute is applied. This differs from most emerging/developing countries where tendency is to give the fisc more time to investigate TPM, with *statutes of limitation* being set at periods averaging 5 or more years. In Brazil for example, this is fixed at 5 years. In the GoG where tax authorities are only just starting to focus on issues of TPM, the trend has been to adopt *statutes* of 6 or more years. Ghana like Nigeria adopts a period of 6 years, Kenya adopts 7 years, and Botswana 8 years. In these countries lengthy *statutes of limitation* sometimes apply to TP only and runs parallel with other limitations that might be applied to other tax schemes. On this specific issue, many French speaking countries in the GoG that traditionally adopt the light approach ironically engineer their regimes to apply a much reduced statute of 4 years⁵⁹⁷ when compared to other African countries.

From the standpoint of detecting TPM, it is questionable whether adopting a somewhat rigid *statute* of 4 years in context where genuine constraints exist to source comparables is effective. In France for example where the standard statute is 3 years, flexible mechanisms are actually built into the regime such that if the FTA addresses a request for TP-related information from foreign tax authorities during an audit, the period is prolonged from 3 to 5 years following that which is being audited within meaning of Art L.188.⁵⁹⁸ This buys an extra two years for the fisc to scrutinize pricing policies of an MNEs, a luxury denied to Cameroon's fisc under presently rigid statute of limitation rules. Similar concerns exist regarding the number of years to preserve TP documentation following the relevant book entry. The obligation might be for MNEs to retain these documents only for periods open to tax audits, or for documents to be kept for periods exceeding that covered by the statute of limitation. Nigeria requires documents to be kept for 6 years that corresponds to its *statute*, whereas Cameroon obliges these accounting documents to be kept for a period of 10 years thus exceeding its 4 years statute. In a sense, the requirement to preserve documents for long periods is pretty tight and guarantees that the fisc can access this information within a reasonable timeframe even after audits.

Timeframe Allotted for Actual Audits:

The timeframe within which auditors need to complete a tax audit once it is initiated is also important. If tightly engineered, the task of detecting TPM would be rendered quite difficult since

⁵⁹⁷ s. M89 of Cameroon's CTC is a good example that prohibits audits after four years of receiving annual tax returns

⁵⁹⁸ For example assuming a calendar year, the Fisc in tax year 2008, can serve taxpayers with examination notices covering tax years 2005-2007 (three years). Therefore all intragroup transactions engaged in 2005 are open to reassessments until December 2007. If the Fisc requests for information from foreign government in 2008, then statute of limitation may extend up till Dec. 2010.

these investigations are complex, requiring ample time to gather, process and analyze data on multiple cross-border transactions. The task of auditing TP is certainly not to be hurried over even in countries with extensive experience on the issue. In the US for example, IRS has roughly 24 months within which to initiate and close TP audits. During this timeframe it sources both principal and background documents needed to close the audit directly from the audited company or third parties.

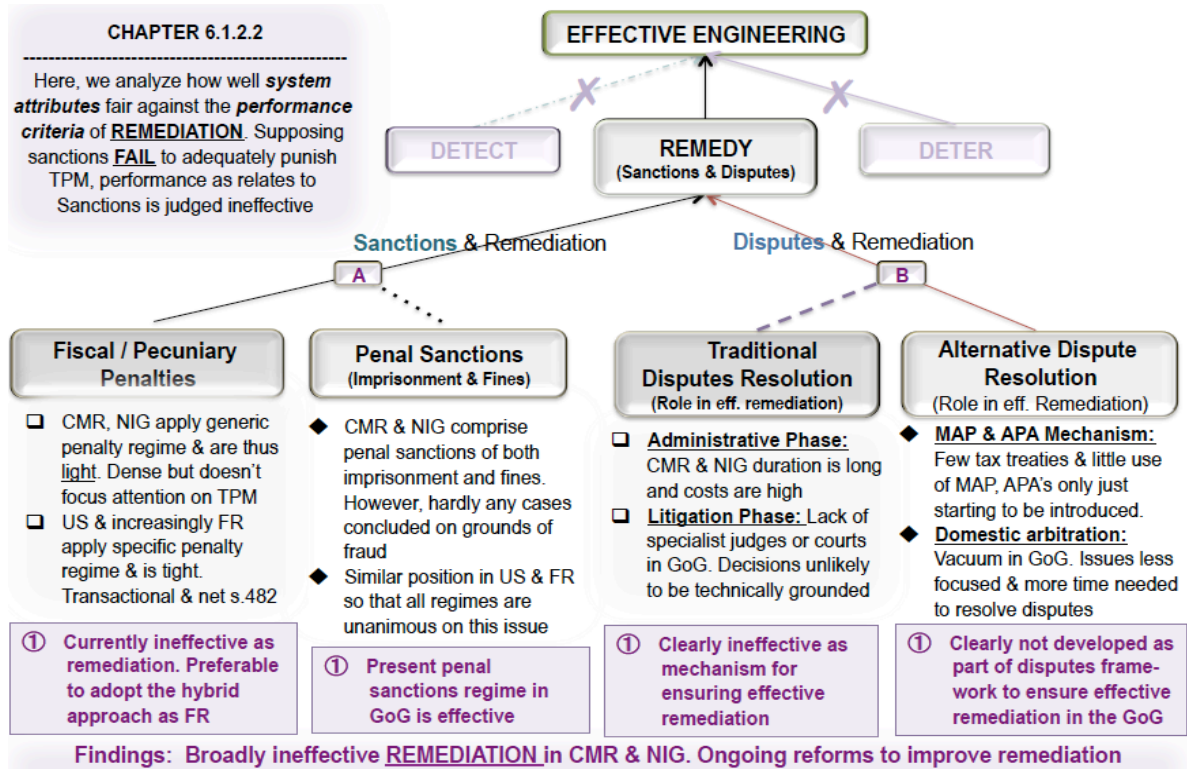
Logic suggests that longer timeframes for closing audits are needed in the GoG where a significant gap in the relevant skillset to detect TPM exists and where data is still reported on an aggregated basis. However, this is not the case as most tax audit frameworks in the GoG are instead engineered to substantially limit the duration within which auditors must bring the process a close. This could have the undesirable causal effect of forcing them to rush the process, or to pick and deal with other less complex issues in an effort to meet statutory deadlines. In Nigeria, once FIRS issues a notice of reassessments for TP audits, the taxpayer may object to such assessments within 30 days to which the Panel has 90 days to determine formal final assessments. Although the duration of field visits in Cameroon can be extended from a standard 3 to 6 months if tax auditors initiate TP investigations, this advantage is profoundly erased by limitations on the accessibility and sourcing of TP information and comparables that is mainly imposed by s. M19 of the GTC. Given that these countries have very limited experience investigating issues of TPM it is hard to see how the pursuit of TP adjustments within such a constrained timeframe could be anything but defective engineering.

6.1.2.2 TPM REMEDIATION Frameworks in the GOG

In the bigger picture of things, detecting TPM during audits does not suffice. Anti-avoidance regimes should be engineered to also *sanction* abuse effectively, without which noncompliance could become an attractive option for IOCs seeking to minimize tax costs. Therefore, remediation is as important as detection in tackling TPM. The main focus of this subsection is to examine effectiveness of actual remediation frameworks being used to tackle cases of TPM in the GoG. As with detection, the main perspectives on remediation vary between the *tight* (US) and *light* (France)⁵⁹⁹ approaches. Effective remediation is achieved by engineering a combination of mechanisms or tools that are capable of being used to sanction cases of TPM (B), and to resolve appeals that arise as a result of tax auditors issuing deficiency reassessments to MNEs deemed to be in default (A).

⁵⁹⁹ That is, applying general sanctions to TPM rather than loading the system with extra remedies specific to TPM.

Figure 6-4: Effective Engineering of Remediation Mechanisms



A. Effective Remediation of TPM -Sanction Mechanisms

The main tool used by engineers to remedy TPM is sanctions, which could either be *fiscal* or *penal* in nature. The first (fiscal) is traditionally applied by the fisc at the close of tax audits while the second (penal) is applied at litigation by courts with competence to handle tax cases.

Fiscal or Pecuniary Sanctions

Sanctions are either engineered to be generic –*the light approach*, or designed to remedy specific tax losses arising from TPM schemes –*the tight approach*. In both cases, the engineer aims to provide a sanctions toolkit that is robust enough to restore parity to the system *by recalling the principal tax* (i), disadvantage non-compliant taxpayers by using *penalties* to increase their tax cost (ii), and to find an appropriate balance between punishing businesses and ensuring that they continue to operate and not go bankrupt as a result of applying such sanctions (iii).

Diversity of Approaches: Generic and Specific Penalties:

Cameroon and Nigeria both adopt the light approach in their engineering of penalties to apply even in cases of TPM. Penalties are not designed to specifically target TPM and can therefore be

described as generic. For example, Nigeria's PPTA imposes a penalty charge of up to 5% of the principal for failing payment deadlines. Fines are also applicable for each day of delay for breaches that are not subject to any specific penalty. Further, filing of incorrect accounts, understating profits, or failing to withhold taxes at source attract penalties of up to double the tax that should have been paid or withheld. The penalty regime in Cameroon is consistent with that applied in Nigeria except that the applicable rates differ. Tax recalls in Cameroon attract a 30% or 100% penalty charge on the principal, depending respectively on whether the taxpayer's action or omission is judged to be of good (*bona fide*) or bad faith (*mala fide*). If recalls are the result of arbitrary assessments, the fisc may apply a minimum penalty charge of 100% or 150% in case of additional offence. And should compliance deadlines be missed, a charge of 10% per month of delay up to a maximum of 30% is levied. In addition interests of 1.5% are charged per month of delay up to a maximum of 50%.

This generic approach adopted in the GoG is different from that detailed in s.6662 of US tax law. The US's sanctions regime is tightly engineered, comprising specific penalties to be applied to cases of TPM on US and/or other Foreign source incomes. As concerns the manipulation of foreign source incomes, the US has adopted transactional and net-section 482 adjustment penalties. The former is applied on a transaction-by-transaction basis,⁶⁰⁰ while the latter is applied on an aggregate basis.⁶⁰¹ However, the engineering of penalties for US source incomes is fairly less complex. If a CFC partly or wholly fails to file forms F.5472 in compliance with s.6038A, IRS could charge a fine of \$10,000 per failure as *initial penalty* given that the filing of forms F.5472 in the US is mandatory. Within meaning of s.6038A however, IRS could further make a request to noncompliant taxpayers to file forms F.5472 in which case it could, 90 days after serving its request, move to apply *additional penalties* of \$10,000 per failure for every 30 days delay that the taxpayer fails to respond.

Is Remediation Effective Under the Generic Sanctions Approach?

Although tax penalties in France are engineered using the light approach, they make for interesting contrast with those in Cameroon and Nigeria. In effect France has attempted to create what might be described as a hybrid approach. Noting that the critical mass of penalties applied to tax avoidance schemes in France remains generic,⁶⁰² it is important that the country in 2013 took the significant (*but subsequently contested*) step to introduce at least one penalty instrument that

⁶⁰⁰ A 20% charge on tax recalls for *high or low SVM's*; and a 40% for *high or low GVM's*

⁶⁰¹ SVA is applied if net-adjustments equal \$5 millions or 10% of the company's gross receipts; or the GVA is applied if net-adjustments equal \$20 millions or 20% of the company's gross receipts

⁶⁰² Including for example a 0.40% (annual 4.8%) interest charge for failing statutory deadlines

sanctioned TPM specifically. These penalties apply if the taxpayer, after receiving a formal documentation request from the fisc, fails to or provides incomplete documentation that leads or doesn't lead to reassessments within meaning of Art.1735 Ter. of the FTC. As per these rules the fisc could move to charge 0.5% of the amount irregularly transferred abroad (the minimum charge being €10,000) in penalties. However, the Constitutional Council in its Decision N°. 2013-685 DC of 29 December 2013 censured this specific instrument. This new approach nonetheless signals increasing interest on the part of French Tax Authorities to keep an open eye for TPM and to explore tighter mechanisms that resolutely punish noncompliance linked to the transfer of taxable profits abroad.

There is no doubt that nonspecific penalties applied in Cameroon and Nigeria is engineered with some degree of success. That is, these regimes are engineered to restore parity given that mechanisms are built into them to ensure a recall of *unpaid taxes*, and also that extra *costs* in the form of penalties *are imposed* on noncompliant taxpayers. It is not clear how effective these relatively high penalty rates are (100%, 150%, also 200%). There is a risk that high penalties could force noncompliant companies into bankruptcy, thus defeating the long-term socio-economic goals of retaining and creating jobs in the oil sector, and securing a stream of tax revenues even from companies judged to be in temporal breach of the rules. By far the greatest engineering defect of generic penalties is that it fails to focus the minds of decision makers within IOCs on the fact that tax authorities are keeping an open eye to detect TPM and to unfailingly punish cases of noncompliance. This engineering defect increases chances that sanctions would be perceived as weak and indeterminate and as such ineffective from the standpoint of compelling compliance. The adoption of tighter and more specific penalties in the GoG could focus the minds of IOCs on noncompliance costs relating to TPM, in effect creating an extra incentive to comply.

Penal or Criminal Sanctions

Irrespective of whether a country uses the light (*generic*) or tight (*specific*) approach in engineering its fiscal sanction, there is consensus that penal sanctions also need to be adopted to cover cases where a determination is made of tax evasion. In the US for example, penal sanctions have been sought for tax evasions in some key industries.⁶⁰³ In France, judges might amongst others issue search warrants against suspects of tax fraud and imprison or fine (€2,000,000) those that are found to have evaded taxes. Although penalties in the GoG are not as tight, they are engineered to

⁶⁰³ See *U.S. ex rel. Johnson et al. v. Shell Oil Co.* discussed in Chapter 5.2.1.2

contain imprisonment and fines. In Nigeria, fines include ₦200,000 (\$ 1,220), treble the amount of tax defrauded and a possible 3 years imprisonment for fraudulent schemes. Cameroon for its part implements imprisonment of from 1 to 5 years and a fine of between 500,000 to 5,000,000 Fcfa.⁶⁰⁴

Other sanctions include legal action by the fisc to obtain the award of temporary prohibition of the taxpayer engaging in commercial, industrial or other professional activity (5 years in Cameroon). Another common sanction that tax authorities pursue against companies engaged in tax avoidance is the disallowance of such expenses for CIT computation purposes. Thus, penalties resulting from the violation of legal, economic and fiscal provisions are not deductible expenses in Cameroon and Nigeria. Likewise, the US approach to this issue is uncharacteristically less exigent since tax penalties are in principle deductible expenses. However, taxpayers that persistently fail to comply with tax obligations in spite of requests from IRS lose the right to deduct all penalties arising or likely to arise from TP adjustments. From this perspective, it is observed that all select countries engineer their penalty instruments to disallow any tax deductions resulting from penalties costs borne as a result of noncompliance. On this issue, we conclude that GoG regimes are fairly well engineered to adequately sanction fraudulent noncompliance, but there is reason to doubt their effectiveness from an administrative standpoint since hardly any suspects of tax fraud stand charged or imprisoned.

B. Effective Remediation of TPM -*Disputes Mechanism*

Further to the above, it takes effective engineering of the appeals regime to consolidate gains regarding detection and sanction. Defective engineering of appeal systems could inadvertently result in courts quashing otherwise justifiable tax recalls and sanctions, whereas an effective system should safeguard effectiveness of the regime. This raises questions concerning the extent of effectiveness of existing dispute resolution mechanisms in Cameroon and Nigeria, notably from the angles of administrative review, litigation, MAP, APA and binding arbitration.

Shortcomings of the Administrative Phase:

Traditionally the fisc is judge and party during tax disputes at the administrative phase. This applies to all four select countries where preliminary objections by taxpayers are lodged with the fisc as a means of seeking early and mutual settlement of disputes. In the US for example, IRS's Appeal Division has successfully used this mechanism to vet 80% of tax disputes with a mere 20% filtering

⁶⁰⁴ That is about \$1000 to \$10,000 at an exchange rate 500 Fcfa to \$1

through into litigation. Similar procedures are used in France, Nigeria, and Cameroon albeit with different levels of success. Of all disputes handled by Cameroons Tax Appeals Department in 2013, less than 2% made it to litigation. In terms of tax recalls and penalties, about 40% of taxes contested were dropped at the administrative appeal indicating that this phase effectively filters the number of disputes that go through to litigation. However, procedural bottlenecks and lack of impartiality are known to be reasons why some taxpayers decide not to engage or to discontinue administrative appeals. During this phase of appeals there is an element of partiality engineered into the system since the fisc plays both the roles of judge and party in the proceedings (*nemo iudex in causa sua*).

Another defect observed relates to long durations that statutes prescribe for handling disputes at the administrative phase. Not only are especially long timelines provided for this purpose, but high costs are also involved moving objections further up from one competent appeals authority to another. Assuming that a taxpayer in Cameroon disagreed with tax reassessment and decided to take its objections all the way up to the Minister, the process was engineered to last about **10** months⁶⁰⁵ during which mutual settlement could be achieved before leave is granted to litigate. Although the timeline for administrative appeals in Nigeria is slightly better, certain defects that were identified in Cameroon to affect the effective resolution of disputes at this phase such as long durations and high costs also apply to Nigeria.

From an engineering standpoint, these defects raise doubts regarding the effectiveness of actual administrative appeals in remedying TPM, with signs emerging that GoG countries are starting to improve the quality of appeals at this phase. In Cameroon for example the 2014 Finance Law has cut the duration for issuing final rulings to **4** months even if appeal goes all the way up to the Minister.

Shortcomings of Litigation:

Considering the depth of challenges confronting tax auditors investigating TPM, it can be expected that the complexity of these schemes would pose a similar (if not greater) challenge to judges that are non-specialized in the area. Even in the US where specialized courts handle tax matters some TP disputes have taken about 10 years to resolve, and similarly long periods have been taken in France to resolve these disputes. In the GoG, where as noted earlier TPM poses a significant challenge even to highly qualified personnel of tax administrations, a greater challenge is

⁶⁰⁵ As recently as 2013, taxpayers with objections had 90 days in which to appeal an assessment with the Regional Chief of Taxes who had 30 days within which to issue a decision. He then had 30 more days to appeal the decision to the Director General of Taxes (DGI) who had 60 days to issue its ruling. The taxpayer was then allowed a final 30 days to appeal the DGI's decision to the Minister of Finance who had 60 days to issue a **final** administrative ruling.

likely to be faced by judges who arguably have very little experience analyzing and handling rulings on tax matters. This challenge is compounded by the absence of specialized tax courts in most GoG countries, where conventional judicial or administrative courts are competent to handle tax matters. Given the complex nature of TPM it is discernable that the process of litigating these schemes would be costly, experience delays and there is no guarantee of the technical quality of rulings to be issued. This raises questions as to whether actual litigation mechanisms achieve effective remediation.

Shortcomings of the MAP and APA Mechanisms:

Although the MAP is useful in remedying TPM disputes, its major shortcoming is that only signatories of Double Taxation Treaties (DTT) can engage it. Given the huge number of countries that France and the US have tax treaties with (over 68 and 100 respectively), they could easily engage the MAP. However, this is not true in Nigeria and Cameroon where the mechanism can hardly be used in any significant manner given that these countries are respective signatories to 10 and 4 tax treaties only. The effect of this limited network of tax treaties is that stakeholders do not perceive or rely on MAPs as a medium for handling TPM disputes, reinforcing doubts over its effectiveness as a mechanism for remedying TPM. A similar weakness exists with respect to APAs. It would be recalled that this mechanism is designed to preempt disputes and the need for remediation by allowing the fisc and taxpayers to negotiate TP's prior to the latter engaging the transaction, with the possibility of applying sanctions if agreement is breached. This mechanism is in principle uniquely relevant in minimizing costs and time that are otherwise wasted by fisc and IOCs pursuing TP disputes. Although the APA program is barely important in France, it is increasingly occupying quite an important role in the US. In the GoG however, the engineering of TP regimes has traditionally given APAs no role in tackling TPM. Indeed, most of these countries have hardly adopted any policy or anti-avoidance regulatory framework allowing for bilateral or unilateral APAs.

Although there are signs of both countries making effort to increase their Tax Treaty networks as a means of broadening leverage in this and a range of other issues, the ineffectiveness of MAPs in the GoG as a remediation mechanism is poised to last for as long as efforts do not translate into concrete results. Likewise, while the need to adopt APAs is now being taken seriously in the GoG with Ghana and Nigeria fairly recently taking steps to adopt it, the more common posture amongst other countries like Cameroon, Chad and Gabon not to adopt APAs diminishes its perception as a alternative mechanism that is suitable for effectiveness remediation of TPM in the GOG.

Absence of Domestic Arbitration:

Voluntary and binding domestic arbitration is another useful dispute resolution mechanism that is absent from the engineering of GoG TP regimes. It has more advantages compared to litigation.⁶⁰⁶ Adopted in the US in 1990 as Tax Court Rule 124, domestic arbitration proved in the *Apple Arbitration Affair* to be a useful way to expeditiously settle *issues of fact* that arises during TPM disputes. It has the particular advantage that issues submitted to arbitration are more focused and parties acting rationally have an incentive during agreed settlement discussions to resolve or narrow down their differences prior to seeking arbitration since there is little or no certainty in which direction the arbitration panels' decision will go. If indeed a decision is made to resolve a dispute at arbitration the *burden of proof* on either party is substantially reduced as neither need prove its original or any changes it makes to its initial position within a period of three months prior to the arbitration.⁶⁰⁷ Most importantly, the procedure provides an accelerated timeframe in which a final decision would be issued compared to litigation. And because parties agree prior to arbitration not to appeal the merits of arbitral rulings or the procedure used, this ensures that disputes are brought to a rapid close.

Both Cameroon and Nigeria have not engineered into their regimes a similar mechanism that can be used by dispute parties to expedite appeals. This creates a vacuum in the disputes resolution framework. This mechanism can be quite useful in achieving effective resolution of disputes that arise from TPM adjustments and to also consensually avoid being entangled in litigation if settlement is not found at the administrative phase. It also has the advantage that those selected to seat on the panel are experts who are possibly more knowledgeable on matters of transfer pricing than many judges in the contemporary court system. It is likely their decision would be perceived by parties to the dispute to be more fair and technically grounded. This is not to suggest that Cameroon and Nigeria are not open to using arbitration, as provisions exist in their petroleum legislations that allow for international arbitration for disputes arising in oil transactions.⁶⁰⁸ Given that need exists to expedite resolution of TPM disputes and that governments are habitually reticent to allow arbitral jurisdictions rule on matters of domestic taxation, reengineering GoG regimes to introduce domestic arbitration is a viable proposition to consider in efforts to enhance the effectiveness of GoG remediation frameworks.

⁶⁰⁶ See Chapter 5.2.1.2.E *supra*

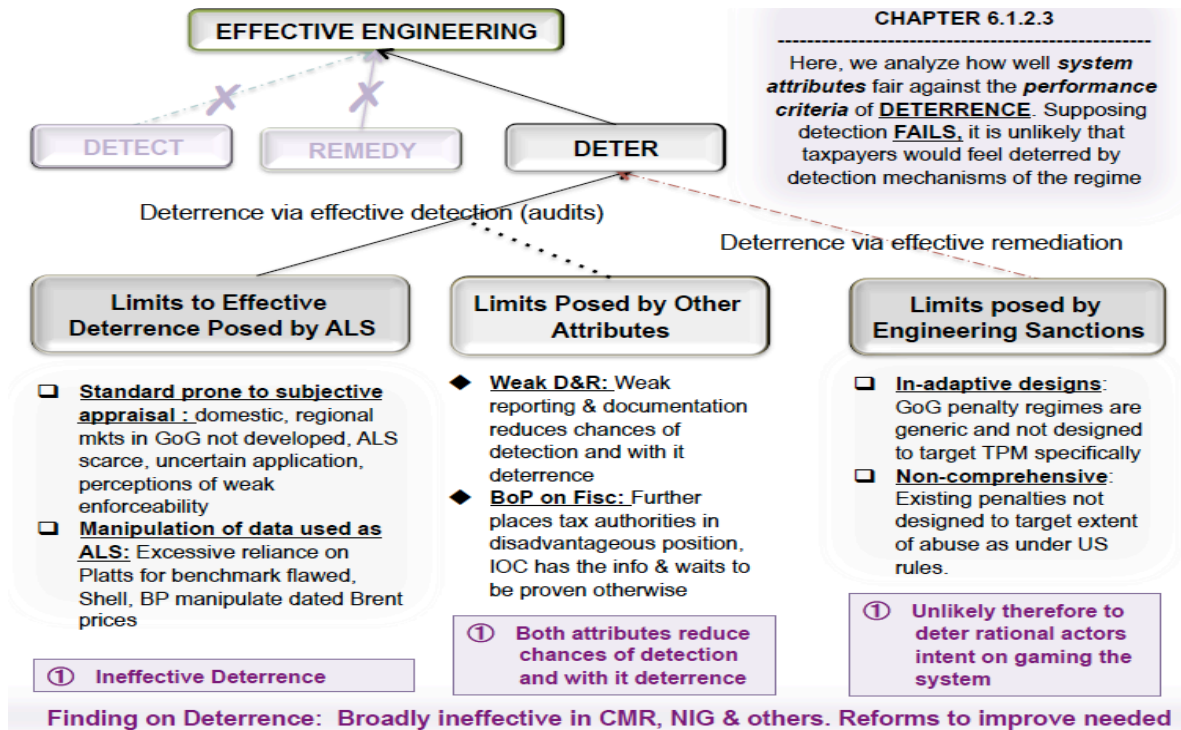
⁶⁰⁷ Eden (1998), *supra* note 3 at p.480

⁶⁰⁸ Cf. s. 115 (2) of CPC

6.1.2.3 Effective DETERRENCE of TPM in the GOG

TP regimes are ideal if they *deter* noncompliance. If successfully achieved deterrence produces the most effective and efficient anti-avoidance outcome as it wholly eliminates costs of detecting and remedying noncompliance. There is as such need to engineer TPM regimes in a manner that intimidates prospective avoiders into complying, by ensuring that they actually perceive as probable the chances of being detected and sanctioned. Engineers should aim to keep MNEs from implementing schemes that disrupt otherwise *equitable, neutral, efficient, certain* tax regimes, by giving themselves undue tax advantages over their (mostly domestic) competitors. However, it is to be noted that deterrence is not itself achievable without the existence of effective detection and remediation. Indeed, it relies on extents to which detection and remediation are themselves effective - *or perceived as such by taxpayers*- to itself prove effective. From this perspective, lapses in the engineering (*and administration*) detection or remediation components of the regime are likely to result in a correlative defect in terms of deterring noncompliance.⁶⁰⁹ In the paragraphs that follow, we examine how effectively detection (A) and remediation (B) contribute to deterring TPM in the GoG.

Figure 6-5: Effective Deterrence of TP Regimes



⁶⁰⁹ This does not mean that a regime found to be effective from the detection or remediation perspectives, is necessarily so in terms of deterrence

A. Appraising the Role of Detection in Deterring TPM

A regime is effective in deterring TPM if engineered to prevent not punish and only sanctions behavior that causes harm. Under such a regime, noncompliance costs should outweigh all potential benefits such that rational actors judge compliance to be the more attractive option. While emphasis here is on using sanctions to dissuade taxpayers looking to abuse the system, deterrence cannot be analyzed on this basis alone, since one needs to first of all detect abuse before implementing sanctions. Therefore, even if sanctions are perceived as robust and broadly capable of dissuading abuse, a parallel perception of the engineering (and administering)⁶¹⁰ of tax audit frameworks as incapable of detecting TPM weakens the intimidating effect of sanctions. A defective detection system takes away the sting or bite of sanctions such that taxpayers intending to pursue noncompliance feel undeterred by sanctions if breaches are unlikely to be caught in the first place. This notably includes defective engineering of the *ALS, documentation and disclosures*.

Limits to Effective Deterrence Posed by Application of the ALS

Defects in the engineering of rules linked to the ALS could render the implementation or enforcement of these rules during audits difficult. Ambiguity in the rules designed to empower the fisc in its duty to source reliable comparables for arms-length purposes is unlikely to deter taxpayers from trying to beat the system, since efforts to enforce the ALS during audits would most certainly be met by MNE objections: *Unilever Kenya Ltd. case*.⁶¹¹ Two main challenges exist in this respect.

Firstly, it is *a standard prone to subjective appraisals*. In light of this, implementation of the ALS can be approached differently especially in contexts where rules applicable to the standard are ambiguous (i), and information on independent transactions in regional markets is not available to the public (ii). For example, the fisc under actual rules is expected to source and analyze comparable data regarding transactions over which it has no in-depth knowledge of. Likewise it cannot attest to the supposedly uncontrolled character of data it even uses given the very complex web of corporate ownership structures that exist in markets today. Stakeholders could thus disagree on transactions that qualify as comparables, or markets to draw these comparables from. Practical guidance in some

⁶¹⁰ Deterrence from the perspective of administration is discussed in 6.2.1.3 [infra]

⁶¹¹ (2005) Income Tax Appeal No 753 of 2003. In this case, Visram J., of the Nairobi High Court ruled against the Kenya Revenue Authority's (KRA) reliance on broadly worded TP rules contained in Section 18(3) of the Income Tax Act to adjust TP. Without adopting appropriate legislation and guidelines, the Kenya court reasoned that KRA could not successfully rely on such broadly worded provisions to challenge methods used by Unilever.

countries that comparable transactions should be “sufficiently similar” and information “sufficiently complete” does not eliminate this ambiguity. The fisc needs to find unrelated party transactions that *sufficiently compare* to that examined. ALS’s potential to deter is based on an assumption that the availability of suitable comparables on the open market eliminates an incentive to manipulate intrafirm prices. In the US where IRS can find comparables by accessing an incredible volume of transactional data filed by taxpayers and/or consult databanks (Platt’s, NYMEX), deterrence might be effective.

Considering that benchmarking databases from which to draw uncontrolled comparables are scarce in the GoG, enforcing the ALS in this context is challenging. Indeed, substantial amounts of transactions in this region take place under barely transparent market conditions, making it almost impossible to obtain domestic or regional markets perfect comparables. The acceptance of US or European comparables in the GoG serves to increase a need for sophisticated adjustments engineered to account for functional and other market differences. Adjustments resulting from the analyses of contextual differences between GoG and foreign markets are subjective and open to being successfully challenged by taxpayers approaching the issue from a different perspective. Defects linked to the implementation of ALS create a perception of weak enforceability that could have a waning effect on deterrence and embolden those looking to beat the system to press ahead.

Secondly, tax authorities are likely to determine *ALPs* on the basis of benchmarks quoted on commodity exchanges and databanks that could be manipulated.⁶¹² The challenge in respect of taxing IOC’s has been that governments broadly tend to rely on benchmarks drawn from commodity exchanges. For instance, ss.90-94 of Decree N^o.2000/465⁶¹³ requires Cameroons crude to be valued on the basis average ‘Dated Brent’ or other reference crudes published on *Platts Crude Oil Marketwire*.⁶¹⁴ However, it is possible that the trust placed on price quotations published on these exchanges is misplaced given claims by petroleum traders that these quotations are themselves occasionally manipulated. As recently as November 2013 a class action lawsuit was filed in the US against traders in the global oil markets (*Shell, BP, Phibro, Vitol* and *Trafigura*) alleging that IOCs like BP, Statoil and Shell artificially fix benchmark prices at which crudes are bought and sold. Morgan Stanley and energy trader Vitol Group are accused of manipulating “closely watched spot prices for Brent crude oil for more than a decade”. In 2012, they rigged the markets via “a combination of spoofing, wash trades and other artificial transactions” in the price determination process of Platts.

⁶¹² Rotterdam, NYMEX, LPE, (Platts, Bloomsburg and Amadeus

⁶¹³ June 30, 2000 Establishing Modalities for the Application of Law N^o. 99/013 of 22 Dec 1999 bearing the Oil Code

⁶¹⁴ s. 90 of Decree N^o 2000/465; *prix courant du Marché International*

Likewise, there have been raids by EU antitrust authorities on Platts' offices alongside those of BP and Shell amidst claims of collusion in fixing crude prices.⁶¹⁵ If Shell and BP actually manipulate price quotations on Platts by wielding "collusive market power" this raises concern regarding the reliability and wisdom of GoG oil rich countries continuing to rely on Platts benchmarks as basis for enforcing ALS. If Shell a significant player in GoG oil sector indeed colludes in fixing North Sea Brent prices that are then used to value Cameroons crudes, it is obvious that using Platts as basis for adjusting its TP's is meaningless since these benchmarks technically already fixed to their advantage.

In principle however, these sources provide benchmark prices for 'unrelated' comparable transactions that can be used to determine the ALP, in a sense diminishing the need for complex comparability analysis in the O&G sector compared to other industries. This alone should deter IOCs intending to manipulate crude prices, although evidence shows that some have not been dissuaded by the availability of these benchmarks from engaging in TPM. Therefore, ALS as applied presently in the O&G industry may not contribute to effective deterrence of TPM.

The Impact of Weak Documentation and Reporting Rules on Deterrence

If audits prove effective in detecting TPM, this should have a correlative effect on deterrence. This is feasible in countries operating the tight approach where documentation and reporting are both mandatory components of the compliance regime, with the UK further tightening its regime by extending to third parties the requirement to disclose tax avoidance schemes that they facilitate. If documentation, reporting and disclosures are comprehensive and fully implemented, this has the potential to effectively dissuade taxpayer's intending to engage in TPM since pre-audit avenues for gathering information are optimized. However, this situation can be contrasted with what applies in countries where the light approach is adopted in engineering detection.

In section 6.1.2.1, audit instruments including the use of general tax audits, short statutes of limitation and the duration of audits were mostly judged to be defective in detecting TPM. Therefore, they can hardly be seen as engineered to deter abuse effectively. Similar defects apply to the roles played by other system attributes in detecting abuse. For example, most compliance requirements in the GoG including documentation, reporting and disclosures are *generic* with quite limited potential to tackle complex TPM schemes in an effective manner. Under these systems IOCs are not compelled to be transparent with their TP policies, as information required to detect TPM is often only provided

⁶¹⁵ The Guardian (2013), supra note 587

to the fisc in statutory conditions and timelines that constrain their thorough exploitation. Given that the preparation and filing of TP documentation is not mandatory, IOCs can delay reporting intrafirm transfers until such a time within the framework of *general tax audits* as the fisc might suspect price manipulations and address a formal request for information regarding these transactions. This approach is defective since arguably insufficient time is allowed the fisc (6 months in Cameroon) to analyze IOC data, source comparables and effect complex adjustments. Should IOCs perceive these restrictions as effectively limiting the chances of schemes being detected, it is unlikely that they would feel deterred from engaging in TPM.

Impact of the Burden of Proof on Ineffective Deterrence

The **burden of proof** requirement actually applied by many GoG countries is not likely to deter noncompliance effectively. Although Cameroon, like France rests the burden to prove TPM on the fisc, there is a huge capacity gap between both countries in terms of shouldering this burden. For example FTA is better equipped to shoulder the *burden* since it benefits from a vast network of tax treaties, information exchange agreements and has the financial resources needed for sophisticated investigations, whereas CTA struggles on all these issues. Coupled with limitations on access to information regarding the circumstances and nature of transactions or control exercised by the buyer over the seller, it is hard to see how tax authorities in the GoG could effectively shoulder the burden of prove relating to TPM. Actual systems are engineered such that authors of otherwise abusive schemes are spared the trouble of having to disclose the full extent of their maneuvers, could idly stand by watching the fisc as it tries to prove wrongdoing, and yet take advantage of the latter's lack of information to successfully attack on appeal errors that light have been made by the aggrieved party (fisc) in the process. Unless sufficient access to data on these operations are made available to the fisc, it is illogical to rest the burden to prove noncompliance on the party that does not participate in management meetings where intrafirm transfer prices are decided, which has little initial knowledge of these operations, and whose right is likely to be adversely affected. If anything, this disadvantaged position increases the chances of error, renders the ensuing adjustment subjective, and enhances the possibility that TPM adjustments can be successfully challenged on appeal. By retaining the statutory advantage on the question of *proof*, IOCs are unlikely to feel deterred under this system.

There is evidence that GoG countries notably Nigeria and Ghana are starting to move away from this defective approach by shifting the burden of proof to taxpayers to show compliance with TP

regulations once doubt arises. The US in 1994 revised its *burden of proof* rules by shifting it from the fisc to taxpayers for TP purposes. France has now adopted at least one aspect of this tight approach. For cases where the transaction takes place between French companies and partners in tax havens, France now exceptionally shifts the *burden of proof* from the fisc to taxpayers. Therefore, in areas where FTA has difficulties sourcing information needed to effect mispricing adjustments, it has been willing to revise its BoP rules as a means of filling the gap. Given France's flexibility on the issue, it is logical that GoG countries *facing even greater difficulties to obtain information* on intragroup transfers consider shifting the *onus* to IOCs as a means resolving regime weaknesses caused by this defect.

Given that little changes have been made to existing ALS, documentation, reporting and BoP rules in many GoG countries, it is unclear whether this light engineering of the rules can influence the calculus of MNEs to the point of deterring TPM. Actual rules are not robustly engineered to instill the fear of authorities detecting abuse during audits and are therefore unlikely to deter TPM effectively.

B Engineering Sanctions to Deter TPM

Notwithstanding the important role that audits can play in deterring TPM, **sanctions** are the main component of attributes with a correlative impact on effective deterrence of TPM. In principle, deterrence assumes that actors are rational players making rational choices such that if a sanctions regime were tight, rational actors would be *intimidated* into complying. It is only truly effective if actors know, believe and/or perceive *enforcement* of sanctions as unavoidable once the fisc detects TPM. The role played by sanctions in influencing compliance is critical since one is only deterred if there exists causality between the decision to comply and fear of the applicable penalties for failing to do so. Therefore, the engineering of actual sanctions should be tight enough or perceived as such by taxpayers in order to *intimidate* intending abusers into complying with contemporaneous documentation and other regulations. The scope of the sanctions component must leave no doubt in the minds of IOCs as to their severity (i) and sacrosanctity (ii), given a demonstrated resolve on the part of tax authorities to implement them. However, if the engineering of sanctions create doubts as to the circumstances in which they apply or are perceived as such, it is unlikely that taxpayers intending to engage in TPM would feel deterred. The engineer therefore needs to factor both of these aspects as triggers to intimidate intending but rational actors into complying with their obligations.

While it might suffice from a remediation standpoint to simply judge the engineering of sanctions as effective if penalties apply to cases of abuse, a similar conclusion is technically impossible to reach if one adopts deterrence as the prism for analyzing the same issue. Sanctions deter noncompliance if rational actors evaluate the long-term costs of noncompliance as *certain to outweigh* any short-term benefits and acting upon this assessment chooses to comply. Put differently, it is in the long run exceedingly less costly to the IOC if it chooses the option of complying today with its routine filing obligations. Crucially, the need to find a balance between preserving continuity of business concerns and sanctioning TPM is quite important. If sanctions result in ruin or bankruptcy, it cannot be seen as intended to deter avoidance unless it is mainly aimed to serve as specific avoidance. Although liquidation might serve as a good deterrent to other companies, it can be assumed that several irrational actors might be simultaneously caught in this net and suffer the same fate. Such a proposition is unattractive in many developing GoG countries where actual policy is to attract FDI into the capital-intensive oil sectors. However, the possibility of liquidation is actually not remote considering excessively high penalties (100%, 150%, 200%) being applied in the GoG.

Most GoG sanction regimes are not designed to deter TPM specifically. For example, while the US for example designs s.6662 to distinguish between penalties that apply to profit transfers of a substantial or gross nature, including the adoption of Transactional (20% for SVM, and 40% for GVM) and Net-Section 482 Adjustment penalties (\$5 mm or 10% of gross receipts for SVA, and \$20 mm or 20% of gross receipts for GVA),⁶¹⁶ this useful approach is not reflected in current GoG regimes. Besides, while France and US provide specific fines of €10,000 (US\$ 13,584.94) and \$10,000 for taxpayers who fail documentation requirements,⁶¹⁷ there is indeed no direct pecuniary sanction under s. M19 of CTC in Cameroon for failing to or providing incomplete documentation 30 days after receiving a formal notice to do so. From this standpoint, IOCs interpreting and applying the French and US sanctions regime are more likely deterred from withholding documentation than their counterparts in Cameroon or many other GoG countries. By not imposing specific sanctions for failing documentation requirements these regimes are deprived of a key instrument that could enhance its capability to deter TPM. Even if the argument were to be made that the severity existing sanctions have the potential to effectively deter TPM, this is at best qualified in the sense that current designs have the defects of not targeting the extent of abuse and could lead to bankruptcy.

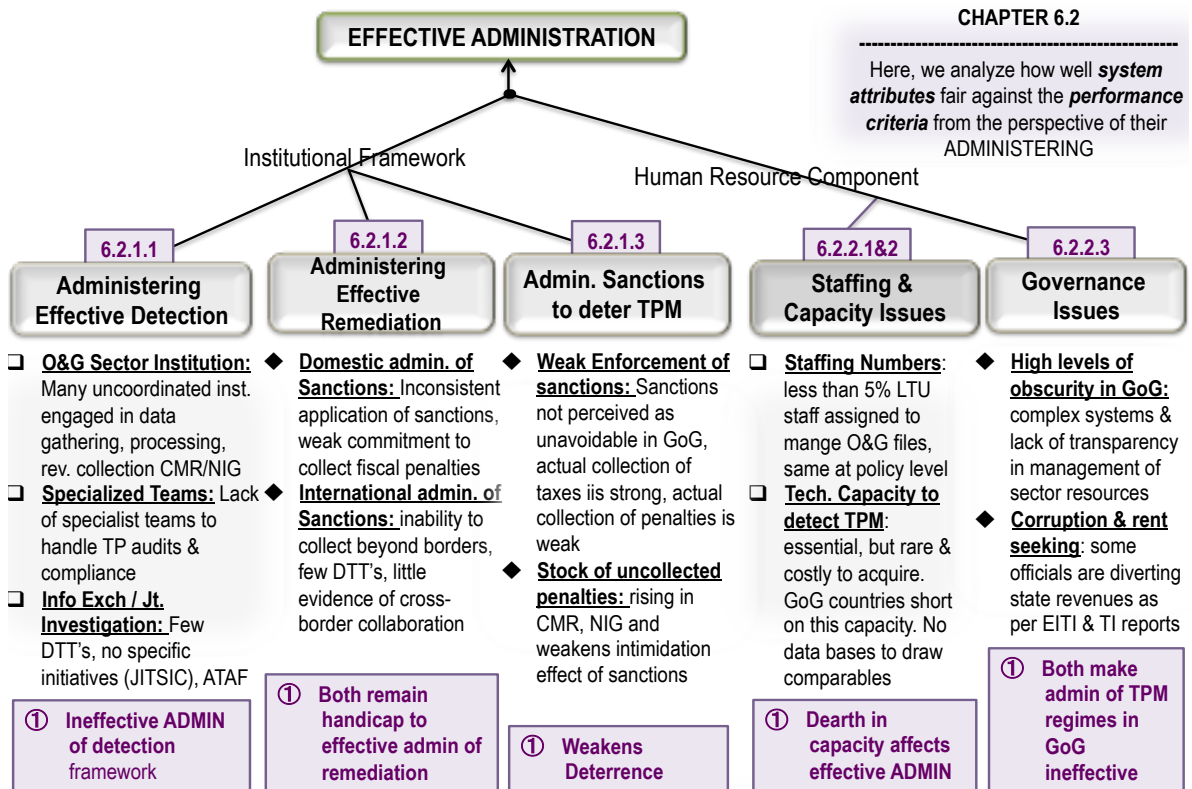
⁶¹⁶ See Chapter 5.2.1.2.D for detailed discussion of these penalties

⁶¹⁷ Art. 1735 Ter. and s.6038A of France and US tax Codes respectively

6.2 Administering Effective TP Regimes in the GOG

Focus in the GoG has been to engineer effective tax anti-avoidance regimes without paying as much attention on building robust administrative frameworks for their effective implementation or enforcement. There is however increasing recognition in these countries that effective administration - as engineering- plays an equally important role in determining a tax regimes overall effectiveness. For example, administration of a TP regime is very likely to be perceived as defective if implemented by incompetent staff or bureaucratic rent-seekers. Conversely, staffing the fisc with highly competent personnel that have access to relevant intrafirm data, pursue effective audits, and apply appropriate deficiency penalties to breaches is indicative of effective administration. There are two main facets that can be explored when examining effective administration of regimes, that is: **organization of the institutions** (6.2.1) and **human resources** (6.2.2) that are deployed to administer the detection, remediation and deterrence objectives of TP regimes.

Figure 6-6: Effective Administering of TP Regimes



Finding: Broadly ineffective ADMIN in CMR & NIG. Ongoing reforms to improve ADMIN.

6.2.1 Review of Institutional Framework

The institutional framework put in place to source and process comparable intrafirm data needed to implement/enforce TP anti-avoidance is important in ensuring overall effectiveness of the regime. Therefore, the paragraphs that follow analyze possible defects in institutions put in place in Nigeria and Cameroon to *detect* (6.2.1.1), *remedy* (6.2.1.2) and/or *deter* TPM (6.2.1.3).

6.2.1.1 Administering Effective Detection Frameworks

Actual institutional frameworks reveal three main defects as far as administering effective detection is concerned. Firstly, the organization of oil sector institutions presents certain structural defects in terms of detecting abusive intrafirm transfers. Secondly, the actual structuring of teams that administer TP compliance and audits is arguably defective. Thirdly, there are identifiable defects in actual institutional frameworks created in the GoG to source vital data on independent cross-border transactions that is needed to adjust mispriced intrafirm transfers.

Institutional Dysfunctionalities in the O&G Sector

Historically, the complex nature of the hydrocarbons sector has seen the creation of multiple institutions with roles that vary from handling sector data, negotiations of concessions/contracts, state interest and participation in E&P activities, setting of domestic oil and product prices, to collecting fiscal revenues. In Nigeria for example, institutions that intervene in the taxation of oil companies include the DPR that gathers data and collects royalty, NNPC that plays a role in determining hydrocarbon prices via COMD and NAPIMS, and FIRS that simultaneously charged with assessing and collecting PPT and other direct taxes, and implementing the country's TP Reg. No.1, 2012 in the hydrocarbon and non-hydrocarbon sectors. A similar situation exists in Cameroon where several institutions are involved in the assessment and collection of different types of extractive fiscal revenues, including the Hydrocarbons Department of the Ministry of Mines, SNH, CSPA, CTA and Treasury department.⁶¹⁸ This panoply of agencies involved in data gathering, processing and revenue collection present challenges to the effective administration of TP regimes.

A good example is the detection of TPM when it comes to collecting royalties. Technically, the competence to adjust, compute and collect direct or indirect taxes resides with the fisc, while the

⁶¹⁸ The CTA collects CIT, fixed duties and Land Royalties; the Ministry of Mines (Hydrocarbons Department) collects training fees; SNH collects signature and production bonuses, royalties, dividends and revenues from sale of petroleum.

assessment of *royalties* resides either in the oil Ministry or the NOC. In principle, if the fisc detects mispricing practices that result in PPT or CIT tax deficiencies being recalled, this should prompt other agencies to automatically initiate procedures meant to recall royalty deficiencies. There is actually no properly coordinated collaborative platform between agencies on the basis of which the fisc in can invite the Ministry/NOC to make correlative adjustments to royalties. Likewise, should the NOC or Ministry make price adjustments for royalty purposes, it is unclear if and how it could pass this information to the fisc to administer PPT adjustments under TP Reg. N°1 rules. This defect suggests that actual institutions tasked with collecting oil sector revenues are not designed to interact in a way that ensures effective data gathering and sharing amongst themselves. There isn't operational harmony between relevant agencies, which actually creates dysfunctionalities in the collection, processing and centralization of vital data that is needed to detect TPM.

Lack of Specialized Teams to Administer TP -Compliance and Audits

In both Cameroon and Nigeria sector teams lodged within the Large Taxpayers Unit (LTU) are competent to handle TP compliance and audits.⁶¹⁹ Considering the very challenging nature TPM schemes, it is doubtful if this approach is particularly effective since international tax experts that are not assigned to a particular sector team can hardly assist LTU examiners of that sector during audits. This organizational defect is further exacerbated by the absence of an “*official transfer pricing audit roadmap*” intended to guide auditors and MNE's on the audit process. The result is arguably few, TP adjustments in contexts where conditions and evidence suggests that IOCs engage in TPM. In Cameroon where upwards of 20 tax audits have targeted IOCs since 2010, hardly any deficiency claims have been based on TPM. While it is often initially proposed as a point of adjustment,⁶²⁰ there is hardly any follow through. In the absence of specialized teams designed to initiate and lead TPM tax deficiency recalls, it is likely that such adjustments result in disputes that are quashed on appeal. Hence, the incentive amongst teams of non-specialized auditors to initiate TP audits is weak, and clearly operates against effective detection of TPM in Cameroon. Similar challenges exist elsewhere in Africa.⁶²¹ This relatively weak model of administering TP regimes can be contrasted with models operated in both the US and France where increased resources are being devoted to investigating base erosion and profit shifting. Examples include IRS's Transfer Pricing Operations (TPO) lodged

⁶¹⁹ In Cameroon, the LTU manages taxpayers with annual revenues of at least 3 billion Fcfa (US\$ 6.2 millions).

⁶²⁰ My discussions with tax auditors and review of unpublished adjustment notices confirm this point

⁶²¹ See, Daniels et al. (2010), *supra* note 7 at chaps. 11-12; Where Jack Calder elaborately discusses problems confronting tax administrations in developing countries as far as audits are concerned

within Large Business and International, and FTAs creation of the 30th Brigade that is specialized in transfer pricing to assist all 30 DVNI sectorial audit teams of the *Direction des Vérifications Nationale et Internationale* (DVNI).⁶²² The said brigade comprises dedicated in-house economists akin to the US' model⁶²³ and may draw comparables from databases like InfoGrefe, Bureau Van Dijk's Diane and Amadeus in providing assistance to inspectors of other brigades if need arises.

However, some GoG countries are taking steps to improve the administration of TP issues by creating teams specialized in detecting TPM. Nigeria has moved to improve implementation of its broadly worded TP provisions by holding consultations (2011) and issuing TP guidelines to taxpayers (2012). FIRS's management has also set-up units to handle TP in both the O&G and Non-O&G Large Taxpayers Offices. Already, teams these *units* are working on identifying the nonresident parent (MNE) and affiliates with whom Nigerian subsidiaries engaged in intrafirm transfers that are likely to result in TPM. Over 5000 companies have been indexed as netted by Reg. N^o.1.⁶²⁴ By failing to constitute and assign specialized teams to administer TP issues in the GoG, it is evident that existing institutional models are arguably defective in administering effective TPM detection.

Frameworks for Information Exchange and Joint Investigations

Notwithstanding that information is essential to efforts aimed at tackling TPM, the problem of *asymmetric information* makes it hard for tax authorities in the GoG to effectively detect TPM. That is, IOCs engaged in E&P activities are always better informed of the geology and economics of projects than policymakers and tax authorities. Given that host governments seek to optimize tax revenues from natural resources and rely on IOCs to provide the data needed to secure their interests, taxpayers have very little incentive to share this information since the outcome is inevitably going to be increased tax liability. If anything, the incentive is to reduce liability by understating the stock of resources and overstating challenges tied to the extraction of crude oil. Examples include IOC's engaging in schemes purposely designed to understate or shift profits to foreign jurisdictions via TP or other schemes.⁶²⁵ In this context it falls to host countries to source needed data by compelling IOCs to directly provide this information or using inter-jurisdictional corridors to obtain the same.⁶²⁶

⁶²² Competent to audit companies (industry) with turnover or €152.4 millions (US\$ 207.9 million) or service companies with turnover of €76.2 millions (US\$ 103.9 million)

⁶²³ Berger, F. et al., *French TP Documentation Regulation Formalizes Enforcement Efforts*, EY March 2013 available at www.ey.com [Last visited: Jan. 15, 2013]

⁶²⁴ Bamidele (2011), *supra* note 515 at ppt.2

⁶²⁵ Daniel et al. (2010), *supra* note 7 at p.23

⁶²⁶ The domestic dimension of this issue has been discussed in in Chapters 5 [*supra*]. See Documentation and reporting

The question of sourcing this information internationally is vital, and information exchange mechanisms are quite useful in this regard.⁶²⁷ Countries seeking external information have habitually relied on generic international platforms to address their needs. Under this approach embedded in Art.26 of OECD Tax Treaty, the number of treaties that a country is signatory to determines its access to external information. For example, France (US) has a large network of tax treaties such that the FTA can use this platform to source information from the US, Germany, Belgium or UK to name a few.⁶²⁸ Others, including over 60 countries and a further 10 aspirants have sought to secure this information by joining the joint OECD and Council of Europe Convention on Mutual Administrative Assistance on Taxation.⁶²⁹ The exchange of information between competent foreign authorities via this platform takes any of three main forms, namely *spontaneous*, *automatic* or *request-based*. There have been other initiatives to create more sophisticated frameworks that respond to specific group needs, a good example being the *Joint International Tax Shelter Information Centre* (JITSIC) to which the UK, US, Australia, Canada and Japan are participants. Its objective is to foster collaboration in combatting cross-border avoidance via real time information exchanges between members. JITSIC is already producing significant results in tracking abusive tax avoidance schemes like TPM,⁶³⁰ and its focus is now being broadened to “sharing best practices on risk assessment and other key areas of interest, and particularly increasing the transparency of cross-border transactions in order to create a level playing field for taxpayers who are voluntarily compliant.” The plan is to prudently expand membership to cover North America, Europe and Asia.

The ability of GoG tax administrations to access foreign information is quite limited since these countries have only fairly recently started to create viable platforms for exchanging information. If tax treaties are taken to be the yardstick, then CEMAC oil and gas producing countries are actually signatories to only few such treaties (Cameroon 4; Gabon 5, Equatorial Guinea 1). Notwithstanding the OECD's assessment that only four tax treaties of which Nigeria is a signatory meet international standards, it has an impressive 16 tax treaties to its credit compared to other GoG countries.⁶³¹ There is no doubt that this network of treaties is quite limited and cannot be relied on to effectively source

⁶²⁷ OECD Seoul Declaration (2006)

⁶²⁸ PWC, *France, International Transfer Pricing 2013/14*, p.426 at www.pwc.com/internationaltp [Last visited: April 13]

⁶²⁹ Convention on Mutual Administrative Assistance in Tax Matters, developed in 1988 and amended by Protocol in 2010 following the 2009 London Summit of G20 countries, available at <http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf> [Last visited: March 12, 2014]

⁶³⁰ IR-2007-104, May 23, 2007 available at <http://www.irs.gov/uac/Joint-International-Tax-Shelter-Information-Centre-Expands-and-Opens-a-Second-Office-in-the-United-Kingdom> [Last visited: March 11, 2014]

⁶³¹ *Nigeria Needs Effective New Tax Treaties*, March 20, 2012 at <http://www.taxationinfonews.com/2012/03/nigeria-needs-effective-new-tax-treaties/> [Last visited: March 14, 2014]

information from foreign tax administrations. Even in cases where such treaties exist, it is observed that they are rarely concluded with countries that are major off-takers of GoG crudes. For example, Cameroon has a full tax treaty with only one of its major crude off-takers, namely France. A similar pattern is observed in Nigeria although it outperforms Cameroon on this issue since it has treaties with more of its major crude off-takers. Equally, there are no initiatives to create a JITSIC-like platform in the sub-region. By failing to develop viable international platforms for sourcing vital information on cross-border intrafirm transfers, it is evident that existing institutional models are arguably defective in ensuring effective administration of TPM detection components. However, as more governments accede to initiatives like (ATAF's) Agreement on Mutual Assistance in tax matters, it is likely that this institutional gap would be progressively closed.⁶³²

6.2.1.2 Administering Effective TPM Remediation

The two examinable dimensions as far as the question of administering effective remedies is concerned in the GoG are the domestic and international enforcement of sanctions.

Domestic Frameworks for Administering TP Sanctions

The tasks of *imposing, collecting and/or staying execution* are critical in administering effective TP penalties. Although sanctions in the GoG are broadly generic, these can hardly be described as effectively administered. In Cameroon, the requirement is that penalties apply in cases where returns filed by taxpayers are adjusted. However, it is observed that discrepancies exist between the actual amount of taxes recalled as principal and the minimum penalty threshold that should otherwise have been charged following audits. An explanation of this defect could be the lack of rigor in assessing penalties, which renders the administration of remedies ineffective. This lack of rigor also extends to tax collection. Of the stock of penalties issued by Cameroon's fisc in 2012, only about 60% was effectively collected by close of the period. This indicates a weak commitment on the part of tax authorities to collect penalties when compared to collection of principal tax recalls. A reason could be that tax collectors tend to regard principal tax recalls with greater importance than they do penalties. Persistent failures to collect penalties are likely to culminate in taxpayers perceiving as negligible, risks of non-compliance. Indeed, an otherwise effective architecture, engineering and administration a regime turns ineffective if imposed penalties are not collection.

⁶³² *African Tax Administration Forum (ATAF)* at <http://www.ataftax.net/en/> [Last visited: June 4, 2014]

Further, the appeal procedure in some countries makes it hard to administer remediation effectively. The actual execution of tax recalls can be stayed on appeal until such a time as the matter is conclusively decided. If one considers that TPM are amongst some of the most complex disputes to resolve and that the appeal process in many GoG countries is quite long, IOCs could deliberately stay execution by lodging further appeals. Further, courts created in the region to resolve tax disputes have little specialized knowledge on the subject of transfer pricing. Courts are thus unlikely to issue technically satisfactory rulings within a reasonably short period, thus increasing the chances of these rulings being challenged further. Prolonged appeals have the undesirable consequence of deferring the timing of tax collection in a way that increases uncertainty, reduces efficiency and ultimately affects sanctions enforcement. Equally, if this lack of specialized knowledge in the existing appeal system results in judges quashing otherwise founded adjustments, this incentivizes noncompliant taxpayers to gamble on using appeals as platforms for reversing penalties charged by the fisc.

International Frameworks for Administering TP Sanctions

Given the international character of the oil industry, efforts to remedy TPM effectively should be made international. Under the *status quo* even if the fisc were to issue penalties against an IOC that holds the bulk of its taxable profits abroad, a major challenge is going to be that of collecting taxes recalled since these sums are lodged outside the reach of its officials. This problem is neither unique to the GoG nor the oil industry. In *Government of India v. Taylor* [1955] the courts resolved that under the 'Revenue Rule' UK courts would not assist the Indian government to enforce its tax laws by collecting unpaid taxes from a UK company that had been doing business in India. The court, reasoned that tax enforcement was a matter of sovereignty, effectively establishing what for a while became the greatest impediment to international collaboration in the enforcement of foreign tax sanctions. *Taylor* was decided at a time when international trade was not huge or complex, nor was international tax avoidance as much a menace to domestic tax bases as it is today. What seemed then to be a sound *rule* to adopt is ineffective when administered in today's context.

Since the 1980s when international tax avoidance began posing serious challenges to tax administrations, viable platforms allowing countries to collaborate in the enforcement of foreign tax laws have been created including Art.27 of OECD Model Tax Convention (2002). The article provides a framework for competent authorities to assist each other administer foreign taxes and sanctions, the modalities of which are detailed in the Convention on Mutual Administrative Assistance in Tax

Matters briefly discussed above.⁶³³ The nature of assistance envisaged here is *administrative*, not technical and does not require signatories to change domestic laws, policies or administrative procedures.⁶³⁴ In practice, the assistance in recovering foreign taxes or sanctions is easily achieved if both countries are neighbors or historically cooperate on a range of other issues, an example being collaboration between EU member states. While the idea of cooperation is in principle now accepted by many countries, it is the scope of assistance they are willing to provide that varies. Most countries would agree to, but limit the extent and type of assistance given to partner tax administrations in recovering foreign taxes. An example is the US/UK agreement for mutual administrative assistance in collecting taxes due the other.⁶³⁵ Therefore, some countries assist in collecting the principal tax only (not penalties) since doing so would amount to enforcing another sovereign's sanctions regime against the 'revenue rule'. Others might assist in collecting the principal tax and related penalties.

In the GoG where an obvious need exists to seek international assistance in the area of tax collection, there is little evidence that resources are being mobilized towards developing such a collaborative platform for administering TP sanctions. ATAF's mutual assistance agreement is helpful in this regard although Cameroon and Nigeria are yet to join the platform. In the absence of an operational platform through which oil producing countries in the GoG can seek assistance of foreign partner administrations to collect or enforce taxes, TP sanctions cannot be administered beyond the territorial boundaries of these countries even if need arises to do so. Notwithstanding that the *withholding tax mechanism* is used to reduce the extent of untaxed profits transferred abroad, the absence of a comprehensive tax assistance platform remains a handicap to effective administering of TP remediation abroad, should domestic attempts to recover debt prove futile.

6.2.1.3 Administering Sanctions to Deter TPM

From the standpoint of deterrence, it is important that intending abusers perceive the implementation of sanctions as inevitable (*enforcement effect*). The administering of *pecuniary* or *penal* sanctions to all forms of noncompliance detected *during* audits is crucial lest a perception would be created that non-compliers can occasionally escape the penalty net. In Section 6.2.1.2 above it is noted that tax officials in the GoG sometimes impose penalties inconsistently by applying

⁶³³ Exchange of Information, <http://www.oecd.org/tax/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm> [Last visited: March 12, 2014]

⁶³⁴ Only slight changes in domestic laws, policies and administrative procedures might be needed.

⁶³⁵ Miller and Oats (2009), *supra* note 29 at p.148

reduced rates (30% -*good faith*) in circumstances where mid (100% -*bad faith*) or maximum (150% -*evasion*) rates are required. This inconsistency eliminates the intimidating effect that sanctions are meant to have on rational actors, and weakens the *reinforcement* of tax compliance since taxpayers are not quite intimidated into choosing compliance by force of habit. Defects in the imposition of sanctions weaken their effectiveness as a deterrent mechanism under existing GoG regimes.

Furthermore, the actual collection of principal *taxes* recalled and *related penalties*, rather than mere imposition of it, is what effectively intimidates taxpayers intending to redeploy these schemes in the future. Put differently, the cost of noncompliance must be effectively felt in order to deter IOCs and other intending non-compliers from engaging further in the manipulation of TP's. Unfortunately, the pattern presented earlier is for emphasis in the GoG to be placed on collecting principal tax recalls than on collecting related penalties. A reason for this outcome is that performance assessment systems of tax administrators in these countries are often based on actual receipts of budgeted revenues (principal taxes) than of non-budgeted revenues of which penalties are a part. This is not unique to Cameroon as similar trends can be observed amongst other GoG oil producing countries. Gabon recently took steps to correct this trend by recovering unpaid taxes and penalties from oil companies, and Nigeria is presently taking similar steps. This notwithstanding, trends of a rising stock of unrecovered penalties observed in some of these countries create a perception of ineffective implementation/enforcement of sanction regimes. As with imposition, the lack of rigor that is noticed with the collection of penalties weakens the regimes intimidating effect since fines imposed on paper, but that remain uncollected, can hardly be perceived by intending abusers as biting. In this context, there is no reason for potential abusers to feel deterred by this defective sanctions regime.

6.2.2 Review of the Human Resource Component

In addition to the institutional defects discussed above, there are identifiable *human resource* concerns that render the effective administration of TPM regimes difficult. These include staffing numbers (6.2.2.1), technical capacity issues (6.2.2.2) and governance concerns (6.2.2.3).

6.2.2.1 Staffing Numbers Assigned to Handle TP Issues

Many tax administrations around the world experience a dearth in the number of tax professionals specifically assigned to handle TPM and other related issues. For example, in the US where the approach to tackling TPM is tight and where substantial progress has been achieved in

administering TPM regimes, it has nonetheless been argued that IRS was understaffed in tax year 2013. This resulted in the *Service* spending 18% fewer staff hours auditing large businesses that own assets of at least \$10 millions compared to tax year 2011.⁶³⁶ Further, IRS employees fell 23% between 1992 and 2012 even though returns filed by taxpayers during this same period rose by 27%.

The situation is grim in the GoG where very few tax professionals have experience handling cross-border taxation challenges like TPM. Both Cameroon and Nigeria tax administrations face shortages in the number of staff assigned to reflect on policy and to administer TP regimes. For example, in spite of the oil sector contributing some 28% of Cameroon's 2013 state revenues, less than 5% of LTU staff were assigned to either monitor compliance or audit the accounts of over 20 companies operating in the country during said tax year. Of these professionals, few have received formal training in matters of petroleum or international taxation. This dearth of expertise in both areas renders TPM audits in the oil sector less effective. Similar staff shortages exist at the level of policy formulation. Of a unit of 7 professionals, less than half are assigned to handle the entire workstream linked to transfer pricing reforms. Based on these figures, it can be expected that efforts to drive effective policy reforms on the subject (i), to monitor compliance (ii), and to ensure effective auditing of companies (iii), would be thwarted. Therefore, the actual understaffing of these institutions weakens efforts to effectively administer TPM detection and remediation frameworks in the GoG.

6.2.2.2 Lack of Technical Capacity to Detect TPM

The technical capacity needed to detect and remedy TPM when auditing IOC's, though essential, is scarce and costly to acquire. This is partly explained by the very complex nature of the industry. While the oil industry is highly profitable, it is dominated by a small number of complexly structured companies that undertake huge volumes of cross-border intrafirm transfers and is actually hit by numerous rent-based fiscal instruments. Notwithstanding that these factors are not unique to the oil industry, the impact that they could have on producing economies if the fisc fails to effectively administer TP regimes is good enough reason to justify investing in the capacities to detect and remedy mispricing's. The actual cost *-in lost taxes-* to a country that doesn't invest in this capability, outstrips any financial costs it might expend doing so. Policy should match the capacity to identify transactions subject to TP adjustments, and the ability to source suitable ALP's for these cases.

⁶³⁶ Sally P. Schreiber, *Significant Decline in IRS Staff Leads to Fewer Audits*, Journal of Accountancy, <http://www.journalofaccountancy.com/news/20137763.htm> [Last visited: March 12, 2014]

A review of actual GoG regimes does not reveal the existence of comprehensive domestic databases from which tax authorities could draw comparable transactions. This impacts the ability of these countries to administer effective detection since comparables on the basis of which appropriate ALPs can be determined are not readily available. By insisting statutorily that MNEs (excepting oil companies) source comparables domestically, this raises questions as to whether tax auditors in the GoG are precluded from using international comparables in their adjustment of TPM. And supposing, that both domestic and international comparables were allowed, there is still a challenge as to whether tax officials in these countries possess the required technical capacity to source **sufficiently comparable** transactions that can be successfully used in adjusting manipulated transfer prices. After gazettement Reg. No.1,⁶³⁷ Nigeria's main challenge has been to upgrade stakeholder capacity on the issues of applying the ALS, performing comparability analysis, mastering the legal framework and detecting cases of TPM.⁶³⁸ It has in this respect been beefing-up capacity through seminars aimed at training both FIRS personnel and taxpayers on the implementation of Nigeria's TP rules.⁶³⁹

Likewise, Cameroon's DGI has similar capacity concerns when it comes to administering effective TP detection and remediation. It would be recalled that country's overall approach to tackling TPM (similar to France's) was earlier questioned given *significant capacity differences* between the FTA and CTA in terms of their ability to administer effective TP audits. Unlike France, Cameroon has not constituted any specialized Brigade (30th Brigade) with the required capacity to support other audit teams pursuing TPM adjustments during audits. Even the International Tax Unit that otherwise leads policy and administrative reform on this issue is inadequately staffed by professionals that have the competence to handle issues of TP specific to the oil sector. There is as such an obvious dearth in capacity that expectably thwarts efforts to effectively detect and remedy TPM in the GoG, which defect should be fixed in order for these countries to protect their domestic tax basis from being unduly eroded by extractive companies. However, it is worth pointing out that effort is now being made in Cameroon via the organization of seminars and other training forums to beef-up the capacity of tax officials in the areas of extractives and international taxation.

⁶³⁷ PricewaterhouseCoopers, *Nigeria Releases Transfer Pricing Regulations*, p.3 Nigeria Tax Alert November 2012 at www.pwc.com/ng [Last visited: August 31, 2013]

⁶³⁸ FIRS (2012), note 518. Transactions are defined as arrangement, understanding, agreement, or mutual practice whether or not legally enforceable or intended to be legally enforceable, and includes deals between two or more connected persons within or outside Nigeria

⁶³⁹ Bamidele (2011), supra note 515

6.2.2.3 Governance Issues –*Corruption and Rent Seeking*

In chapter 3 it was discussed that sophisticated fiscal instruments are being used to capture resource rent, which creates complex administrative challenges for host governments, including that of governance. This is important because contexts in which oil companies operate remain traditionally obscure and are lacking in transparency as concerns government accountability in the administration of oil taxation. An impressive trail of academic literature in the 1990s and early 2000s argued amongst others, that poor system designs and sector governance account for the inability of resource producing countries to optimize and/or take full benefit of opportunities offered by the sector to promote broader economic growth (the so-called *resource curse*).⁶⁴⁰ High levels of corruption and bureaucratic rent-seeking involving IOCs and tax administrators are part of accusations made by rights organizations against the industry. The degree of obscurity and lack of public oversight over resource contract negotiations and tax collection has made it possible for corrupt officials to easily divert revenues intended for governments. Likewise, the absence of good governance encourages businesses to avoid paying taxes since the perception tends to prevail over time that taxes collected, only serve the interest of corrupt officials and not the greater wellbeing of the country.⁶⁴¹

The EITI process has exemplified the lack of accountability that exists in the GoG extractives sector. The process that requires *regular publication* of payments by oil, gas and mining companies to governments (“payments”) and revenues received by governments from oil, gas and mining companies (“revenues”);⁶⁴² reveals that not all *payments* declared by IOCs are accounted for as *revenues* by receiving countries. In Nigeria for example, there was a \$98.958 million difference between figures declared by oil companies as having been paid and what the government stated as having been received during tax year 2011. Although this is within the EITI acceptable margin of error rate of 0.5%, and this difference cannot be specifically pinned on corruption or rent seeking, the amount of taxes lost between IOC and State accounts is nonetheless significant. At best, this indicates that the revenue collection and reporting processes are defective. Further, it is evident from Transparency International’s 2012 corruption index that Nigeria (139) and Cameroon (144) are

⁶⁴⁰ Led by authorities in the extractives industry such as Jeffrey Sachs, Joseph Stiglitz, Terry Lynn Karl and Paul Collier

⁶⁴¹ See, Max Everest-Phillips & Richard Sandall, *Linking Business Tax Reform with Governance: How to measure success (undated)* at P. 2 (noting that: “State legitimacy is a fundamental influence on intrinsic willingness to pay tax, also called “tax morale.” Business-owners as citizens will actively seek to avoid paying tax to a state they do not believe in.”), available at: www.fias.net {Last visited Dec 20, 2014}

⁶⁴² The EITI Criteria, <http://eiti.org/eiti/criteria> [Last visited: March 30, 2014]

perceived as some of the world's most corrupt countries.⁶⁴³ Poor governance of taxation, customs and other public finances are significant contributors to perceptions of these countries being corrupt. Information on both countries published by the EITI and TI initiatives confirm the lack of transparency and proper accountability in the extractives sector. There is as such need to staff institutions with officials that lack the technical capacity or moral integrity to honestly detect or remedy TPM and it is hoped that initiatives by EITI, TI, OECD and UN multilateral conventions to combat bribery of public officials in international business transactions would help tackle the problem in the O&G industry.

6.3 Chapter Conclusion

In this chapter therefore, the effectiveness of select GoG anti-avoidance regimes have been analyzed from the dual perspectives of system engineering and administration. In reviewing effectiveness from an engineering standpoint, two sub-frameworks were analyzed, the first being the interval between *system attributes* and their conformity to baseline canons of taxation referred to as the upstream sub-framework, and the second that examines the interval between *system attributes* and a *select number of performance criteria* namely detect, remedy or deter TPM referred to as the downstream sub-framework. As concerns effective administration of these regimes two main facets to the issue were explored notably the organization of institutions and the availability of human resources to effectively administer detection, remediation and deterrence of TP regimes. Findings drawn from these analyses are presented in the paragraphs that follow.

On whether actual anti-avoidance regimes in the GoG are engineered effectively:

As concerns the Upstream Sub-framework, we note that the regime is mostly engineered in a manner that effectively conforms attributes of the system to the baseline design canons of taxation. For example, while countries adopt different approaches in tackling TPM, the fact that rules and procedures are built on the basis of the ALS from an engineering standpoint conforms the system to the canon of *equity*. Likewise, it is observed that the *choice of ALS* as the common pricing standard to be used in valuing crude exports and as basis for *engineering adversarial procedures* enhances the neutrality of TP regimes in both Nigeria and Cameroon. As far as engineering compliance rules to conform to the canon of certainty is concerned, it is observed that Nigeria and Cameroon have

⁶⁴³ TI, Corruption Perceptions Index 2012 p. (Published on 05 Dec. 2012), available http://www.transparency.org/whatwedo/publication/corruption_perceptions_index_2012 [Last visited: March 30, 2014]

increasingly clarified these requirements in ways that effectively enhance system *certainty*. However, engineering of compliance and adversarial attributes do not necessarily achieve *efficiency* since substantial inefficiencies inherent to the system can be observed. In spite of limitations resulting from the failure to adopt mandatory compliance and specific audits which both limit access by the fisc to information in the GoG, it is conclusive that actual engineering of system attributes largely conform to baseline canons of taxation.

As concerns analyzes relating to the Downstream Sub-framework, it is concluded that the light approach mostly adopted in the GoG to tackle TPM does not quite facilitate effective detection, remediation and ultimately deterrence. For example, the *Light General Tax Audit* approach (LGTA) is particularly not adapted for detecting complex TPM schemes that are used to transfer profits abroad. The same is true of *light documentation and reporting*, *burden of proof* and also *statute of limitation* requirements in most GoG countries. Indeed, a combination of the light approach and the context in which these rules are applied in the GoG⁶⁴⁴ makes it highly unlikely that tax authorities would effectively detect TPM. Coupled with claims that benchmarks like Platt's from which auditors get prices to adjust oil transfers are themselves manipulated, effective implementation of the ALS is more than ever a true challenge. From a deterrence standpoint, it can be argued that if the anti-avoidance regime is not engineered to detect and eventually remedy TPM effectively, it is unlikely that it would intimidate intending abusers into complying. From this viewpoint, it cannot be claimed that most GoG regimes are engineered to deter TPM effectively.

As concerns remediation (penalty) and deterrence, the engineering of generic dispute resolution technics cannot be seen as effective. Procedures for deciding objections remain lengthy and costly with only little guarantee of the quality of rulings that these courts are likely to issue, given that they are mostly presided by non-specialized judges who tend to find TPM matters complex. Unlike *generic audits* and *appeals* that stand ineffective, the analyses of TPM penalties reveal a certain degree of effectiveness in terms of their engineering. Whilst being engineered along generic lines the penalty regime in these select countries are severe, combining both pecuniary and penal components. These penalties could result in bankruptcy in some cases if they are blindly applied. However, the greatest engineering flaw of generic penalties is their failure to focus the minds of IOCs on penalty related risks specific to the decision to engage in TPM.

⁶⁴⁴ That is dearth in capacity, information asymmetry

On the issue of Administering Effective TP Regimes in the GoG

It is concluded that dysfunctionalities exist in the **organization of institutions** created to assess and collect oil sector revenues. This is largely a result of defective structuring of institutions meant to manage the sector. Further, the absence of specialized teams and limited existence of platforms for information exchange and joint investigation of TPM schemes impedes the ability of tax authorities to detect, remedy or deter noncompliance. From an administrative standpoint this adversely affects the effectiveness of these regimes. As concerns the collection of taxes and penalties, it is observed that tax authorities place greater emphasis on recovering principal taxes that are recalled than they do for related penalties. The failure to apply equal rigor in the collection of penalties weakens remediation mechanisms in these countries, simultaneously reducing the deterrent potential of these regimes in the process.

Finally, it is observed in both countries that there is a dearth in **human resources** assigned to handle TP issues. The number of tax examiners and policymakers with combined competence in both the areas of international and oil sector taxation is quite limited. This, coupled with high levels of corruption and bureaucratic rent seeking, render the administration of existing regimes difficult. From this standpoint, the extent of revenue leakages as revealed by the EITI and TI reports only go a long way to affirm the existence of defective administrative frameworks that have a negative impact on the detection, remediation and deterrence of transfer pricing schemes in the GoG.

PART III

RECOMMENDATIONS ON IMPROVING TP REGIMES IN THE GOG

CHAPTER 7

PROPOSITION I: DOMESTIC MEASURES TO IMPROVE EFFECTIVENESS OF TP REGIMES IN THE GOG

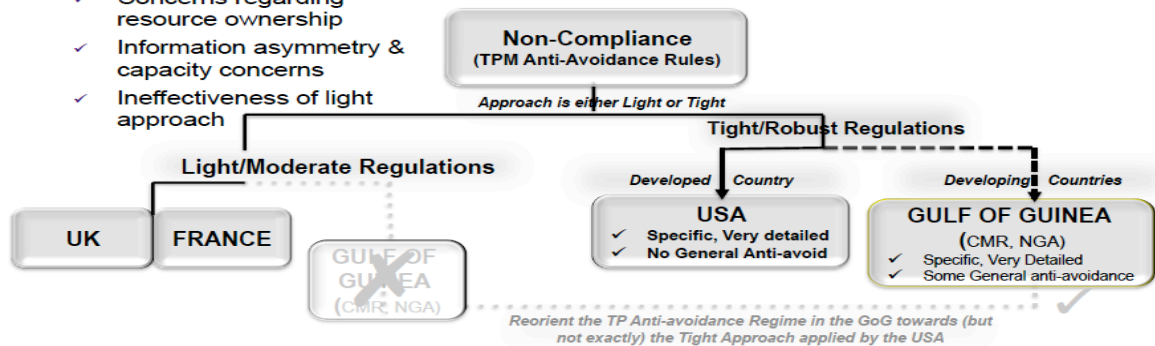
In chapters 3, 4, 5 and 6 we examined the taxation of oil companies, evidence of TPM in the oil industry, existing anti-avoidance frameworks and extents to which these regimes are effective. Although it is difficult to quantify the extent of revenue losses that hydrocarbons producing countries suffer as a result of abusive transfer pricing, one could in light of the evidence discussed in Chapter 4 conclude that these amounts are substantial. Further, we concluded after analyzing existing anti-avoidance regimes in the GoG that their engineering and administration are significantly ineffective in detecting, remedying and deterring TPM. As far as tackling abuse is concerned, it was noted that the decision by some policymakers to blindly copy the light approach without making the necessary kind of adjustments that render them workable in the context of the GoG. By adopting this cut and paste approach, in spite of significant contextual differences that exist between developed and developing countries, oil and gas producing countries in the GoG significantly limit their ability to effectively tackle TPM and other avoidance schemes. Indeed this approach is wasting a great opportunity for hydrocarbons rich countries in the GoG to effectively prevent the erosion of their resource revenues.

Considering the importance of O&G to many sub-Saharan economies and its potential to generate in a short time the scale of funds needed to transform these economies without relying on foreign aid, there is an urgent need to upgrade existing policy on tackling TPM. This is the objective pursued by the present chapter. In seeking solutions to these shortcomings, we propose adoption of a *holistic approach* and recommend an integrated package of tested and reasoned measures to address all key areas of TP anti-avoidance. Amongst others, we propose modifications to existing legal frameworks including: maintaining the ALS and reorienting policy on tackling TPM from a light to the tight approach. This chapter is structured as follows. First, we review both the AL and UT standards with a view to deciding which is most suitable to operate in context of the GoG (7.1). Next, we explore the need to reorient TP anti-avoidance regimes towards tighter frameworks (7.2) and conclude by providing brief remarks to our present recommendations (7.3).

7.1 Determining a Suitable TP Standard for the GOG

As would be recalled we noted that governments use either the separate or unitary entity approaches to allocate intrafirm incomes.⁶⁴⁵ Under the separate entity approach, segments of the MNE are treated as separate business units that are for tax purposes treated as dealing at *arm's length (ALS)* with each other. This differs from the integrated entity approach that treats intrafirm transfers as taking place within unitary businesses and for which *unitary taxation (UT)* is needed to allocate incomes. In terms of preference there is little doubt that ALS has gained an upper hand over UT both globally and increasingly within Africa. But, unlike Europe and North America where anti-avoidance regimes are already built on the ALS most African countries are only just starting to develop the legal and regulatory frameworks needed to tackle TPM. This means that the question as to which approach best tackles the problem of TPM is relevant in these countries and far from settled considering that experts have expressed diverse views on the issue.⁶⁴⁶ Thus finding the right response to this question is as relevant a preoccupation in the EU as it now is in Africa. Besides, while most GoG countries have in principle adopted the ALS they are yet to develop comprehensive frameworks for its implementation. On account of the long-term impact that decisions currently being made in the GoG (or other regions in sub-Saharan Africa) are likely to have on tackling TPM, the timing is arguably right to have this debate and to weigh in on either side given the context. In this subsection we examine both ALS and UT as alternative standards for tackling TPM in the GoG (7.1.1) and opine on which to maintain going forward (7.1.2).

- **Maintain the ALS over UT/FA**
 - ✓ Has it's theoretical limits: isolationist approach, mythical
 - ✓ Practically more feasible at moment than UT
- **Migrate policy from the light to tight approach**
 - ✓ Concerns regarding resource ownership
 - ✓ Information asymmetry & capacity concerns
 - ✓ Ineffectiveness of light approach



⁶⁴⁵ See Chapter 5.1.2 for detailed discussions on both standards.

⁶⁴⁶ See 7.1.1 [Infra] for development of these schools of thinking

7.1.1 TP Standards in the GOG –*Settling for ALS or UT?*

The absence of international consensus on whether to use ALS or UT as basis for building prescriptive norms of TP anti-avoidance regimes is problematic to GoG countries that are now thinking to develop such regimes. In this context the decision to adopt one over the other depends on profound analyses of the merits and demerits of each standard from both the theoretical and **practical** perspectives when applied in given contexts. Considering that we already discussed the merits of adopting these standards in Chapter 5.1.2, we hereinafter place more emphasis on analyzing the demerits of applying either ALS (7.1.1.1) or UT (7.1.1.2) in context of the GoG.

7.1.1.1 Demerits of ALS Within Context of the GoG

Although some expert's favor orienting policy towards UT, it is increasingly clear that ALS is preferred as the prescriptive norm for adjusting TP in OECD and most non-OECD countries. OECD supports its position by arguing that ALS is sound in theory and has in a majority of cases been found to recreate market conditions that place oil majors and independents on parity in terms of tax treatment.⁶⁴⁷ Some leading experts do not share this view as they dispute the theoretical soundness of ALS. Langbein argues that problems linked to its implementation are not simply "practical difficulties of a theoretically sound idea" since they are predictable and inevitable consequences of using the separate entity approach to allocate profits earned by integrated international business entities.⁶⁴⁸ Hence, we examine both theoretical difficulties linked to applying ALS in the GoG, and practical enforceability of the standard given the context in the GoG.

Demerits of the Theory in Context of the GoG

Unrealistic and Mythical Standard

Firstly, the ALS is an unrealistic attempt to treat integrated intrafirm transactions as taking place between independent and/or competing parties. It fails to take proper account of the fact that segments of integrated businesses could genuinely behave in ways different from independent businesses, and deliberately attempts to ignore the synergy that is in reality generated by doing

⁶⁴⁷ OECD Guidelines (2010), supra note 453 at p.27

⁶⁴⁸ Langbein, S., *The Unitary Method and the Myth of Arms length*, p. 627 (1986)

business as an integrated multinational.⁶⁴⁹ This creates a situation in which *tax administrations* are expected to construct a **mythical world** and market out of data almost entirely provided to them by the companies they are supposed to be auditing. This notably happens in cases where a company is sole owner of the commodity or intangible supposedly traded and where no equivalents are available on the open market that can be used as comparables. In view of this, Bird argues that the ALS at best turns the taxation of multinationals into a *game of bargaining* and *negotiation* between the fisc and audited MNE.⁶⁵⁰ In developed countries where capacity exists to cause MNE compliance, this is not a major problem. However, in the GoG where such capacities are rare risk is that ALS leaves tax payments to the conscience of MNEs or arbitrary decision of the fisc. Such an outcome reinforces Langbein's assessment that the theoretical underpinning of ALS is flawed.

Secondly, the ALS is based in theory on stakeholders using comparable transactions to determine transfer prices (notably the fisc), which is in practice not easy to source. Therefore it prescribes a rule of universal import that can be applied effectively only to few cases. Indeed, while transactions might be comparable, differences pertaining to specifications of the products, services or intangibles often exist. Prices drawn from these transactions are never conclusive and are likely to result in disputes notably with vertically integrated industries transferring intermediate products. It is thus hard to discern comparability since MNEs genuinely trade in apparently similar but in fact different products and possibly using different patterns of sharing functions and risks. This creates uncertainty notably in GoG countries where comparables are not easy to find.

Thirdly, ALS is transactions based. That is, it is analyzed on a case-by-case basis imposing an important amount of practical compliance burdens on *taxpayers* and the *fisc* during audits. Effectiveness of the standard thus requires timely sourcing and processing of third party data in light of intrafirm transactions being considered. This might prove unnecessarily burdensome to both the MNE and fisc in terms of the cost and time invested in sourcing non-aggregated documentation disclosing details of each intrafirm transaction engaged. Even if information were gathered parties still have to agree on a given TP method to be used in adjusting transfer prices. Due to difficulties noted in sourcing comparable data very few countries are in a position to effectively apply the three traditional transactions/price-based methods that strictly comply to the ALS, namely: CUP, C+ and RP. However, practice shows that even in developed and highly experienced countries like the US

⁶⁴⁹ Francescucci, D.P., *The Arms-Length Principle and Group Dynamics –Part 2: Solutions to Conceptual Shortcomings*, pp.235-246 ITPJ (2004)

⁶⁵⁰ Bird, R., *Shaping a New International Tax Order*, p. 294 International Bureau of Fiscal Documentation Bulletin (1988)

and France, tax authorities broadly prefer to apply transactional profit based methods like TNM and TPSM. These latter methods are in fact closely based on *formulary apportionment* lending credence to the argument that ALS is in theory flawed and hard to enforce in contexts as those described in the GoG where comparables are hard to source.

An Essentially Isolationist Approach to a Truly International Problem

ALS theoretically favors an isolationist approach to tackling what is essentially a cross-border problem. It adopts the separate entity approach by which each country (home or host) considers firms of an MNE operating within its borders as an isolated entity with whom the fisc on a *one-on-one* basis negotiates the portion of business operations to tax within its jurisdiction. All other *competent authorities* laying similar claims to tax the MNE are excluded from the process, until such a time as they move to exercise similar rights, in which case it initiates new negotiations on a one-on-one basis to determine its own share of taxable operations. This is conceptually flawed as it creates room for double taxation, high collection costs and time consuming since each country in a bid to protect its share of taxes is likely to ignore actions already taken by others.⁶⁵¹ Likewise, lack of coordination between tax authorities create avenues for MNEs to game jurisdictions if loopholes are found, or might at close of process result in the MNE accumulating a huge tax bill if authorities prove inflexible. From a theoretical standpoint therefore, ALS disregards a singular opportunity to strengthen intergovernmental collaboration, integration or harmonization of fiscal systems (host and home). This assessment is only partly true vis-à-vis developed countries that have over the years built platforms for information exchange and tax collection to make-up for these inherent flaws. Nonetheless the argument is valid in most emerging countries that have failed to build the legal infrastructure needed to pursue collaboration and integration as a preferred response to the issue.

Demerits Linked to Practical Implementation of the ALS in the GoG

It would be recalled that in chapter 6.2.2 it was argued that certain administrative lapses notably weak staff numbers and a staggering dearth in capacity are major impediments to effective implementation/enforcement of the ALS. We need not belabor this point safe reiterate that the dearth

⁶⁵¹ For example: (i) reduce the amount of headquarter-related costs that can be deducted in its jurisdiction, (ii) increase valuation of sales to foreign countries, (iii) discourage the deductibility of expenses related to royalty payments, HQ expenses, cost sharing, etc. (iv) institute the use of withholding taxes on payments abroad, (v) use thin capitalization rules to limit intrafirm corporate charges, (vi) disallow the deduction of central management fees by viewing them as shareholder expenses borne by the parent company.

in TP expertise faced by GoG countries today is similar to that experienced in Europe in the 1960s.⁶⁵² In this context tax authorities are seen by IOCs/MNEs as unlikely to detect TPM during audits since in many of these countries the number of staff assigned to monitor and check intragroup transfer prices for thousands of intragroup transactions are inadequate. Further, developing the capacity of tax administrations to understand the matrix of rules and methods needed to implement the ALS requires the spending of vast resources. Although the institutional framework for implementing ALS already exists in many GoG countries it is worth noting that these remain varied and uncoordinated. The myriad of institutions competent to intervene in the sector has made it hard to coordinate, the result of which is structural ineffectiveness.

In effect different government agencies often intervene in the collection of petroleum revenues at the exploration, production, transportation, refining and distribution phases of the value chain. Inefficiencies take the form of revenue leakages as money transits from one agency to the other, supplementary costs and increased probability of corruption. This in part explains differences existing between revenues declared by IOCs in Cameroon and Nigeria with those declared by these states as having been received under the EITI process. The ALS is from this angle practically hard to enforce in context of the GoG. It can be argued in light of these factors that while ALS remains the true prescriptive norm, it is in practice the true descriptive norm of UT that most TP anti-avoidance regimes apply; and this includes the US and France. Indeed they mostly use profit-based methods (mainly UT oriented) as opposed to price-based ones (mostly ALS oriented).

7.1.1.2 Moving to Unitary Taxation– *Is the Proposition Tenable?*

In view of the factors discussed above, one wonders why many countries still maintain ALS as the prescriptive norm while applying UT methods. Why not jettison ALS in favor of UT that is in practice already being applied? This proposition is pertinent to the GoG where true comparables are rare and the chances of using any of the transactional arm's-length methods (CUP, C+, RP-) to determine ALPs are weak. Rather it is more likely to use transactional profit-based methods for TP adjustments. There is a school of leading international *public finance economists* (Richard Bird) and *tax lawyers* (Stanley Langbein) who argue that UT should indeed replace ALS as the applicable norm. If one considers this proposition in context of the GoG, is it tenable?

⁶⁵² Langbein (1986), supra note 648 at p.640

UT is Theoretically Sound and Cooperation Based

In chapter 5.1.3.2 TNM and TPSM were identified as *ad hoc* formulary apportionment methods of allocating related party profits.⁶⁵³ From this angle, UT is judged by some experts to be sound in **theory** and **practice** and presents certain unique advantages over the ALS. For example, it is simple to implement, likely to produce relatively certain/efficient outcomes, and should increase the share of economic rents captured by host governments in the GoG. In addition, it reduces risk of MNEs engaging in TPM since it theoretically favors a concerted cross-border response to the problem. Unlike ALS that favors a typically isolationist response allowing IOCs the possibility to easily dodge taxes by moving taxable incomes between jurisdictions, UT neutralizes this possibility by adopting a more practical and concerted approach to the allocation of taxable profits amongst group members. It is being applied in the US, Canada, Switzerland and the EU.

Practically Impossible to Apply in the GoG– *Timing and Context*

These advantages notwithstanding, ALS remains favored by the US and OECD which express outright rejection of unitary taxation as basis for taxing intragroup transfers. Indeed the OECD's reasons that the adoption of "...global formulary apportionment approach would not be acceptable in theory, implementation or practice".⁶⁵⁴ This raises a number of questions. Is OECD's argument that UT is arbitrary⁶⁵⁵ any more compelling than the counter argument that its proposed ALS is mythical and unrealistic? Is it necessarily true that UT ignores management' decision in terms of the allocation of resources and might ultimately share profits in a manner inconsistent with economic objectives and facts defined by the group?⁶⁵⁶ Whatever side of the theoretical argument one agrees with, the prospect of adopting UT in the GoG (as an alternative to ALS) is indeed thwarted by predictable challenges linked to its **practical implementation**.

Firstly, the operationalization of UT requires broad negotiations and logistics since countries in which the MNE operates must on a regular basis jointly agree to the: (i) factors and their respective weightings, (ii) precise formula, and (ii) *modus operandi* of the system. These issues are hard to agree and even if consensus were reached, nothing stops participating countries from *constructing* or

⁶⁵³ Langbein (1986), supra note 648 at p.627

⁶⁵⁴ See TP Guidelines 1994. This notwithstanding, the OECD recently considered applying *formulary apportionment* to tax e-commerce transactions. Although dropped as being too extreme a response to the problem, it cannot be said that it has entirely dropped the idea of adopting UT in the future (OECD Report Dec 2005, OECD 2008 at p.72).

⁶⁵⁵ Disregards market conditions and circumstances unique to certain or each enterprise

⁶⁵⁶ OECD 1979, p.14

construing the formula to their advantage. This outcome is most likely in cases where the formula is negotiated by tax authorities of developing economies and their counterparts in powerful/wealthy economies. In these circumstances one cannot neglect the possibility that political pressure can be exerted on weaker parties. Further, the vantage position of developed countries acquired through years of experience dealing with TPM can be exploited to the detriment of less experienced states. Considering that many countries do not apply UT it is evident that adopting the standard would lead to jurisdictional overlaps and double taxation. That is, UT ignores the so-called ‘water’s edge’ resulting in the taxation of incomes accruable to MNE affiliates abroad especially if one jurisdiction uses ALS while another applies UT.⁶⁵⁷ Hence, exercise of an option by Country X to apply UT increases risk of double taxation and higher tax bills for IOCs if other countries hosting their operations maintain the ALS and do not take corresponding steps to reduce tax liabilities.

Secondly, one major advantage that UT is often presented as having over ALS is its ability to reduce the incentive for IOCs to manipulate intrafirm transfer prices. This is not entirely correct as an important but often rarely mentioned flaw of UT is that it does not completely eliminate the risk of manipulation that ALS is often criticized of. For IOCs (MNEs) determined to develop schemes aimed at reducing their overall liability to tax, ingenuity can be put to work to beat UT’s supposed advantage by simply moving away from manipulating prices to *manipulating components of the formula* if the standard were to change from ALS to UT. For instance, they could manipulate the “factor allocation ratio” so that the formula results in more of the group’s income being seen as having been contributed by firms in jurisdictions with lower tax rates instead of firms in jurisdictions with higher taxes. **Thirdly**, administrative exigencies involving bookkeeping, reporting, information exchange and other components of the system are bound to increase. In addition effective implementation of the system is likely to turn on tax authorities working together to consolidate and share relevant documents and/or information of group affiliates concerned by the transaction. This increases the need for logistics and system coordination. Logistics is needed to translate, interpret foreign accounting rules, convert foreign currencies, and share information on MNEs held within respective jurisdictions. This is a critical piece of the UT puzzle and it requires governments to be more forthright about sharing sensitive information on home companies with foreign governments, including countries with whom they actively compete. MNEs also need to get used to the risk that this information in the hands of foreign governments might then be accessed and/or used by their competitors. The logistics and

⁶⁵⁷ Eden (1998), supra note 3 at p.315

degree of transparency that goes into operating a truly international UT system is definitely less appealing than its counterpart ALS.

7.1.2 The Way Forward -Maintaining ALS in the GOG

Taking into consideration the merits and demerits of both the UT and ALS approaches that are jointly discussed in Chapters 5.1.3 and 7.1.1 above, it falls on us for purposes of charting a way forward to recommend which of both standards GoG government's are best placed adopting in their effort to tackle TPM. Going forward, it seems technically grounded in the present context of the GoG, at least from the practical standpoint, to maintain the **Arm's-Length Standard**. This view is reasoned by the fact that response capabilities of ALS have been strengthened to now include the use of profit-based methods like TNM and TPSM. The unavailability of comparables is no longer an issue that could render impossible implementation of the ALS even in contexts of the GoG.

Reasons for Preferring ALS to UT- *Context of the GoG*

If weaknesses of ALS relating to tax collection are put aside, one is likely to agree with the OECD⁶⁵⁸ that ALS is sounder in theory than UT. **Economic realism** contributes greatly in reaching this conclusion. It would be recalled that markets have broadly proven to be the best medium for allocating resources and rewarding efforts expended by factors of production. Indeed current international trade is largely driven by ideals of market competition and the liberal interplay of market forces of demand and supply. This ensures fair valuation of cross-border transactions and in some cases markets serve as basis for resolving trade disputes. Notwithstanding that intragroup transfers do not require markets to fix internal prices, it is consistent with conventional international trade best practices that the TP regime adopts market considerations (NYMEX, Rotterdam) as basis for valuing intrafirm transactions and/or allocating cross-border incomes for tax computation purposes. This is reflected in Art.9 of the OECD and UN Model DDT. In fact, by seeking to place both controlled and independent firms at parity as far as taxation is concerned, ALS weakens the incentive for companies to base cross-border economic decisions on tax considerations.

Secondly, similar to criticism that ALS makes it easy for MNEs to game tax systems around the world, we argued that UT is itself vulnerable to manipulation of elements that are likely to be included in the formula. This effectively offsets a major advantage that UT is broadly seen as having

⁶⁵⁸ OECD's 1994 1994b, p.160 discussion draft report on Transfer Pricing

over ALS. Therefore, to recommend on this point alone that existing TP standards be migrated to UT is at best experimental since it presents no truly unique advantage over ALS. Further, migrating the standard would certainly require: (i) assembling together controllable and uncontrollable factors, (ii) coordinating all these factors, and (iii) mobilizing *domestic and inbound* expertise on the subject. In addition to the above, the amount of financial costs needed and likely to be involved in dismantling systems already built around ALS, the time needed to pilot the transition if service disruptions are to be avoided, and the dearth in expertise available to manage the process makes it less likely that GoG governments would consider adopting UT at this point in time.

Through fair allocation of MNE revenues between tax jurisdictions, ALS has proven over the years to be a reliable international standard in tackling TPM. It is today the true international prescriptive norm on the basis of which many DDTs have been concluded. In view of this, migrating the system to UT implies renegotiating amendments to practically all tax treaties including those to which GoG countries are themselves signatories. In the absence of global acceptance of the standard, let alone growing consensus on migrating the international prescriptive norm to UT, a unilateral move in this direction by GoG resource rich countries would create huge uncertainty vis-à-vis the taxation of operations in their jurisdictions. It is also likely that this would result in increased taxation of these companies thus impacting efforts by GoG countries to attract FDI into the highly capital-intensive extractives sector and wider economy. The economic ramifications of taking a unilateral move towards UT could be immeasurably adverse. It is likely to prove impracticable since present international thinking on the issue opposes such a move. This current lack of wide support for the UT makes its adoption very unlikely.

Lastly, there are major policy considerations that GoG governments need to make in deciding whether to migrate to UT. That which quickly comes to mind is the extent to which they are ready to cede sovereign rights established under the 'Revenue Rule', which outcome is more likely to occur under UT than the ALS. In other words, operationalization of UT requires a high degree of collaboration and coordination bordering on the edge of competent authorities relinquishing part of their sovereign rights in revenue matters. Domestic ability to act on tax issues as sovereign is likely to be affected, as the fisc might not unilaterally modify rules on allocating MNE profits once this is agreed with other participating states. Just how far states are willing to go to succumb to such a system is unpredictable. However, considering the degree of interest shown by most GoG countries to control their taxation policies it is clearly predictable that they would prefer ALS to UT as it presents

a right balance between tackling TPM and maintaining sovereign control over mobilization of domestic tax revenues. Domestic tax rules can also be changed as and when need arises.

Steps at Improving Existing Regimes in Line with ALS

It is argued in chapter 6 that the bulk of problems relating to GoG TP anti-avoidance regimes are not directly attributable to the ALS, but to other policy and practical considerations. Firstly, the adoption by GoG countries of an overbearingly light approach in tackling TPM results in weak and arguably ineffective anti-avoidance regimes. This light orientation suggests that existing engineering frameworks of the regime rarely result in effective deterrence of TPM, nor does it facilitate effective detection and remediation of the practice. Secondly, implementation was found wanting due to highly uncoordinated institutional frameworks, dearth in competent staff, and the lack of a supranational support system designed to help tackle this international tax challenge. This domestic response based system, devoid of any comprehensive framework for cross-country coordination on the issue makes it easy to notice cracks/loopholes in existing implementation frameworks within the GoG. In light of the preceding analyses, it is conclusive that GoG countries are better of maintaining ALS instead of shifting the applicable standard to UT. We recommend however that both the legal and implementation frameworks of the ALS should be improved by reorienting existing policy away from the light approach towards the tight one. Going forward, we propose a two-pronged approach with clearly defined steps that could be adopted as basis for improving the effectiveness of GoG transfer pricing regimes. The first concerns a tight domestic policy response intended to upgrade the existing engineering and administration of GoG anti-avoidance regimes (7.2). The second for its part entails building an international TP support system to assist governments in their efforts to effectively tackle the issue. This is examined in chapter 8.

7.2 Tightening Transfer Pricing Regimes in the GOG

In light of the fact that several components of existing TP regimes were deemed ineffective in the present context of the GoG,⁶⁵⁹ it is important in reforming these systems that engineers adopt a holistic approach. It is recommended that governments explore alternative approaches to regulating TPM and undertake a complete overhaul of existing regimes. One simply cannot afford to pick and

⁶⁵⁹ For example, rarity of comparables, capacity issues and ownership of companies that are mostly foreign and not GoG

choose aspects of the domestic regime to be reformed immediately, and to defer others to some future unspecified date. Such a piecemeal approach is likely to leave lacunae in the system that can still be exploited by ingenious noncompliant taxpayers to abuse it. A major risk linked to reorienting policy on the issue is the impact it might have on inbound FDI as investors in the GoG could perceive these reforms as indicating resolve to tighten the entire tax regime. It is therefore crucial to find effective ways of promoting the alternative perspective that intended reforms are only meant to tighten noncompliance (avoidance) rules and not compliance aspects of the tax regime.⁶⁶⁰ In this section we argue in favor of tightening TP anti-avoidance regimes in the GoG (7.2.1) and propose some practical steps that can be taken to achieve this goal (7.2.2).

7.2.1 The Case for Migrating from Light to Tight Regimes

In principle most GoG countries with some form of TP provision have adopted the light approach to regulating TPM.⁶⁶¹ These regimes are influenced by OECD guidelines and practical orientations of developed economies along historic colonial lines.⁶⁶² This raises questions as to whether this approach is propitious and designed to optimize the interest of these countries. Put differently, is the light approach adopted to regulate TPM in the GoG effective? Are there broad-based domestic factors that militate against going light on MNEs as far as the regulation of TPM is concerned? Given that hydrocarbons contribute immensely to the GDP and tax revenues in these countries, even the slightest prospect that IOCs would rely on TPM to erode economic value must be taken seriously. In our review three factors are identified as militating in favor of the need for GoG governments to migrate existing anti-avoidance regimes towards *tighter* ones. These are, concerns on corporate ownership (7.2.1.1), information asymmetry and capacity (7.2.1.2), and ineffectiveness of the light approach (7.2.1.3).

7.2.1.1 Ownership Concerns and Choice of TPM Regulation

When designing anti-avoidance rules it is necessary that system engineers understand the nature of target transactions, legal ownership of businesses and peculiarities of the sector it seeks to tax. Comprehensive knowledge of the context should be used to assist the engineer design regulations that essentially and effectively protect domestic tax bases from being unduly eroded by

⁶⁶⁰ It helps to accompany these reforms with investment incentives, which however is not the objective of our study

⁶⁶¹ Nigeria's can be described loosely as intermittent since reforms are already underway to tighten regime

⁶⁶² For examples: Cameroon, Gabon, Ivory Coast along French model; Nigeria, Ghana, Kenya along British model

international tax avoidance. For example it helps to know the complex relationship existing between resource rich (host) countries and producing companies over *resource ownership*. In most countries around the world the host country owns resources in the ground, which only passes to companies at wellhead or some agreed point after extraction. Governments in producing countries therefore have legitimate claims to economic rents derived from extraction activities and the prospect that TPM might be used to unduly erode rent is reason enough to migrate from regimes that ineffectively protect their interest to ones that amply do so. In the GoG this entails migrating away from light and wanting regimes in terms of tackling TPM to tighter and more robust ones. The need to urgently do so is supported by the fact that GoG countries are economically more reliant on revenues from the extractive sector, than many other countries around the world are. In Chapter 1.2 we noted that the production of O&G resources contributes sizably to export earnings, state revenues and GDP in the GoG. Data places figures at 28% of state revenues and 60% of export earnings in Cameroon -2010; and over 70% of State revenues and 90% in export earnings in Nigeria. This significantly contrasts with France where at 72, 000 bbl./day O&G production represents an infinitesimal portion of total GDP and state revenues. As long as the subject is appraised through the lens of extractives, GoG countries have a greater need to jettison the light approach than France does.

In addition, many GoG countries *wholly* or *partly* copy their TP provisions from developed countries. For example, ss.19 and M.19 of Cameroons CTC replicate Art.57 and L.13 of France's. A similar observation can be made of s.15 of Nigeria's PPTA, which is textually alike to s.2(5) of the UK's OTA.⁶⁶³ However, there is a relevant detail that GoG countries often ignore when transposing OECD rules on the subject. Firstly, the bulk of companies operating TPM schemes within their extractive sectors are resident for consolidated tax purposes in OECD member countries including: US's ExxonMobil, Chevron, ConocoPhillips, Noble Oil, Hess, Marathon; UK's BP, Tullow Oil; France's Total SA, Perenco; and Holland's Shell; to name a few. These companies account for the bulk of hydrocarbons extracted in the GoG and eventual exports to consuming countries. In Equatorial Guinea for example, ExxonMobil and Ocean Energy produce 121,000 bbl./day, Noble -50,000 bbl./day, Marathon 70,000 bbl./day, and finally Hess, Tullow and GEPetrol produce 26,000 bbl./day. Similar patterns are observed in other GoG countries. However, in contrast to this massive presence of OECD based companies in these economies, there are very few, if any, GoG based oil companies with interests in OECD member countries. Involvement typically moves in one direction and therefore

⁶⁶³ Oil Taxation Act 1975, CHAPTER 22

the risk of eroding host country tax bases largely flows in one direction as well. And, since home countries sometimes claim the right to tax worldwide earnings of IOCs (US) it is likely that taxable revenues lost by GoG countries to TPM could be ultimately caught in tax nets in developed countries where these companies are tax resident. The chances of GoG countries having a similar reach is virtually remote since they are overbearingly host⁶⁶⁴ and very rarely, if at all, home countries of IOCs.⁶⁶⁵ There is on basis of preceding analysis and circumstances very little logic in GoG countries adopting a light and ineffective approach to tackle the problem. Logically one would expect them to tighten their response to TP and other international tax avoidance schemes.

Secondly, in some cases OECD members are both *home* and *host* to IOCs with legitimate expectations of reciprocity guarantees in terms of the treatment reserved for each other's company. For example, UK based BP operates in the US Gulf of Mexico, while US based ExxonMobil has interests in the UKCS. Measures adopted by the US that affect BP's interests in the Mexican Gulf are likely to be reciprocated in the UKCS, thus placing a silent code of **auto-restraint** on the extent of action that each other can take. This peculiar context is likely to have influenced the OECD's guidelines, and its members their respective domestic anti-avoidance regimes. Considering that host countries seeking to tackle TPM are themselves likely to be home country beneficiaries of the practice, one could argue that there exists an interest to operate mutually protective regimes which might explain the broad-based preference for the light regulatory approach in these countries. The US is an exception. From this perspective, that which for all intents and purposes is a light and acceptable response by countries that both benefit and suffer the impact of TPM might not be so of those that endure and hardly benefit from it. By adopting the legal and regulatory frameworks of some OECD countries without appropriate adjustments and contextualization, GoG countries are missing an opportunity to engineer and administer TP regimes that are specifically adapted to their circumstances. It is recommended that these countries reform existing frameworks by migrating to, and adopting more robust rules that culminate in tighter TP regimes.

⁶⁶⁴ GoG countries are mostly recipients of FDI through permanent establishments (subsidiaries, branches, affiliates, etc. In fact very few companies in these countries, if any, have the financial or technical muscle to undertake large-scale international ventures with respect to petroleum sector activity

⁶⁶⁵ Sonangol EP of Angola is gradually growing into a multinational corporation

7.2.1.2 Information Asymmetry and Capacity Concerns

Effective tackling of TPM depends on the *capacity* of tax authorities and their *access to information*. Logic dictates that governments in GoG countries facing challenges on both issues adopt tighter orientations when shaping TPM anti-avoidance policy. Unfortunately this is not the case with existing GoG regimes. The poor flow of information between IOCs and governments and weak capacity to implement TP regimes remain concrete factors contributing to ineffectiveness of these regimes. Policymakers and tax authorities in most oil producing countries do not have ready access to information on the geology and commercial underpinnings of transactions. IOCs on the other hand are directly engaged in the exploration, development and production of resources and therefore have superior knowledge of the stock of reserves in place and difficulties in extracting them. However, it is not in their interest to accurately share this superior information with authorities since the result of doing so is increased taxation. Rather incentive is to thwart efforts by *hosts* to capture economic rents essentially underpinning extractive fiscal regimes by misfiling data for tax purposes and in extreme cases deploy abusive schemes like TPM to avoid paying taxes altogether. Although this problem confronts all tax administrations across the world, it is nonetheless prevalent in developing countries. Developed countries can easily access and draw information from assets and global group operations reported by MNEs in their home countries (France, US) or source such information from markets. This disposition is further reinforced by vast networks of information exchange agreements between developed countries already working to fill the information gap with IOCs. This is not true of GoG countries that only host parts or components of IOC operations with little access to information on their overall activities (or competitors), or accurate and reliable data on markets. Secondly, tax administrations in developed countries have longstanding experience monitoring MNEs and have developed immense capabilities matching those held by multinationals in most sectors. France and the US for example have created specialized units to ensure effective taxation of MNEs. GoG countries simply do not have similar capabilities.

Although developed countries continue to face difficulties in their drive to deter, detect or remedy TPM, whatever shortcomings may arise from choosing a specific regulatory approach is likely to be compensated by fairly reasonable access to information and their capacity to implement such regulations. They could afford to adopt the light or tight approaches and still tackle TPM fairly effectively. This is not necessarily true of GoG countries that are, as argued, burdened by the lack of capacity matching those of IOCs and have limited access to information. Hence, *contexts differ* and

so should approaches adopted to tackle TPM. One cannot help but wonder why in spite of these significant contextual differences with countries like France and US; oil producing countries in the GoG persist in maintaining the light approach in tackling TPM that has -as argued in Chapter 6- proven to be ineffective from the architectural, engineering and administrative perspectives. Given the present circumstances there is a strong case for GoG countries to migrate towards tight anti-avoidance regimes with clearer rules and more predictable outcomes making implementation of the regime more focus-based and target managed.

7.2.1.3 Ineffectiveness of the Light Approach

The need to adopt tighter anti-avoidance regulations is further reinforced by the inability of existing GoG regimes to deter, detect or remedy TPM effectively. Though the *architecture* of most GoG regimes is comprehensive, we argued that their *engineering* and *administration* were largely ineffective. For instance these regimes are engineered to handle detection and remediation of TPM schemes within the framework of General Tax Audits, which are technically non-specific and arguably **un-adapted** for this purpose. Not enough time is given to auditors in these systems to thoroughly investigate complex intragroup transfers that can result in TPM. Weak documentation⁶⁶⁶ and reporting⁶⁶⁷ exigencies characteristic of the light approach impede access to the kind and quality of information needed to detect TPM. This is also true of the decision to rest the burden of proof on the fisc whereas their access to information on intragroup transfers is very limited compared to that held by IOCs. Likewise, the statute of limitation applied by some GoG countries (4 years) is not so different from that of developed countries like the US, Belgium and France (3 years), in spite of contextual differences and the complexity of investigations needed. These defects suggest an urgent need for upgrades to anti-avoidance policy frameworks in the GoG.

Secondly, the process of gathering and processing oil data in the GoG is encumbered by dysfunctional and poorly coordinated institutions. There is no clear roadmap for TP audits or the role of agencies in the audit process. Coupled with the fact that O&G related TP examinations are unlikely to be carried-out by specialist with competencies in both international and extractives taxation, prospects of effectively detecting TPM under existing regimes are remote. In addition there are hardly any platforms for exchanging information. Not only are these countries short on treaty networks for

⁶⁶⁶ Briefs on the MNE' structure, controlled transactions, relevant economic analysis, methods and reasons for selecting methods, and information about comparable uncontrolled transactions available

⁶⁶⁷ For example Form 5472 in the US

the exchange of vital information on intragroup transfers; they are equally short on bilateral/multilateral platforms for sourcing such information.⁶⁶⁸ Likewise, poor governance of extractive revenues also contributes to the systems ineffectiveness with GoG countries performing low on EITI and TI's indexes as far as perceptions of transparency and corruption are concerned. These shortcomings call into question the effectiveness of light approaches commonly used in the GoG to engineer TP regimes. Taking into consideration the amount of revenues likely to be lost, the fisc in developing countries are under immense pressures to select anti-avoidance rules that effectively tackle TPM. It is hard, given the context in which IOCs operate in the GoG, to envision the light approach playing any substantially effective role in mitigating this risk. The tight approach is more suitable and likely to achieve this outcome so that there exists a strong case to tighten existing TP regimes, with indications that some GoG countries (Nigeria, Ghana) are starting to do so, albeit not as tightly as might be needed to ensure a comprehensively effective response.

7.2.2 Recommendations on Tightening TP Regimes

In light of shortcomings identified in chapter 6 [supra] and the need to improve effectiveness of existing regimes in detecting and remedying TPM, certain measures aimed at **tightening** the engineering (7.2.2.1) and administrative frameworks (7.2.2.2) in the GoG are hereby recommended. These proposed anti-avoidance measures are direct responses to the shortcomings discussed earlier. Further, due to the uniqueness of extractives in terms of commercial and taxation arrangements discussed in chapters 3 and 4, the adoption of these measures are crucial complements to efforts in GoG resource rich countries to tackle TPM. However, these proposals are by no means intended to apply to extractives only. Their usefulness cuts across the board and can be applied to all other industries operating in the GoG (financial, agro-processing, automobile, agriculture). It is worth noting that most of the proposed measures intended to tighten existing TP regimes are not novel, since countries have been picking and applying them at different paces and in various ways. However, it is hoped that a purposeful and more determinate combination of these measures in the manner proposed below would considerably strengthen the effectiveness of TP anti-avoidance regimes in detecting, remedying and to a large extent deterring tax avoidance.

⁶⁶⁸ An example is the JITSIC to which the UK, US, Australia, Canada and Japan are participants

Table 7-1: Reinforcing Existing TP Attributes in the GoG

Attributes	Short-term Measures to Tighten Anti-avoidance Regimes (Architecture and Engineering)	Timeframe
1. Arms-Length Standard	<ul style="list-style-type: none"> ◆ Clarify the following: TP methods, acceptable comparables, safe harbors ◆ Constitute a domestic databank to automatically record cross-boarder Comparable Transactions 	
2. Compliance D&D	<ul style="list-style-type: none"> □ Introduce systematic reporting by IOC's of Intragroup transfers using specific FORMS provided by Fisc for filing this information □ Oblige third party facilitators (banks, consultancy firms, advocates) to spontaneously disclose TPM schemes (matrix of actors) 	
3. Audits & Penalties	<ul style="list-style-type: none"> ◆ Introduce special Transfer Pricing audits and special audit Teams ◆ Elaborate an "official transfer pricing audit roadmap" ◆ Place the Onus of Proof on MNE's to justify TP Methods or show compliance ◆ Increase timeframe for completing field examinations ◆ Increase Statute of Limitation within which to engage TPM specific audits ◆ Adopt sanctions that are applied specifically to TPM [D&D, tax recalls) 	
4. Tax Appeals System	<ul style="list-style-type: none"> □ Firm deadlines for handling TPM disputes at the administrative phase □ Introduce domestic arbitration for TP cases (safeguard against rent seeking) □ Introduce APA's in these jurisdictions as an alternative procedure to preempt protracted TP disputes related to appropriate ALP's 	

7.2.2.1 Measures to Tighten Existing Engineering Frameworks

The present subsection recommends both **engineering** and **administrative** measures that can be taken by GoG countries seeking to tighten attributes of their TP regimes including *ALS*, *compliance*, *adversarial* and *appeal*. The recommendations comprise such far reaching measures as introducing mandatory D&R or placing the burden of proof on IOCs; and those as basic as increasing statutes of limitation or adopting TP audit roadmaps.

Reinforcing the ALS –The Detection Component

Clarify the Applicable TP Method and Safe Harbor Rules

On the question of reinforcing reactive components of TP regimes two key reforms can be envisaged. Firstly, some GoG governments need to clarify position on how acceptable TP methods would be determined. As noted earlier the current rule (*any method*) used by France and Cameroon to determine pricing methods is ineffective within context of the GoG.⁶⁶⁹ Unlike the “best method” rule that allows flexibility whilst providing guidance on the order in which methods would be accepted, the *any method* rule is indeterminate and likely to result in unwarranted and protracted disputes over what method to use in given circumstances. Since operations are broadly or sometimes structured

⁶⁶⁹ See Chapters 5.2.2.2 and 6.2.1.2

differently even within the same industry, it is important that the rule adopted upholds the principle of flexibility vital to choosing methods, whilst giving priority to those that can be easily applied in context of the GoG. Hence, it is proposed that GoG countries move away from the ambiguous “any method” to the pointed “best method’ rule. Emphasis should be on promoting the adoption of *profit-based methods* that are simpler to apply in the GoG than price-based ones.

Secondly, governments need to adopt or clarify safe harbor rules. This is relevant in the GoG where sourcing independent comparables has proven quite difficult due to rarity of such data. Considering that TP adjustments are by nature inexact and approximative, it is necessary that these countries factor into the architecture of their regimes ‘*safe harbors*’ that clearly guide IOCs on transfer pricing methods and price ranges that would be considered acceptable provided they fall within stipulated upper and lower quartile delineations. In effect, transactions would be deemed non-compliant if they fall outside of stipulated ranges. Unlike the present system consisting of several gray areas, policy reforms leading to the adoption of *safe harbors* provide greater certainty to IOCs since it becomes possible for multinationals to work out what aspects of their intragroup pricing policies might be accepted by the fisc and what others might not. This outcome is more efficient and has the advantage that it reduces the risk of any or protracted tax disputes.

Constitute Domestic Databanks for Sourcing Comparables

Considering that successful implementation of the ALS depends on tax officials accessing data on comparable independent transactions to base economic, functional and other relevant TP analyses, challenges faced by GoG countries to access such data domestically raises concerns as to the standard’s practicality. Although data can be occasionally sourced from Europe, US and Asia they nonetheless present weaknesses in terms of their adaptability to GoG markets as differentials to eliminate are numerous and more complex. This makes ALP’s resulting from the process prone to being successfully challenged. In deed, there is a clear mismatch between the choice of ALS by policymakers in the GoG on the one hand, and the actual ability of tax authorities (*including steps taken to acquire capabilities needed*) to implement the standard effectively. In this context and with a view to providing a long-term solution to the problem, it is proposed that immediate and concrete steps be taken to: (i) create domestic databanks for all transactions taking place within and across GoG borders, and (ii) syncing/feeding these domestic data’s into an international databank that is

designed to serve the needs of participating states.⁶⁷⁰ Suffice to note that coordination on this level should quickly address concerns over the quality and source of data used by tax authorities for TP adjustments. The potential impact of creating such a system in terms of making data available to authorities and debunking the cloak of obscurity bedeviling GoG markets is quite significant.

Introduce Advance Pricing Agreements (APAs)

The introduction of APAs is another aspect that is urgently needed to reinforce the architecture of TP regimes. The advantages of operating APAs is that it promotes substantive dialogue between the fisc and taxpayers and facilitates mutual agreement between parties on the: relevant facts and circumstances, applicable methods and the acceptable arms-length range, prior to MNE's engaging in intrafirm transfers. After expressing intent to negotiate an APA, both parties hold pre-filing conferences that result in tax authorities acquiring a comprehensive list of documents from taxpayers supporting their proposed method.⁶⁷¹ Documents are evaluated and details of the APA negotiated, culminating in tax authorities issuing a ruling for a determined period if consensus is reached. It is also important to note that through the APA process, vital commercial information and facts underpinning the economics of different transactions are provided upfront and thereafter yearly to ensure compliance and continues relevance. Information from these documents can be fed into the domestic databanks proposed above and provides tax authorities with data needed to carryout office-based monitoring of IOC intrafirm transfers. APAs further have the advantage that they do not prevent the fisc from scheduling formal field examinations to ensure full compliance.

In the US for example, IRS still does TP audits during which taxpayers must demonstrate: *bona fide* compliance with terms and conditions of the APA, continuous validity of material representations made to IRS, accuracy and analysis of data underpinning TP methods, (iv) continuous validity of critical assumptions, and uninterrupted application of method and critical assumptions. Besides, initial APA rulings can always be revoked 'for cause' and tax recalls ordered if IOCs are found to have misrepresented material facts or failed to comply with terms and conditions. Thus APAs are vital, *but largely missing* from the architecture of GoG transfer pricing regimes. It materializes efforts to preempt lengthy disputes that often arise when parties do not at the outset seat on the negotiating table to agree on modalities for intrafirm pricings. The need to introduce this platform is already being acknowledged by countries in the GoG (Nigeria, Kenya, Ghana) that have

⁶⁷⁰ This reasoning and proposed platform are developed further in Chapter 8 [Infra]

⁶⁷¹ Administrative fees are widely charged for these negotiations (IRS charged \$25,000 in 1996, \$ 50,000 presently)

recently elaborated APA frameworks in their regulations [see Chapter 5.2.2.1.E]. Although the effectiveness of these new frameworks is yet to be evaluated, it is recommended that others in the GoG follow their example.

Tighter Compliance -*The Detection Component*

Institute Systematic Reporting of Intragroup Transactions by IOCs

D&R are important components of the anti-avoidance regime since access by the fisc to both aggregate and detailed information on intragroup transactions is basis for assessing risks, detecting abuse and enforcing remediation. It also assists policymakers formulate effective deterrence policies. Earlier we found that existing D&R frameworks in many GoG countries are ineffective. Reversing this trend requires these countries to adopt a two-pronged approach; the one is meant to upgrade international and the other domestic standards. Firstly, states need to *upgrade relevant international accounting rules* on documentation in order to incorporate recent concerns and developments regarding transfer pricing. For example, the OHADA accounting system does not clearly provide guidance on how documentation for intrafirm transactions should be kept. Often, data is aggregated in the *Statistical and Tax Returns* that makes it difficult to assess risk of TPM or to perform any kind of adjustments without requesting further details.⁶⁷²

Secondly, respective governments in the GoG should introduce mandatory documentation and reporting rules for IOCs and other MNEs. This should be done on forms designed by the fisc on which multinationals are required to report aggregated and detailed data on intragroup transfers. As noted in Chapter 6.2.1.3 such information should include detailed records of: parent-affiliate activities, all non-sale activities or transactions –*loans or services*, ownership and capital structure of the business, and documents backing pricing policies and other financial returns filed in foreign or third party countries.⁶⁷³ This approach is increasingly being used around the world to monitor intrafirm transactions with the US's Form 5472 being a well-known example. Tax administrations in the GoG therefore need to move away from the light approach that only requires TP documentation to be disclosed if the fisc addresses a formal request during audits, to a tighter one that makes the preparation and reporting of such information systematic and mandatory. Again as indicated earlier some GoG countries like Nigeria and Ghana are already adopting this approach by introducing

⁶⁷² See Chapter 6.2.1.3 for discussions on this issue

⁶⁷³ As discussed in Chap 8.2.2.5, information gathered in participating countries can be fed into supranational databank

disclosure forms and requiring MNEs to *file TP documentation* alongside general returns. This has the advantage that tax authorities can *-from the office-* already begin to assess risks, and notify taxpayers to provide further specified information if unsatisfied with information provided in these forms. Although the extent of effectiveness of these measures is yet to be tested, its theoretical underpinning is sound enough to merit a recommendation that GoG countries adopt mandatory D&R as a means of sourcing information that is crucial to detecting TPM in the O&G industry.

Mandatory Disclosures by Promoters and Intermediaries

In addition to the requirement that taxpayers file mandatory TP returns, similar obligations should be extended to cover third party promoters of these schemes (lawyers, accountants, banks). Third party disclosures could be required at two main levels, that is, (i) when promoters finalize design and open these schemes to clients for adoption, and (ii) when clients actually employ their service to implement such schemes. Although taxpayers are likely to oppose the adoption of this rather unconventional approach to disclosures, it nonetheless has the advantage of acquiring timely information on the nature and characteristics of new schemes before they go operational, and when indeed they do, early information on taxpayers that are buying and using these schemes. While the significance of adopting the measure is not immediately evident to critics, its relevance cannot be ignored in contexts where anti-avoidance legislation has historically only trailed behind avoidance schemes. That is, the duration between gestation and implementation of these schemes, and the adoption by authorities of adequate anti-avoidance responses are often quite long. This is notably so in sub-Saharan Africa where anti-avoidance measures have traditionally followed only several years after implementation of aggressive base erosion schemes by taxpayers.⁶⁷⁴

Therefore, early disclosure by promoter's and/or intermediaries of these schemes provides policymakers with advanced warning of impending tax leakages, enables performance of timely risk assessments, and ensures adoption of suitable anti-avoidance measures to counter them as they come on-stream. Naturally, policymakers are best advised to narrow the scope of schemes falling within 3rd party disclosures to include only those that are most aggressively designed to provide undue tax advantages to some taxpayers and for which the fisc may not have ready information about. It is proposed that GoG countries adopt this higher standard of disclosures which could

⁶⁷⁴ Examples, it is only in 2014 that Cameroon has introduced Thin Capitalization rules

enhance detection, remediation and ultimately deter intending but rationale taxpayers from taking up avoidance schemes whose existence the fisc might be aware of and/or is actively monitoring.

Tighter Audit Frameworks –*The Detection Component*

Introduce Specialized TP Audits and Team of Examiners

We earlier observed that general tax audits are in principle useful platforms for the fisc to investigate various types of tax avoidance schemes such as gold plating, treaty shopping and TPM.⁶⁷⁵ Although GTAs maintain simplicity and diminish risks of taxpayers being subject to frequent tax examinations, it has nonetheless proven ineffective in the GoG as far as investigating TPM is concerned. During GTAs examiners struggle with a range of varied but important issues, some of which are simple to handle and others complex. Faced with a decision on which issues to pursue given the limited statutory timeframe allotted to complete audits, it is likely that auditors would target easy-to-adjust points, and relegate to second place other important but highly complex ones. This means GTAs are unsuitable platforms for thoroughly analyzing TPM. Going forward this inherent defect might be corrected by switching to the alternative tight framework that entails carrying out partial and specific transfer pricing audits. This focused approach presents certain technical advantages over the light one. First, it greatly narrows the auditor's scope of investigation to *exclusively* transactions concerned by intrafirm transfers. Second, this tight approach prioritizes adoption of target driven work-streams when auditing companies engaged in intrafirm transfers. It thus releases examiners of the pressures and distractions associated with having to simultaneously examine other noncompliance schemes, thus ensuring thorough probing of related party accounts for traces of TPM. Since timelines under the tight approach are relatively flexibility compared to the light one, this allows the fisc a lot more time to source and analyze related party documentation prior to scheduling audits and during execution thereof. This enables effective detection of TPM.

However beneficial the tight approach is and because it has until now primarily been adopted by the *US, UK and increasingly Nigeria*,⁶⁷⁶ critics may argue trends suggest that TPA's are conceptually suitable for countries with the Anglo-Saxon legal heritage than the French. However, there is no technical reason why adopting TPA's in replacement of existing GTAs should pose a problem besides being seen as deviating from a *traditional inclination* to align domestic tax laws to

⁶⁷⁵ See Chapter 6.2.1.1

⁶⁷⁶ In the US for example, IRS's Examination Division carries out specific TP audits, as does Nigeria's Large Tax Department since 2012.

France's. Indeed, the concept of target audits of the type we are proposing is already adopted in the laws of these countries on a range of other important tax issues. An example is the adoption of tight audits for the validation and reimbursement of VAT credits (also VAT specific sanction).⁶⁷⁷ Another reason for critics arguing against tight audits in the GoG has to do with FDI considerations. TPA's increase the man-hours and resources needed by companies to comply with documentation, filing and frequent tax enquiries that unnecessarily burden businesses and are likely to discourage FDI. From this angle, GTAs provide a one-off chance to address all noncompliance issues and reduce risks of frequent partial audits that could negatively impact perceptions of a country's attractiveness as investment destination at a time when the extractive sector is badly in need of inbound capital. Although this argument has some merit to it, countries should choose wisely between maintaining ineffective anti-avoidance audit systems that can and often result in IOCs eroding tax bases, and upgrading policy to ensure effective tackling of tax avoidance if and when they occur. It is more likely that investors would be discouraged if charging components of the tax regime are tightly engineered than if components designed to prevent abuse are upgraded. If the taxing component is attractively designed, there is no reason why the decision to invest or not to invest should be taken on the basis of how tightly crafted a country's anti-avoidance regime is. This only poses a problem if the taxing component is so poorly designed so that investors rely on and turn to weaknesses of the anti-avoidance regime as the means of guaranteeing a decent return on their investments.

Elaborate an "Official Transfer Pricing Audit Roadmap"

Tax authorities in the GoG have limited experience pursuing TP audits and therefore hardly carry out such audits successfully. It is thus important that GoG governments consider introducing TP audit roadmaps that provide practitioners with the needed toolkit to audit TPM. Roadmaps elaborate the stages and timelines to be followed during TPM audits and establish clear guidelines on the tools that examiners should apply in given circumstances of a case. It is recommended that the roadmap specify three stages of the audit chain being the planning, execution and resolution phases. At the planning phase, enough time should be given examiners for pre-examination analysis in order to attend the opening conference with clear indications on the orientation that the exercise would take. The execution phase starts with a planning conference and orientation, and moves into preparation of

⁶⁷⁷ This is evidenced in Section M.10 on right to audit, Section M.49 on right to investigate, Section M.101-105 on Special fiscal penalties applicable to VAT, Section M.107 on Criminal Penalties; All these provisions enable close follow-up of VAT specifically

initial risks, examination plan and milestones, fact finding, issuing a mandatory IDRs (Information Documentation Requests), functional analysis and mid cycle risk assessments, issues development and preliminary report. Resolution begins with presentation of *pre-notification of proposed adjustments* in which issues to be included in the final NOPA are raised, followed by discussions to resolve issues retained, finalizing the NOPA and closing the case. Therefore, proposed roadmaps should reflect TP specific audits and statutory timeframes for pursuing these audits before issuing the final NOPA's should be extended. The US in February of 2014 adopted such an Audit Plan that could serve as a model for establishing or improving the quality of TP examinations in the GoG. Naturally adjustments are needed to the US model to take account of circumstances specific to the GoG.

Place the Onus of Proof on MNEs -TP Policy and Compliance

In some of these countries the burden of proof should in theory and practice be shifted from tax administrations to MNE's. Resting onus on the fisc in circumstances where they lack access to comparables is ineffective. IOCs are absolutely and completely in control of data regarding all their intragroup transfers with very little, if any, outside influences on the prices they charge for these transactions. They equally have fairly better access to data in markets where they operate, that is, for transactions between themselves and third parties and/or between independent parties altogether. In truth governments in many O&G exporting countries cannot boast of similar access. This applies even to cases where they physically take a share of production and themselves sell on the commodity exchanges. Given these circumstances it is hard to grasp the logic and technical benefit of placing the onus on tax authorities to prove noncompliance. The approach is inherently defective as circumstances make it hard for tax authorities to pull together all the elements needed to undertake well-grounded TP assessments. Further, tax authorities find it easier to prove avoidance in cases where transactions are market based, than they would for controlled ones. Logic dictates that the legislator in these cases exceptionally rests the onus to prove compliance with TP regulations on the party *-that as seller and buyer-* exercises absolute control over the timing and conditions of the transaction. Onus should be on an MNE to justify its TP policy and method. This compels them to be more forthright in providing the fisc with documentation that they would otherwise withhold had onus rested with the latter to dig confidential MNE data. It compensates for capacity shortages, reduces the time, finances and effort otherwise needed/spent to dig for this information, allowing the fisc time to focus on other pressing issues.

Increase Statutes of Limitation and the Duration of TP Examinations

Also aligning statutes of limitation for TP to statutes broadly applied to other schemes is ineffective especially for periods as short as 4 years (Cameroon). Logic suggests that short statutes are best suited for countries that have easy access to market information and the requisite capacity to tackle TPM. Considering that developed countries like the US, Belgium and France arguably satisfy these conditions retaining 3 years prescription in these cases is fine. Even these countries have sometimes exceptionally extended this period to 5 years to allow auditors enough time to detect and remedy the practice if need arises. In cases where these prerequisites for operating short and effective statutes are absent, countries are best advised to extend the prescription period to 6 years and above as Nigeria, Ghana and Botswana have done. This is suitable for extractive projects with lifespans that typically average 25 or more years and for which auditors require ample time to examine intragroup activities. Although the proposal to extend statutes has its downsides, inaction on this point leaves tax examiners little time to prepare and detect or remedy existing leakages and/or deter TPM. The same argument is true for statutory timeframes given examiners to close TPM audits, with trends indicating that some GoG countries allot substantially insufficient periods for examiners to issue the Final NOPA considering the scope and depth of work required. For example, it is hard to see how 10 months provided by Cameroons law is enough to bring the entire process to a close; compared to 24 months provided for this purpose in the US.

In support of the proposal to increase statutes of limitation and duration of examinations in the GoG, policymakers and regime architects need to reflect closely on the importance of oil in their economies and the cost in terms of lost tax revenues should they continue to operate ineffective TP detection mechanisms. It serves no purpose to operate short statutes and expedited audit timeframes if they fail to enhance chances of tax cheats being caught or deterred. Most agree on the importance for host countries to operate strong anti-avoidance regimes vis-à-vis complex schemes like TPM, and extending *timeframes* for commencing and completing examinations should not pose a problem. In fact one can argue that by reinforcing TP audits, time and costs is saved upfront which would have been spent later to resolve protracted tax disputes. This reform also has the potential to improve host country earnings by enabling proper investigations into IOC intrafirm operations, the obscurity of which is the object of frequent criticisms. In matters of TPM, ample time is thus needed to monitor intrafirm transactions, to collect and analyze data and to build a case for or against proposed adjustments. Reluctance to take action in this direction would only serve to reinforce continues

erosion of host country tax basis. Hence, a strong case exists for policymakers in O&G rich countries in the GoG to increase statutes of limitation to a minimum of 6 years, and timeframes for completing TP audits to at least 15 months. This reform could apply to the entire regime and if the need to reform is not felt elsewhere in the anti-avoidance system, could be limitedly/exceptionally adopted to apply to transfer pricing manipulation only.

Tightening TP Penalties –*The Remediation Component*

Likewise, governments when designing penalties intended to remedy TPM traditionally adopt either the light or tight approaches. Some penalties are **compliance related** (*reporting and disclosures*) while others are **substantive in nature**.

Institute Penalties Relating to Reporting and Disclosures

There are two non-substantive TPM sanctions that engineers can incorporate into their legislation, namely *reporting* and *disclosure* penalties. The one targets IOCs that directly fail to file documentation on TP policy and transactions, while the other targets third parties that fail to mandatorily *disclose* to tax authorities information in their keeping and relating to avoidance schemes whose design or implementation they directly or indirectly facilitate. Firstly, we note that under the generic rules applied in most GoG countries there aren't TPM specific penalties imposed on MNE's for reporting failures. It is recommended that policymakers introduce penalties that target noncompliance on specific issues of *documentation* or *reporting*. Two main options are envisioned. Generic and specific penalties could be jointly applied in which case the taxpayer pays both;⁶⁷⁸ or separate penalties applied in which case the taxpayer pays generic penalties for all other filing omissions and specific penalties for cases of TPM.⁶⁷⁹ Neither option has historically been part of generic GoG remediation frameworks, which loophole creates an operational environment in which IOC decision makers are not particularly pressured -*as they otherwise would*- about the implications of certain TP policies they adopt. Most importantly TP penalties focuses the attention of decision makers on the issue and contributes long-term to deterring noncompliance. However, challenges relating to technical implementation of such a penalty system is likely to arise with authorities finding it complex to enforce, or companies likely to be affected by it resisting implementation thereof. In these

⁶⁷⁸ As discussed in Chapter 5.2.2.2 D.2 France has recently introduced this approach. Incomplete documentation resulting in TP adjustments attracts a maximum fine of 5% of the amount transferred abroad with a minimum of €10,000/year audited. In any case there is a non-compliance fine of €10,000/year audited

⁶⁷⁹ This complements the need of a separate filing regime for all transactions with possible impact on TP

contexts governments need to combine dialogue and effective implementation, as ways of pushing MNEs to change their TP compliance attitudes over time.

Secondly, although ‘mandatory third-party disclosure’ is simple and optimizes chances of effective detection and remediation, it is more likely than any of the measures recommended above to encounter resistance from MNE’s operating in the GoG. Instead of waiting for taxpayers themselves to file information on their transactions,⁶⁸⁰ the fisc proactively moves to source such information by imposing a duty on conceivers and/or facilitators of such schemes to disclose their existence and known beneficiaries. If implemented effectively the measure has real potential to ease remediation of TPM although it can be criticized as adding an extra layer of complexity to existing compliance obligations. These criticisms notwithstanding, the benefits in terms of increased materialization of parity between compliant and noncompliant taxpayers of adopting the measure cannot be ignored. It is recommended that GoG countries adopt and pursue implementation of this measure as part of policy reforms on existing TP anti-avoidance regimes. Precision would be needed on type of schemes to be disclosed, the category of legal persons (third parties) mandated to file disclosures, and the monitoring systems of this measure (*e.g. transaction references*).

Institute Penalties for Substantive Non-Compliance

Current engineering of substantive penalty regimes in most GoG countries is in principle effective from the remediation and deterrence standpoints. However, it is indeed the absence of an operational framework for triggering various penalty thresholds that make it practically ineffective. For example, there are no clear criteria to be used by auditors to decide which of the penalty thresholds to apply so that it is left to each auditor’s discretion to decide which rate to apply. There is quite a great deal of room in these circumstances for penalties to be used capriciously if one chooses to. System engineers need to tighten rules pertaining to penalties by creating an operationalization framework for determining applicable penalty thresholds. Rather than pursue the option of creating specific substantive penalties for TPM cases, it is tactically more feasible to improve the modus operandi of existing ones by clarifying criteria to be used in determining the applicable penalty rate. Let us take for example application of good faith penalties of 30% intended for taxpayers who commit certain filing errors or omissions under Cameroons tax law. It is questionable if this rate should apply to TPM that is not the result of errors or omissions but rather the result of well-calculated and

⁶⁸⁰ Has characterized the basis of existing relations between the Fisc and taxpayers for centuries

deliberate policy attempts to game the jurisdiction off tax revenues. However, one shouldn't rule out applying good faith penalties if the nature of the price variation is substantial⁶⁸¹ but not grossly exaggerated. In cases where price variations are gross, it seems logical that system engineers design a penalty regime that considers such outcomes as falling within the threshold of transactions engaged in bad faith (100% penalty). The US has successfully operated such a system that could be used as a source of inspiration.

Secondly, we argued earlier that TPM is rarely treated as evasion (see chapter 4.1.3.2). Although it is not envisaged that this approach would change, certain extreme cases might warrant application of evasion penalties (both pecuniary and penal). As concerns evasion as well, there is a strong perception that existing penalties are adequate (150% in Cameroon, 200% in Nigeria). Therefore, expected reforms to the penalty system should be oriented towards clarifying criteria used by the fisc to reach conclusions that a precise scheme would amount to tax evasion and not simply avoidance. If set criteria are satisfied one automatically ceases to consider the scheme as qualifying either for *good faith* or *bad faith* penalties that ordinarily fall within realm of tax avoidance, but rather apply penalties pertaining to tax fraud. Therefore, existing generic fiscal penalty regimes as concerns tax avoidance and evasion can be maintained with very minor if any modification to rates and other elements. However, system engineers need to develop operational frameworks and criteria for determining which thresholds should apply to specific TPM cases.

Reinforcing TP Appeals –*The Remediation Component*

Introduce Firm Deadlines for Filing and Treating TPM Disputes

Unless taxpayers perceive the tax appeal system as effective and its principal actors as competent, fair and incorruptible, appeals cannot really be a disincentive to those intending to manipulate transfer prices. Firstly, effective appeals reinforce TP detection and remediation. Were *compliance* and *audits* to prove effective, the regime is still not perceived as such if MNEs succeed on appeal to have perfectly grounded adjustments quashed. If this happens there is a risk of floodgates by noncompliant taxpayers who opt to gamble, with hope of quashing on appeal that which they are genuinely found to owe at the compliance and audit stages. Further, taxpayers seeking undue payment deferrals might exploit lengthy procedures at administrative phase as a means of easing liquidity tensions through tax deferrals. Therefore, appeals should be reinforced to ensure that

⁶⁸¹ Defined as mispricing's falling outside of the safe harbor range, but also not unreasonably exceeding the range

TPM schemes correctly detected and sanctioned during audits are upheld on appeals such that noncompliant taxpayers know and see the system as effective from reporting all the way up to appeals. It is recommended that GoG governments reduce deadlines for handling appeals at the administrative and litigation phases. As concerns administrative appeals, instead of operating a system that has lengthy multiple-level-rulings, this could be reduced to a one-off ruling issued by an authority with full competence to act on behalf of the competent minister. At least an expert with specialist knowledge should be appointed to the competent panel charged with deciding TP cases.

Introduce Domestic Arbitration for TP Cases

In further consideration of the impact of ineffective and slow appeals on the business environment and investments, GoG governments could expedite resolution of tax disputes by introducing alternative dispute resolution mechanisms like *domestic arbitration* designed to handle *issues of fact* arising in disputes. This is a viable proposition considering that few, if any, specialized courts exist in the GoG to handle tax disputes. Judges within court systems often do not have the capacity to discern technicalities pertaining to specific avoidance schemes, let alone pass landmark rulings on complex issues characterizing TP disputes. This limitation is evidenced by slow and long litigation processes that sometimes end in poorly motivated rulings that really do not contribute a great deal to develop the law on this subject. Importantly, TP adjustments are not an exact science and are by nature complex, creating room for regular disputes. A weak appeals system is likely to result in the taxpayer unduly succeeding on appeal in turn dis-incentivizing auditors looking to adjust transfer prices. This has the effect of reinforcing reticence on the part of auditors who already have a tendency to avoid pursuing vital but dispute prone TP adjustments, and to continue focusing on other avoidance schemes that are relatively easy to handle. From this viewpoint arbitration is an intermittent tool laying in-between the administrative and litigation phases with potential to compensate for existing lapses observed in the GoG. Since competent experts are appointed to the arbitration panel to review quarrels on issues of fact, the resolution of TP disputes is expedited. If parties opt to submit their quarrel to arbitration they do so *voluntarily* and agree to its *binding* nature so that the appeals process is expeditiously brought to a close once arbitrators reach a decision. Parties are not granted leave to appeal arbitral rulings to courts, unlike litigation where appeals go all the way to the Supreme Court. Secondly, the *quality of persons* appointed to the panel as arbitrators make-up for the dearth in expertise experienced in domestic courts. Arbitration is thus more advantageous to litigation and addresses many of the latter's flaws discussed earlier.

7.2.2.2 Tightening Administrative Frameworks -Enforcement

In the preceding chapter we argued that institutional and human resource elements of GoG transfer-pricing regimes are ineffective in deterring, detecting and remedying TPM. Policymakers in hydrocarbons producing countries increasingly recognize the need to operate robust administrative frameworks if they are to effectively tackle TPM by IOCs. Table 7-2 recommends measures that can be taken to improve effective administration of these GoG regimes.

Table 7-2: Reinforcing Administration of Transfer Pricing Regimes in the GoG

Attributes	Short-term Measures to Tighten Anti-avoidance Regimes (Administration)	Timeframe
<p style="text-align: center;">A. Human Resource Component</p> <p style="text-align: center;">B. Institutional Reforms/Upgrades</p>	<ul style="list-style-type: none"> <input type="checkbox"/> Increase the number of personnel assigned to monitoring, collecting & analyzing data, and auditing IOC's (<i>quantitative measure</i>) <input type="checkbox"/> Reinforce capacity building programs to beef-up productivity of relevant personnel (<i>Qualitative measure</i>) <ul style="list-style-type: none"> - The application of ALS in petroleum and other industries broadly - TP audit techniques, and procedures for sourcing data <input type="checkbox"/> Design & implement governance measures to tackle corruption/rent-seeking <ul style="list-style-type: none"> ◆ Reduce the number of state institutions intervening in revenue collection ◆ Coordinate institutions to ensure seamless flow & sharing of information <ul style="list-style-type: none"> - Tackling information asymmetry between government and IOC's - Tackling information asymmetry between government departments ◆ Reinforce domestic institutional framework of administering TP regimes <ul style="list-style-type: none"> - Introduce specialized TP teams to assist auditors during compliance & audits - Strengthen the domestic remediation regime ◆ Build a supranational framework for tackling TPM and other challenges <ul style="list-style-type: none"> - Source and exchange Information, joint investigations - Open corridors for enforcing foreign tax recalls in principal and penalty 	

Recommended Steps to Improve Institutional Effectiveness

Institutional dysfunctionalities do impact the ability of countries to optimize oil revenues. In the GoG system engineers can eliminate dysfunctionalities by reforming existing institutional frameworks that are designed using the *light* approach. They could adopt a series of *tight* measures to achieve this end, notably: reducing the number of state institutions that intervene in the revenue collection process and building robust platforms to be used in coordinating interactions amongst state institutions, and also between these institutions and IOCs.

Fuse State Institutions Involved in Extractive Revenues Collection Process

The uncoordinated flow of information amongst government agencies is a major source of leakage and hindrance to effective tax collection. Indeed pieces of information reported by IOCs to different government departments are usually not consolidated and shared with others. Thus, lack of access to vital information is not only the result of IOCs withholding information from states, but also the result of institutional lapses linked to failure by departments to share pieces of information actually reported to them. This makes it hard to monitor revenue assessments, collections and accountability of various state actors tasked with these responsibilities. From the tax collection lens, institutional effectiveness can be improved by tightening coordination frameworks to ensure smooth sharing of information gathered by all departments engaged in the revenue collection process. In order to eliminate leakages in revenue collections, governments should consider using either of two approaches. Firstly, create the relevant framework for **joint audits** comprising the fisc and all other institutions that are competent to collect extractive revenues. Although this approach should improve administration of existing regimes it does not go far enough in mitigating or eliminating leakages likely to result from institutional dysfunctionalities.

Secondly, institutional frameworks could be improved by creating an integrated agency with competence to supervise, audit and collect all revenues generated by resource extraction. Such a *technical agency* should comprise representatives of all institutions having responsibility to collect oil and mining revenues including the Resource Ministry, NOC, taxation and customs departments. The agency should be empowered to carrying-out the delicate task of consolidating fragments of data filed by resource companies and establishing new systems for receiving declarations. This information is then disseminated amongst teams of examiners who could, if need arises, use it to adjust and issue recalls for all unpaid taxes. Such an agency eliminates risk of leakages linked to fragments of data being held by different state institutions. The reform is also likely to increase revenues contributed by extractives while decreasing risks of corruption and/or bureaucratic rent seeking both of which thrive in the present context where coordination and oversight are weak. A good example of such an institution is the Tanzania Minerals Audit Agency (TMAA) created to supervise and audit upstream mining activities, and financial and fiscal statements of large and medium size enterprise's doing business in the extractive sector.⁶⁸²

⁶⁸² <http://www.tmaa.go.tz> [Last visited: June 22, 2014]

Strengthen Coordination of Data Flows Between Relevant Stakeholders

Governments in the GoG could also use this agency (other channel) to narrow the technical superiority and information gap existing between tax authorities and IOCs, both of which make the administration of TP anti-avoidance regimes difficult. In the short and long terms one can identify two perceptible ways by which governments could solve the asymmetric information problem. Firstly, the fisc could itself or by way of a third party source information needed directly from IOCs. In this case dialogue with taxpayers on tighter reporting rules and unwavering demonstration of resolve by the fisc to implement noncompliance penalties should ameliorate compliance of rational actors, going forward. Governments could as well outsource highly technical aspects of the information gathering and revenue collection processes to private but highly specialized firms with competence that measure those held by the filing IOC. Both options should significantly take capacity pressures off the shoulders of GoG governments and increase chances of actually having quality and genuine information on which to compute the IOCs tax liabilities.

As concerns indirect sourcing of information, mechanisms such as third party disclosures, inquiries and information exchanges are effective avenues via which data can be gathered by host governments. Particular importance should be given to the information exchange mechanism, since both host and home countries could use it to acquire information on IOC activities that are located outside a country's traditional borders. The inability of host governments to adjust IOC taxes due to the lack of viable information is substantially eliminated if data can be sourced from foreign tax administrations as part of a treaty arrangement or via some other information exchange platform. There is as such a tactical case for GoG countries to substantially broaden the number of their operational tax treaties, which increases their ability to take benefit of Art.26 of the OECD or UN Model Treaties and improves the likelihood of detecting and remedying TPM. Countries should also consider joining the ATAF and OECD conventions on Mutual Administrative Assistance designed to facilitate the exchange of information. But by far the most important measure that can be adopted is the creation of an information center to serve members. Preferably, this should be incorporated into the supranational response support framework discussed in chapter 8 [infra].

Strengthening the Human Resource Component

It does not really matter how well designed tax institutions are, if the human resource element is ineffective. Therefore, GoG countries also need to take steps to build the critical mass of TP

experts (*numbers and skills capacity*) needed to drive *policy*, to implement and/or enforce TP anti-avoidance regulations. This entails building a team of state officials who fully understand the context of industries susceptible to TPM (*including O&G*), and creating a legal framework to restrain such a team from pursuing corruption and bureaucratic rent seeking.

Increase Numbers of Staff Tasked with Tackling TPM

We noted in Chapter 6.3.2.1 that the number of staff assigned to units tasked with driving policy and enforcing rules on TP in the GoG is inadequate. Taking into consideration the number of MNEs (IOCs) operating in the GoG that tax authorities are supposed to audit annually, it is highly unlikely that all transactions with TP implications would be properly investigated in the time allotted by statute to **commence** or **close** audits. If the fisc is to eliminate or substantially reduce chances of its adjustments being challenged by IOCs in appeals, it should consider increasing the number of staff tasked with determining the appropriate TP method, sourcing comparables, and determining the proper ALP on a transactional basis. Since viable domestic comparables are hard to find in the GoG handling these highly technical and complex processes would require substantial amounts of manpower and man-hours. This underpins our recommendation that GoG governments increase staff assigned to monitoring, collecting and analyzing data, and importantly auditors tasked with examining IOC accounts. Considering that GoG governments have only recently started taking concrete steps to combat TPM this proposed measure has a couple of advantages. It enables the fisc to expedite audits of tax years likely to be caught by prescription, reduces workload per auditor, boosts effective probing of accounts, and increases productivity during the period in which the backlog of unaudited affairs are being cleared. In the short-term, the likelihood of detecting and remedying TPM is improved. Long-term chances of deterring noncompliance are increased.

Reinforce Technical Capacity of Staff Tasked with Handling TP Issues

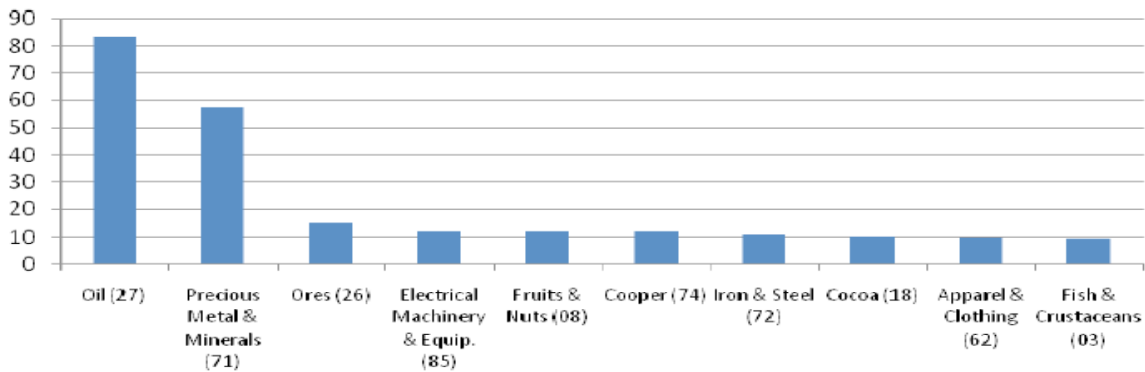
Further to increasing staff assigned to TPM units, governments should take steps to beef up their technical capacities in the areas of monitoring, analyzing and processing data on mispricing schemes. Due to the highly specialized character and time needed to acquire capabilities in the areas of extractives and international taxation, it is recommended that long-term capacity building programs be created to train relevant personnel. Efforts to strengthen the capacity of a select but effective number of tax officials on the subject of TPM should cover the ALS, compliance, audits and penalties, and appeals as relates to extractives and other key industries. As concerns O&G, some key areas to

focus on include valuation, metering of crude at wellhead, and technics for sourcing market data. Considering that effective detection and remediation substantially depend on effective TP audits, techniques and procedures conventionally used to audit companies in the O&G sector is an important aspect of the system that auditors need to be trained on.

Strengthen Governance Measures- Against Corruption/Rent Seeking

The fight against corruption and bureaucratic rent seeking has been at the center of recent efforts by governments to improve good governance of international transactions, culminating in the adoption of OECD (40 ratified) and UN (170 ratified) anti-bribery conventions intended to combat corruption of foreign public officials in international business transactions. The African Union has also adopted the Convention on Preventing and Combating Corruption that has already been ratified by 31 out of 53 African countries. It would be recalled that the O&G and mining industry account for a sizable part of all international transactions. Extractive industry transactions are thus major potential targets of resource rich countries that sign-up to these conventions. Implementation of these conventions is key considering that out of roughly \$229 billions in illicit financial flows (IFF) estimated to have taken place on the African continent in over 10 years (2000-2010), about 56% comes from oil; precious metals and minerals; ores; iron and steel; and copper. In addition, out of 19 sectors indexed as most likely to bribe abroad, O&G and mining appear amongst the top five.

Figure 7-1: Top 10 Sectors by Cumulative IFF (2000-2010) for Africa in US\$ Billions⁶⁸³



The purpose of all these conventions is essentially the same. For example, under Art.1 (1) & (2) of the OECD version, parties undertake to establish as a **criminal offence** in their laws, actions intentionally carried out by any person if it amounts to “bribery of a foreign public official”. Bribery is

⁶⁸³ www.transparency.org [Last visited: June 22, 2014]

deemed to take place if a person offers, promises or gives “any undue pecuniary or other advantage, whether directly or through intermediaries, to a foreign public official, for that official or for a third party, in order that the official act or refrain from acting in relation to the performance of official duties, in order to obtain or retain business or other improper advantage in the conduct of international business.” Complicity amounts to bribery: including incitement, aiding and abetting, or authorizing bribery of a foreign public official. This is obviously a viable mechanism by which governance of international trade in hydrocarbons can be improved, and is therefore recommended that GoG countries sign up to these initiatives aimed at curbing leakages resulting from corruption.

7.3 Chapter Conclusion

In conclusion, it is noted that this chapter raises and responds to **three vital questions** that serve as basis for improving the effectiveness of GoG transfer pricing regimes domestically. That is, which of the two competing standards namely *ALS* and *UT* should GoG governments adopt? Should GoG governments reorient TP policy and regimes away from the light to a tighter approach? And, if so, what specific measures need to be taken to achieve this end? We recommend as follows:

On determining the suitable TP standard for GoG countries:

As concerns the adoption of either *ALS* or *UT* as basis for building TP ant-avoidance regimes in the GoG we noted that unlike Europe and North America where such regimes are already built around the *ALS*, most African countries are yet to develop comprehensive frameworks for enforcing *ALS*. Timing is thus right to decide which of both standards to adopt going forward. Notwithstanding criticisms that *ALS* is *unrealistic*, *mythical* and *isolationist*, it is amongst other reasons convenient, practical and easier implemented than *UT* in the present circumstances of the GoG. Though the fisc is expected to construct a **mythical** market out of data almost entirely provided by companies it audits, it is worth noting that a *modus operandi* has been found for its effective operationalization. Further, *ALS* already has broad-based appeal that cannot be altered/changed without extensive and concerted shifts in policy by most countries around the world, which prospect is unlikely anytime soon. From a practical standpoint therefore, it is resolved that countries in the GoG seeking to implement effective TP regimes should maintain the *ALS* or adopt it.

Reorienting TP policy in the GoG: Tightening the anti-avoidance framework

On the issues of reorienting both policy on, and the enforcement of TP anti-avoidance, we definitively question the propitiousness of GoG countries *adopting the light approach* and *copying verbatim TP provisions* from developed countries. Three **main** factors were identified as militating against going light on MNEs when it comes to regulating TP in the GoG. Firstly, most O&G companies extracting hydrocarbons in the GoG are known/or suspected abusers of TP and are resident for consolidated tax purposes in OECD countries. Since few, if any, GoG resident firms reciprocally extract hydrocarbons within the OECD, involvement typically moves in one direction and creates unidirectional risks of tax base erosion. This context may not apply to cross country OECD operations in which member countries are both *home* and *host* to IOC activities. Here, an OECD host country seeking to tackle TPM is itself home country to IOCs operating in other OECD countries and is a likely beneficiary of the practice. In this context there exists, one could argue, a silent code of *auto-restraint* regarding the extent of measures that can be taken by each country since interests are mutual and reciprocal action over treatment given to each other's company would be legitimate. In this context, the light approach to regulating TPM might be quite appealing. Secondly, the weak flow of information between IOCs and governments, and between government agencies in the GoG also militate against adopting or persisting in the choice of the light approach. Effective monitoring of TPM depends on tax authorities getting *access to information* and developing capabilities to match those held by MNEs. Unlike GoG countries that are short on both, developed countries are strong on both points and could, in spite of opting to go light, still operate fairly effective TP anti-avoidance regimes. Lastly, vital *engineering* and *administrative* lapses mainly attributed to the light approach affect the regime's ability to deter, detect or remedy TPM in the GoG.

In light of these factors it is concluded that *contexts differ* and so *should the approach adopted in tackling TPM* given the context. *Hence, it is recommended that system engineers reorient transfer-pricing policy away from the light to the tight approach.* With this policy orientation in mind it is further recommended that system engineers adopt a holistic approach in the implementation of proposed changes to the architecture, engineering and administration of TP frameworks. Ultimately, the proposed changes should improve the effectiveness of domestic anti-avoidance regimes in detecting, remedying and deterring transfer price manipulations in the GoG.

CHAPTER 8

PROPOSITION II: CREATE AN INTERNATIONAL TP COOPERATION PLATFORM FOR AFRICA

In the preceding chapter, a number of domestic measures that could be adopted to improve effectiveness of TP regimes in the GoG were proposed.⁶⁸⁴ These measures are undoubtedly useful to other African countries facing similar challenges and looking to improve their regimes. While the proposed measures can significantly improve response capabilities from the engineering and administration perspectives, it is evident given their cross-border nature that abuses cannot be effectively tackled using domestic means alone.⁶⁸⁵ In fact, the actual consensus-framework that is extensively built around the logic of countries adopting domestic responses to the problem of TPM is fast revealing its defects. The response system is arguably incomplete without parallel existence of an upgraded international cooperation framework designed to support domestic efforts in the areas of information gathering, sharing and tax enforcement.⁶⁸⁶ In many ways consensus is building around collectivizing efforts to tackle base erosion and profit shifting⁶⁸⁷ with policymakers moving in the direction of adopting an *international cooperation-based* model as replacement to the *domestic-based* one that characterizes existing regimes.

The platform for cooperation mentioned above could entail creating *informal ad-hoc* mechanisms (multilateral or bilateral agreements) to manage relations between parties, or *formal* ones such that global (UN) or regional (EU, AU) institutions are used to develop the regime and to manage relations between parties (states) pursuing collective solutions to this jointly shared problem. In the context of Africa, both policy and institutional proposals discussed hereinafter focus on cooperation from a predominantly regional perspective. The idea is to create an African driven *Transfer Pricing Support Facility (TPSF)* to lead reforms on this issue. There are strong reasons for African countries to adopt such a support facility as bases for institutionalizing international tax

⁶⁸⁴ That is, in detecting, remedying and deterring noncompliance

⁶⁸⁵ For example, we earlier discussed the difficulty they face sourcing comparable transactions domestically

⁶⁸⁶ Cooperation is premised on the “folk theorem” by which it is possible for actors to cooperate in repeated games. For more discussion on this, see Friedman (1971), and Fudenberg & Maskin (1986). Also, increased integration of the world economy makes cooperation desirable and feasible, although operationalization remains a problem

⁶⁸⁷ Examples include the recent 2013 G8 and G20 proposals on these issues; also OECD *Multilateral Convention on Mutual Assistance in Tax Matters* that is formalized; see Mercuri, E., *Arguments for an international tax base*, 22(1) [Revenue Law Journal \(2013\)](#)

cooperation. Hence, in the sections that follow the rationale of collectivizing anti-avoidance efforts (8.1), some major developments on international cooperation (8.2), and the challenges linked to setting up TPSF and the proposed institutional framework designed in line with Africa's needs in this area (8.3) are briefly explored. These sections are followed by the chapter conclusion (8.4).

8.1 The Rationale For Cooperation

The importance of ensuring that taxable incomes derived from cross-border operations are shared fairly amongst countries cannot be overemphasized. If a country ignores domestic tax rules that are applied by others, this is likely to result in conflicts between all governments concerned. While tax treaties under the present consensus-framework are a useful way to avert these conflicts, the network of treaties between African countries is weak. This is explained by a widely held perception that TPM is mainly an offshoot of Africa's trade with other continents given that intra-African trade represents only a small fraction of total African trade. During the years 2007 to 2011 for example, the average share in total African merchandise exports to countries outside the continent was 89%, compared to only 11% of intra-African exports.⁶⁸⁸ Therefore, governments tend to view *base erosion* and *profit shifting* as solely used in trade operations between Africa and non-African countries, largely ignoring the risk that TPM could also occur in intra-African trade. As the share of intra-African trade continues to grow, this extra dimension to the problem is becoming quite apparent.

The need is increasing to establish an international tax cooperation platform⁶⁸⁹ to assist African countries in formulating mutually beneficial policies and providing practical rules, norms, principles and procedures designed to tackle the problem of TPM. This is partly explained by defects in the current TP consensus-framework. In creating an **international institution**⁶⁹⁰ via which African

⁶⁸⁸ Osakwe, P. et al., *Intra-African Trade: Unlocking Private Sector Dynamism*, p.2 (UNCTAD: Economic Development In Africa Report, 2013). The share of intra-African trade is quite small compared to Asia's (50%), Latin America and Caribbean's (21%) and Europe's (70).

⁶⁸⁹ Koremenos, B., Lipson, C., & Snidal, D., *The Rational Design of International Institutions*, International Organization 55, 4, Autumn 2001, pp. 761–799

⁶⁹⁰ The phrase 'International Institution' has been used over the past decade to signify a range of phenomena. **Firstly**, *formal International Organization's* usually UN system branches, and later other forms of intergovernmental organizations and non-governmental organizations with agency, agenda's and potential socializing influences (Aker & Russett, 1965; Ball, 1951; Keohane, 1967; Martin & Simmons, 1998). **Secondly**, *international regimes* that ceased to look at IO's as actors, but mechanisms by which rules, norms, principles and procedures are used to focus expectations on international behavior (Krasner, 1983; Haggard & Simmons, 1987). Lastly, both the words organization and regime were reviewed during the 1990's and replaced with **international institutions**. Scholars consider international institutions to be sets of

countries can cooperate on conceiving and implementing practical solutions to the TPM problem, it is important that a sustainable model should be adopted **given** that TPM is still an evolving subject in Africa and the continent has quite a poor record sustaining international cooperation platforms.⁶⁹¹ The TPSF is mainly justified by the needs to coordinate TP policy and to synergize dialogue in finding practical solutions to challenges faced by governments and other non-state stakeholders in this area.

Coordination of Policy and Implementation Responses

In addition to measures proposed in Chapter 7, the introduction of an intergovernmental cooperation platform is likely to significantly assist governments better coordinate efforts at improving TP regimes in the GoG in particular and Africa in general. The need to adopt **cooperation** as basis for countering international tax avoidance was clearly highlighted in the Seoul Declaration of 2006 following the OECD's Forum on Tax Administrations.⁶⁹² It was also recently endorsed by the final declarations of the 2013 G8 and G20 submits respectively hosted by the UK (Lough Erne) and Russia (St. Petersburg). In paragraph 1 of the Tax Annex to the G20 declaration, cooperation was noted as crucial in establishing "a more effective, efficient and fair international tax system." Further, it was observed that "strengthening international cooperation in tax matters, is essential to ensuring the integrity of national tax systems and maintaining trust in governments." There already exist examples of cooperation-based frameworks being developed around the world, including the: *Global Forum on Transparency and Exchange of Information* for tax purposes to ensure implementation of the G20 endorsed information exchange standard (i), *Joint International Tax Shelter Information Centre* to which the UK, US, France, Canada and Japan are participants (ii), and *African Tax Administrations Forum* (ATAF) which coordinates efforts on these issues in Africa. Cooperation is advantageous in that it reinforces canons of international taxation, improves implementation capacity, facilitates dialogue and accelerates willingness of these countries to technically assist each other, and ensures greater transparency vis-à-vis MNE operations as information gathering/sharing is made easier.

rules meant to govern international behavior. Mearsheimer (1994/95) defines institutions as "**sets of rules that stipulate the ways in which states should cooperate and compete with each other**".

⁶⁹¹ Many such institutions have collapsed in the past. For example weaknesses of the OAU led to its replacement by the AU, which itself is today criticized for lack of performance. As far as tax cooperation is concerned, a good example is the CREDAF initiative (Centre de Rencontres et d'Etudes des Dirigeants des Administrations Fiscales). Whilst considered international, most of its members are African countries and as more of these countries join ATAF that pursues similar objectives from an African standpoint it is likely that CREDAF's viability would asymmetrically decline. There are diverse theoretical approaches to the study of international institutions, amongst which are: the **Realist** (Hans Morgenthau, 1985; Boyle, 1980); **Constructivist** (Wendt, 1992) and **Rationalist** (Martin and Simmons; Krasner 1983; Keohanes, 1984) schools of thought. In discussing possible designs of the proposed STSS we adopt the rational choice tradition.

⁶⁹² <http://www.oecd.org/tax/administration/37415572.pdf> [Last visited: Sep. 6, 2014]

Cooperation-based frameworks are advantageous in that they increase system efficiency and serve to close information gaps that exist between countries. In tackling issues of TPM, the adoption of domestic-based mechanisms results in costs duplicity since each country spends huge amounts to obtain data that could have been jointly acquired. The domestic approach also increases compliance costs for MNEs that are bound by different tax rules in different tax jurisdictions. This creates an incentive for MNEs to hire costly tax expertise to mainly help them comply with these obligations, or in extreme cases to advise on ways to minimize exposure to tax risks. These defects in the international tax gathering system can be reversed and collective efficiency achieved by increasing the level of cooperation between countries affected by base erosion, profit shifting and other tax avoidance schemes. The creation of a cooperation platform via which pertinent international tax concerns can be jointly addressed, significantly reduces duplicity in terms of policy and decision-making processes. Cooperation makes it easier for countries to agree on standards and modalities of working on a range of issues that were hitherto seen as areas of exclusive sovereignty. An example is the enforcement of foreign tax laws after ensuring conformity of the request to domestic legislation.

From the standpoint of international taxation it signals that issues of policy, monitoring and enforcement of tax regimes would no longer be approached on a country-by-country basis; but that countries would actively cooperate by assisting each other in tackling international tax challenges. Therefore, instead of allowing each country the burden of fending for itself when dealing with abuses linked to cross-border transactions, cooperation would accentuate dialogue and hasten consensus on issues around which these countries interests align. For instance, existing gaps in accessing cross-border data could be eased by creating a *collective databank* via which intrafirm transfer pricing data would be gathered and shared amongst participants. The adoption of such a system is “incentive compatible”⁶⁹³ with the expressed goal of many African countries to improve mobilization of domestic tax revenues by increasing avenues for exchanging information to tackle tax avoidance schemes.

Synergizing Dialogue Between Major Stakeholders

In spite of these countries aiming to optimize domestic tax collections the realization of this objective is often impeded by exogenous factors. In order to effectively address these concerns stakeholders of the revenue gathering chain might be required to come together under a cooperation platform to synergize their efforts to tackle TPM. This is especially important since tax administrations

⁶⁹³ Koremenos, et al. (2001), supra note 690 at p.768

and companies sometimes hold divergent views on TP and other tax issues.⁶⁹⁴ While some see MNEs as notorious tax cheats, others perceive them as unduly targeted by tax authorities. In spite of this inherent conflict, the existing consensus-framework only sparingly promotes the use of dialogue as basis for narrowing stakeholder differences. Prior to the creation of *ATAF* in Africa,⁶⁹⁵ very little emphasis was placed on intergovernmental cooperation as a viable alternative to the domestic-based approach traditionally used to fight international tax avoidance. As these schemes grow in complexity, there is need to create a platform for broadening dialogue on issues of stakeholder interests, resolving differences, diminishing risks of conflict and improving TP regimes in Africa.

Traditionally, this institutional vacuum has been filled by organizations/agencies from outside the continent including the IMF, WB, OECD, DFID, GIZ and NORAD, which tend to lead dialogue on tax reforms on the continent.⁶⁹⁶ The trend has been for African countries to shop and implement *off-the-shelf* reforms that are sometimes not fully tailored to their needs. Likewise, efforts in Africa to establish and promote dialogue between tax authorities, MNEs and other stakeholders via public-private sector forums⁶⁹⁷ have yielded weak results. Indeed with the exception of *ATAF*,⁶⁹⁸ it is hard to find any other African led tax initiatives that genuinely work to improve high level cooperation on tax policy and the implementation of best practices from the continent's perspective. The proposed *TPSF* platform is mainly intended to enhance cooperation amongst African governments on TP by taking the lead and proposing policy reforms that actually respond to the needs of these countries.

It is worth pointing out that the importance of cooperation, as basis of the broader strategy to tackle TPM, is not unique to Africa. Indeed, recent developments reveal that state and non-state actors are already creating new frameworks of cooperation, or relying on existing international organizations to host such cooperation platforms on TPM and other related issues. Examples include the EU-JTPF, EITI and BEPS, which are hereinafter examined as possible models of international

⁶⁹⁴ Eden (1998), supra note 3 at pp.104-105; Also see Chapter 5.1.2 supra

⁶⁹⁵ Examples of earlier initiatives include CREDAF. While it is not African, it provided a platform through which these countries could pursue cooperation. Also, many regional economic bodies in Africa have occasionally cooperated on fiscal policy issues, with typical examples existing in CEMAC, ECOWAS, and SADC.

⁶⁹⁶ For example the IMF has established AFRITAC regional offices in Africa for this purpose. The mandate of these offices is to provide capacity-building assistance, facilitate the reform process in member countries, and support the region's integration in the world economy. As a regional center, which is close to the countries/territories it serves, AFS offers several services including: (a) decentralized and better tailored delivery of technical assistance (TA) to the particular needs of the region; (b) enhanced country ownership and accountability; (c) quicker and more efficient response to TA requests; (d) closer coordination with other TA providers in the region; and (e) more focused subject-specific and hands-on training for local officials.

⁶⁹⁷ See *Private Sector Development/Investment & Resource Mobilization Division* of the AU's Econ. Affairs Dept.

⁶⁹⁸ It is argued in section 8.1.2.2 that the *ATAF* framework does not go far enough.

cooperation in the area of tackling tax avoidance (TPM) and promoting transparency (oil sector revenues) that African countries looking to coordinate efforts can draw important lessons from (8.2).

8.2 Recent International Cooperation in Tackling TPM

Increasingly complex cross-border intrafirm transactions make it necessary for states to cooperate in tackling international tax avoidance. In recent years states responding to this need have developed cooperation-based platforms to enhance these anti-avoidance efforts at the *regional*, *sectorial* and *global* levels. Unlike in the past when such cooperation would have been limited to traditional *state actors*, there is a noticeable predisposition nowadays to accept the participation of *non-state actors (businesses)* in the policy formulation and legislative implementation processes. In the sections that follow three cooperation-based platforms adopted around the world to tackle international tax avoidance are reviewed. The EU Commission's Joint Transfer Pricing Forum is an example of cooperation at the **regional level** (8.2.1), the Extractives Industry Transparency Initiative an example of cooperation on a **sectorial level** (8.2.2), and the OECD's work on Base Erosion and Profit Shifting that is putting in place a framework for cooperation at the **global level** (8.2.3).

8.2.1 Regional Cooperation – *The EU Joint Transfer Pricing Forum*

There is a recent worldwide trend to broaden cooperation on international tax matters at *regional levels*.⁶⁹⁹ Such cooperation is increasingly being narrowed down to cover specific issues that are identified by states as posing serious challenges to the effective mobilization of domestic tax revenues. In the EU for example, efforts to strengthen the fight against international tax avoidance have ended in creation of the JTPF to advise EU member states on matters of TP.

Institutional Outlook of the Forum

The Forum's origin can be traced back to the release of working paper SEC (2001) 1681 on company taxation in the EU internal market and communication 2001/582 which explored strategies on consolidating cooperate tax bases on EU-wide activities.⁷⁰⁰ It was first set-up within the Directorate General for Taxation and Customs Union in 2002 as an informal expert group to advise the

⁶⁹⁹ The Inter-American Center of Tax Administrations (CIAT), the African Tax Administration Forum (ATAF)

⁷⁰⁰ http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm [visited Sep 9, 2015]

Commission on TP matters. A formal mandate was however conferred to it in 2007⁷⁰¹ that lasted until 2011 and another by Decision 2011/175 extended this mandate to March 2015. The Forum's work is based on the OECD Transfer Pricing Guidelines and focuses on proposing pragmatic, non-legislative advice to the Commission on all practical problems posed by different TP practices in the EU area.

Its membership comprises an independent chairperson, one representative from the tax administration of each EU member state, and a further eighteen (18) non-governmental organization members. In addition, it could invite representatives from the OECD or EU candidate countries to observe its proceedings. As recently as May 2015, the Director-General for Taxation and Customs Union appointed new members and a chairperson to the Forum for a two years mandate running from April 2015. Unlike in the past where the 18 non-governmental members were individually chosen for their expertise, the Commission has for the first time appointed organizations to the group of experts instead of individuals. Each organization is then represented by a TP expert -assisted by an alternate, both of whom were designated by the organization at the time of its application to join the Forum.

JTPF's Work and Achievements

The way the EU views TP challenges is already being influenced by the Forum's work in the areas of improving implementation of the ALS, compliance (documentation), adversarial (audits and penalties), and disputes (avoidance & resolution). Its work in these areas is relevant to discussions on improving cooperation amongst African countries in tackling TPM as would be seen in 8.3 infra.

Work on Improving Implementation of the Arm's Length Standard (ALS)

The Forum acknowledges that businesses in the EU face difficulties in implementing the ALS and has therefore proposed ways to address these difficulties. Issues covered include: compensating adjustments, low value adding intra-group services, cost contribution arrangements on services not creating intangible property, and rules on Small and Medium Enterprises (SMEs).

Compensating Adjustments⁷⁰² refer to adjustments in which a taxpayer for tax purposes, reports as the ALP a transfer price that is different from that which is actually charged between associated enterprises. These adjustments are in principle made before tax returns are filed.⁷⁰³ Owing to double taxation and double non-taxation caused by EU member states having different

⁷⁰¹ Decision 2007/75/EC

⁷⁰² EU JTPF, Report on Compensating Adjustments, DOC: JTPF/009/FINAL/2013/EN Brussels, January 2014

⁷⁰³ Glossary of the OECD Transfer Pricing Guidelines (TPG)

practices in this area, the Forum has made practical recommendations aimed at eliminating these outcomes in cases where adjustments are made in the accounts of MNEs. Member states are invited to accept compensating adjustments initiated by taxpayers if: reasonable effort is made to achieve an arm's length outcome before the relevant transaction described in its TP documentation is engaged (i); done symmetrically in the taxpayers accounts in both member states (ii); the same approach is consistently applied over time (iii); done before the tax return is filed (iv); and the reasons why an MNEs forecast fails to match actual outcomes is well explained (v). These recommendations in no way limit the tax administration's ability to make an adjustment of its own at a later stage.

The second issue in relation to which the Forum contributes in improving implementation of the ALS is the elaboration of practical guidelines on 'low-value-adding intra-group services'.⁷⁰⁴ The guideline is designed to respond to challenges that arise as a result of tax administrations having to allocate major resources in pursuing audits and resolving disputes on an issue that was hitherto seen as a routine aspect of intra-group trade. As resources get scarcer and the need for efficiency of current EU tax regimes grows, the Forum proposes the use of less resource-intensive approaches to evaluate ALS compliance for certain services, instead of standard resource-intensive ones that are currently being used. This approach takes into account factors such as cost pools, shareholder costs and allocation keys; based on the principles of deductibility of relevant costs *subject to domestic law*, availability of relevant and reliable information, and the flexibility of reviewers undertaking these analyses. The Forum's work on this issue was the basis of OECD's discussion draft on the elaboration Action Point 10 under the Base Erosion and Profit Shifting Action Plan.⁷⁰⁵

Improvements have also been proposed to cost contribution arrangements on services (CCAs)⁷⁰⁶ as effective means for carrying out MNE group activities. This is meant to complete the work on low value adding intragroup services and supplement existing OECD guidance relating to CCAs on services that do not result in the creation of intangible property (IP).⁷⁰⁷ Auditors are tasked here with ascertaining if the ALS has been applied to this category of CCAs. Reviewers seeking to determine whether a CCA is consistent with the ALS should examine if: the arrangement makes

⁷⁰⁴ On 25 Jan 2011 the Commission adopted [Communication 2011/16 on the work of the JTPF from April 2009 to June 2010 including proposed guidelines on low-value-adding intra-group services](#)

⁷⁰⁵ Discussion Draft on Low Value-Adding Intra-Group Services issued in November 2014 [infra]

⁷⁰⁶ On 19 Sep 2012 the Commission adopted a Communication ([COM/2012/516](#)) on the work of the EU JTPF in the period July 2010 to June 2012 including the report on CCAs on services not creating Intangible Property (IP).

⁷⁰⁷ The CCA differs from intra group services. In case of the former, costs, risks and benefits are shared between all participants to be contributed in cash or kind; whereas risks of not successfully and efficiently providing the service is generally borne by the service provider as concerns the latter.

business sense (i); the economic substance is consistent with the terms of the CCA (ii); terms of the CCA are agreed to prior to beginning the activity (iii); terms of the CCA take into account circumstances that are known to or reasonably foreseen by parties at the time of entering into the arrangement (iv); each participant has a reasonable expectation of benefit (v) or supports a share of the costs consistent with its share of the expected benefits (vi), assessed in quantitative or qualitative terms (vii); and shares are adjusted for participants who join the CCA in accordance with the ALP.

Further, it has developed practical recommendations to enhance effective implementation of the ALS with respect to small and medium enterprises (SMEs).⁷⁰⁸ Although SMEs represent about 99.8% of all European enterprises, this in principle is not such a big issue considering that only 5% of these SMEs trade with associated companies.⁷⁰⁹ This notwithstanding, tax administrations involved in implementing *standard TP rules* to SMEs have been faced by serious challenges on account of their size, lack of common definition of SMEs for tax purposes, lack of knowledge, limited experience and resources, and the undue administrative/financial burden that compliance with standard TP rules may cause to these category of businesses.

In order to facilitate *compliance* by SMEs *with the ALS*, the Forum has recommended that EU member states adopt a common definition of the term (SME) for tax purposes⁷¹⁰ and that the principle of proportionality be incorporated into substantive and procedural rules applicable to SMEs. This opens the way for tax administrations to simplify procedures as a means of reducing the problem of undue administrative burdens being imposed on SMEs. They could also explore the possibility of building constructive relationships with individual SMEs, using dialogue, access to information and training as means of enhancing voluntary compliance. Simplification of rules is likely to result in more beneficial outcomes for both parties. In light of this, states that have not yet made these reforms could be guided by measures already introduced by other EU states in doing so.⁷¹¹

Further, if an SME relying on the streamline approach decides not to produce documentation that was not required during the pre-audit phase, it is recommended that member states refrain from imposing documentation penalties. And, the Forum has encouraged tax administrations to fast track dispute resolution via use of their authority to unilaterally resolve claims for double taxation relief in

⁷⁰⁸ On 19 Sept 2012 the Commission adopted a Communication (COM/2012/516) on the work of the EU JTPF in the period July 2010 to June 2012 including the Report on SMEs and TP (SME Report) prepared by the JTPF. In its Conclusions of 4 Dec 2012 the Council of the EU welcomed the Commission Communication and the SME Report.

⁷⁰⁹ 2009 Annual Report on European SMEs (http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2009/annual-report_en.pdf, page 15).

⁷¹⁰ Using criteria like the balance sheet value, turnover, numbers of employees, and individual or cumulative transaction

⁷¹¹ France for instance has since adopted TP guidelines for SME's.

noncomplex low value SME cases. It would be helpful to also consider alternative approaches to resolving these disputes including for example promoting direct auditor-to-auditor contact.

Work on improving Transfer Pricing Compliance

Some improvements have been equally proposed in the area of TP compliance, notably with respect to the standardization of documentation and clarification of the masterfile concept. In response to the problem of companies doing business in the EU being subject by member states to onerous and diverse documentation obligations, the Forum has developed a Code of Conduct on TP documentation.⁷¹² Although it is understandable that fears of companies engaging in aggressive tax planning have led to member states tightening their documentation rules, this disposition greatly increases compliance costs and has proven to be a major obstacle to cross-border economic activities in the EU internal market.⁷¹³ In particular costs involved in finding appropriate comparables and preparing TP documentation seriously hit SMEs.⁷¹⁴ From this standpoint, the Code standardizes and partially centralizes rules on TP documentation as a means of reducing tax related complications for cross-border intragroup transfers⁷¹⁵ taking place between associated companies in the EU.

The Code is designed to respond to compliance related difficulties in the EU. It is meant to avoid the imposition of documentation penalties by improving the processes of preparing, maintaining and filing of TP documentation. The use of standardized TP documentation by companies is optional even though states have agreed to accept them as a basic set of information for assessing MNEs in cases where they are produced. SMEs are in principle not required to produce the kind of complex documentation required of MNEs. Generally, countries accept not to increase compliance costs unreasonably or to request documentation that is irrelevant to the transactions investigated. Further, documentation penalties cannot be imposed if the company complies in a timely manner with such standardized documentation requirements. It is worth pointing out that the Code is a mere political commitment that does **not** affect the rights, obligations or competences of member states.

⁷¹² On 27th June 2006, the Council adopted a Code of Conduct on TP documentation for associated enterprises in the European Union (EUTPD). This was part of a Communication of the European Commission adopted on 10 Nov 2005.

⁷¹³ Commission study "company taxation in the EU internal market" SEC (2001) 1681 of 23 October 2001

⁷¹⁴ JTPF, *Discussion paper on Documentation Requirements*, Working Paper Doc: JTPF/0019/2003/EN; Likewise, the JTPF examined PATAs experience with a Multilateral Documentation Package and judged it to be defective as it increased compliance time, effort, expenses, and is too broad -requiring irrelevant documentation to cases examined

⁷¹⁵ Resolution on a code of conduct on TP documentation for associated enterprises in the EU, OJ C176 (EUTPD) at <http://eur-lex.europa.eu/johtml.do?uri=oj:c:2006:176:som:en:html> [last visited Sept 6, 2015]; This code is based on the JTPF's work (IP/02/1105); Other important EU documents on the issue include a Report on the activities of the JTPF in the field of documentation requirements SEC(2005) 1477 (291 kB); Press releases IP/06/850 and IP/05/1403, on a code of conduct for TP; and Code of conduct on TP documentation in the EU – FAQ(MEMO/05/414 (63 kB))

As far as the standardization and partial centralization of documentation requirements is concerned, it covers all group entities that are tax resident in the EU. In order to permit/enable tax administrations fully assess risks of TP, multinationals are required to disclose detailed information on their operations in two sets of files. The first set of information known, as the '*masterfile*' contains common standardized information on all group members and is as such a useful log reference for all member states seeking to understand the MNE's global structure. The second set or '*local file*' comprises standardized documentation containing country-specific information that is separately prepared for each member state hosting a portion of the MNE's activity. These documents elucidate on the complexity of various transactions engaged in, and the structure of the enterprise used to facilitate them. Both files together constitute the *documentation file* that is to be made available to all administrations in the EU with an interest in the tax treatment of any transactions being examined.⁷¹⁶

The 'master file' is essentially a 'blueprint' of the MNEs relevant TP system developed on the basis of the economic reality of the business and made available to all EU states in which it operates.⁷¹⁷ It contains a *general description* of the groups:⁷¹⁸ global business and strategy including changes compared to the previous tax year (a); organizational, legal and operational structure notably an organizational chart, a list of group businesses and a description of the participation of the parent company in these subsidiaries (b); associated enterprises engaged in controlled transactions that involve enterprises in the EU (c); controlled transactions involving associated enterprises in the EU including flows of transactions,⁷¹⁹ invoices and amounts (d); functions performed, risks assumed including changes compared to the previous tax year *-moving from being a full distributor to a commissionaire* (e); ownership of intangibles *-patents, trademarks, brand names, know-how-* and royalties paid or received (f);⁷²⁰ inter-company TP policy/system explaining the arm's length nature of its transfer prices (g); list of CCA's, APA's and rulings covering TP issues engaged in by group members in the EU (h); and an undertaking by each domestic associate to provide any additional information upon request and within a reasonable timeframe in accordance with national rules (i).

The 'local file' supplements information provided in the 'masterfile'. It contains a detailed description of the:⁷²¹ business and business strategy, including changes compared to the previous tax

⁷¹⁶ s. 5.1 of Code of Conduct (Annex to the EU TPD)

⁷¹⁷ s. 4.1 of Code of Conduct (Annex to the EU TPD)

⁷¹⁸ s. 4.2 of Code of Conduct (Annex to the EU TPD)

⁷¹⁹ Such as tangible and intangible assets, services, and finances

⁷²⁰ 28.7.2006 EN Official Journal of the European Union C 176/3

⁷²¹ s. 5.2 of Code of Conduct (Annex to the EU TPD)

year (a); information describing and explaining country-specific controlled transfers notably flows of transactions, invoices, amounts (b); comparability analysis, including characteristics of the property and services concerned, functional analysis -*functions performed, assets used, risks assumed*, contractual terms, economic circumstances, and specific business strategies (c); processes used to select and apply TP methods (d); relevant information on internal or external comparables if available (e); and the implementation and application of the group's inter-company TP policy (f).

Work on Adversarial Procedures: Audits and Penalties

The Forum has also worked on improving adversarial procedures that are used within the EU, notably on the issues of secondary adjustments and TP risk management.⁷²²

In principle, a primary adjustment might be followed by "secondary adjustments", defined by the OECD Guidelines as "an adjustment that arises from imposing tax on a secondary transaction in transfer pricing cases".⁷²³ In this respect the Forum recommends ways to address risks of double taxation that might arise from the implementation of secondary adjustments ensuring that practice conforms to the EU's Parent Subsidiary Directive. In the EU, 9⁷²⁴ out of 27 member states have legislation on secondary adjustments. Legislation in some countries require tax authorities to effect "secondary transactions" in order to make the actual allocation of profits consistent with the *primary adjustment*. If the secondary transaction has tax consequences and leads to secondary adjustments, the result is likely to be double taxation. Where secondary adjustments are not compulsory, it has recommended that states refrain from making such adjustments if the outcome would be double taxation. If however, adjustments are compulsory and provided that the taxpayer's behavior is not suggestive of intent to disguise a dividend in order to avoid withholding tax, the recommendation is to prevent double taxation by using the MAP procedure or allowing an early repatriation of funds. Some EU countries would not impose withholding tax on associated enterprises doing business in the EU for secondary adjustments in situations where the parent, based in another EU state, has suffered liability under the primary adjustment. Even in cases where secondary adjustments are required, penalties as a rule would apply only to the initial TP adjustment and not to secondary ones.

⁷²² On 4 June the Commission adopted a Communication on the work of the EU JTPF in the period July 2012 to Jan 2014 which includes the reports on secondary adjustments, transfer pricing risk management and compensating adjustments.

⁷²³ A secondary transaction is a constructive transaction that a State might assert under its domestic TP legislation after having proposed a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment. These could take the forms of deemed dividends, equity contributions, or loans" That is items treated as though they are dividends, even though they would not normally be regarded as such

⁷²⁴ Austria, Bulgaria, Denmark, Germany, France, Luxembourg, the Netherlands, Slovenia and Spain

The Forum has also recommended improvements to the management of transfer pricing risks. The phrase 'transfer pricing risks' covers not only the risk that MNEs might not comply with the ALS, but also that tax administrations might not allocate scarce resources in an efficient manner when implementing compliance. Given both that the OECD has already done comprehensive work on this issue and that tax administrations have limited resources to deploy in tackling TPM, the Forum only touches on specifics observed within the EU. There is acknowledgment that even within the EU, the economic, legal and administrative settings in which transactions occur differ. It is not feasible in these circumstances to develop a universal approach for managing TP risks. Therefore, it falls to tax administrations to follow recommended general principles including the adoption of a cooperative approach based on dialogue and trust for cooperative taxpayers (i), identifying aspects which involve higher risks (ii), allocating resources mainly to areas with high risks (iii), creating relevant legal tools (iv), and tying the actions envisaged to the circumstances of cases being investigated (v).

Risks can be observed at three main levels: the initial, audit and resolution phases. The period before an audit is scheduled or the initial phase, is used to source information on the basis of which to make a reasoned judgment on whether to pursue or drop investigations. If need arises during the period when audits start to when they end (audit phase) to request additional information, a balance should be found between the needs of the fisc to source this information, and the burden such a request might place on taxpayers. Further to the tax administration taking a decision to commit resources to investigate compliance with the ALS, it needs to set up a work plan for TP audits. And, in the event that it (or other administrations involved in simultaneous or joint audits) disagrees with the taxpayer on aspects thereof, a decision needs to be made on whether this should be resolved within framework of the audit or deferred to the resolution phase. If such differences are judged to be resolvable via litigation or MAPs only, the Forum recommends that administrative frameworks be established to ensure the decision to proceed to resolution is taken in a timely and efficient manner.

*Transfer Pricing Dispute Prevention and Resolution*⁷²⁵

Lastly, the Forum's main achievement has been its work on improving implementation of the EU Arbitration Convention (AC) in respect of TP cases, and the recommended guidelines on ameliorating Advance Pricing Agreements (APAs) in the EU market area.

⁷²⁵ On 23 April 2004, the Commission adopted [Communication 2004/297 on the work of the JTPF in business taxation](#) (Oct. 2002 – Dec. 2003) and on a [code of conduct for the effective implementation of the Arbitration Convention](#). On 7 Dec. 2004 the Council adopted the proposed code of conduct.

Efforts in the EU to effectively Implement the Arbitration Convention of 1990 (90/436/EEC) have often met with challenges. To ensure effective and uniform implementation of this convention by all member states, the Forum has developed a Code of Conduct containing common procedures.⁷²⁶ The Code applies in cases where tax administrations in the EU need to increase the taxable profits of companies on their cross-border intra-group transactions. Examples of procedures covered are the: starting point of the 3 year deadline allowed companies hit by double taxation to file a complaint with the relevant tax administration (i); starting point of the 2 year period during which tax administrations concerned by the complaint must seek to agree on eliminating double taxation (ii); and practical operation, transparency and participation of the taxpayer in the procedure (iii). In the event that there is no mutual agreement between tax authorities during the 2 years allowed by the AC to resolve the dispute, an advisory commission would be established to arbitrate the dispute as part of the second phase of the dispute resolution procedure (iv). It is recommended that the collection of contested taxes be suspended during the duration of the cross-border dispute resolution procedure.

After assessing and finding flaws in the implementation of the original Code by EU members the Forum proposed revisions aimed at improving operationalization of the AC that was adopted by the Council in 2009. The revised code⁷²⁷ provides common interpretations on topics such as: serious penalties (i); expanding the ACs scope to include triangular TP and thin capitalization (ii); interest to be charged by tax administrations for cases dealt with under the AC (iii); the functioning of the AC in respect of deadlines for setting-up the advisory commission and criteria for establishing the independence of arbitrators (iv); and the date on which a case becomes admissible under the AC (v). It also touched on the interaction of the AC and domestic litigation procedures.

It appears EU members concerned by an MAP would face two main types of triangular cases when applying the ALS, namely, cases in which the third associated party to the transaction is tax resident within (*EU triangular cases*) or outside (*non-EU triangular cases*) the EU. Where all three associated enterprises are resident for tax purposes in the EU area, the revised code is designed to respond to triangular difficulties that arise in the course of implementing the Arbitration Convention. Where the third associated company is tax resident outside the EU, it might not be possible to fully resolve double taxation issues that arise from a chain of transactions if it is identified to be the source of non-arm's-length results. Approaches to resolving this kind of disputes are also proposed.

⁷²⁶ JTPF, *Code of conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises*, C 176/8 Official Journal of the EU 28.7.2006

⁷²⁷ Revised Code of Conduct for the effective implementation of the AC (Official Journal C322 of 30/12/2009)

In April 2015, the Forum agreed to further revise the Code to clarify application of the AC in cases where: the taxpayer changes its status to avoid taxes (i); access to the AC is denied (ii); implication of the new Art 7 of the 2010 OECD Model Tax Convention is concerned (iii); functioning of the AC is concerned including the 3 year period for an MAP to be engaged under Art. 6 (1) of AC (iv); and the issues of serious penalties, tax collection and interest charges are to be dealt with (v).

Finally, the Forum has elaborated guidelines to improve Advance Pricing Agreement procedures in the EU.⁷²⁸ The Guideline is based on best APA practices designed to obtain an efficient process in the resolution of specific TP issues and timeframes. For transactions covered by APAs, the aim is to provide certainty and simplicity to the process of selecting TP methodologies as means of avoiding costly and time-consuming TP examinations, disputes and double taxation. The proposals should reduce tax obstacles to cross-border economic activities within the EU, create savings for all parties involved, cut compliance costs and provide more consistency in matters of TP.

Regional effort to cooperate is only a part of the wider trend to improve cooperation between stakeholders. Another noticeable trend to build international cooperation platforms has been sectorial, an example being the EITI process (8.2.2).

8.2.2 Sectorial Cooperation -*Extractive Industries Transparency Initiative*⁷²⁹

The EITI is an example of how the public and private sectors can cooperate on solving International governance problems. Its creation has been a process of moving consensus, learning and adaptation, and strong leadership in enhancing transparency and accountability vis-à-vis tax payments in an industry.⁷³⁰ Academic research on the resource curse⁷³¹ during the late 1990s and early 2000s had prompted civil society activists to push for transparency of resource companies in their dealings with states via publication of tax payments to governments. In response BP released

⁷²⁸ Report on the work of the JTPF in the field of dispute avoidance and resolution procedures and guidelines for APA's in the EU –COM (2007) 71

⁷²⁹ Extractive Industries Transparency Initiative

⁷³⁰ An industry traditionally veiled in obscurity and managed as the exclusive domain of political elites and big corporations

⁷³¹ Led by academics like Jeffrey Sachs, Joseph Stiglitz and Paul Collier. This refers to a situation where some resource rich countries (oil, gas and mining) with potentially huge wealth earnings experience increased poverty, conflict and corruption, instead of economic development. The problem goes beyond the well-known economic phenomenon of 'Dutch Disease' by which natural resource wealth made other export sectors uncompetitive. Other common effects were around the capturing of the revenues by elites, the stunting of the development of tax systems to capture revenue from non-extractive sectors, exacerbated regional and community tensions. These writings outlined out the complexities of the governance of extractive resources – from bidding, exploration, licenses, contracts, operations, revenues, supply chains, local content, transit, services, allocations, and spending. They noted environmental, social and political concerns. They each outlined remedies for addressing the curse, often noting that no single action would be capable of tackling all these challenges. However, the literature was clear – transparency and dialogue had to be part of the starting point.

information on bonus payments to Angola, provoking a strong backlash from the latter. This showed that achieving progress on this issue depended on finding some kind of reporting standard in respect of which both *governments* and *companies* would participate. The EITI thus started as a voluntary corporate social responsibility standard for companies, but has since evolved into a collective public-private disclosure standard comprising twelve principles and seven implementation requirements.

Governance Structure

EITIs governance structure comprises a board, a secretariat and a member's conference. The EITI Conference takes place every two years and has as mandate to appoint the EITI Board of 20 members to represent implementing and supporting countries, industry, investment companies and civil society organizations. With the exception of the Chair, all Board members are entitled to an alternate to assist them. Further, the EITI Board "*may create committees [audit, implementation, validation] to further specific issues*"⁷³² in accordance with Article 14 of EITI Articles of Association. These committees reflect the multi-stakeholder nature of the EITI Association and have as role to facilitate the Boards job, as opposed to deciding on its behalf. The third organ is EITI's International Secretariat with responsibility to turn policy decisions into action and to coordinate global efforts between countries and providers of assistance in implementing the EITI. It manages a resource Centre on revenue management and transparency, performs oversight of the Validation process, and facilitates dialogue with all partners on exchanging global experience and information on the issue.

A Review of the EITI Standard

EITI is a collective governance standard comprising twelve *principles* that set out its aims, a total of seven *requirements* relating to its implementation and a *validation* process.

*The EITI Core Principles*⁷³³

EITI as it is known today mainly emerged from a Statement of Principles agreed between governments, extractive industry companies, multilateral organizations, financial organizations and non-governmental organizations at the Lancaster House Conference in 2003. These principles constitute the cornerstone of the EITI standard, and have been endorsed by all EITI stakeholders as

⁷³² For example, the Validation Committee in accordance with the EITI Standard reviews and makes recommendations on validation procedures to the EITI Board

⁷³³ EITI RULES, 2011 EDITION including the Validation guide EITI International Secretariat Oslo VERSION: 1 November 2011 https://eiti.org/files/2011-11-01_2011_EITI_RULES.pdf [Last visited September 13, 2015]

basis for increasing transparency over extractives sector payments and revenues. These are:

1. We share a belief that the prudent use of natural resource wealth should be an important engine for sustainable economic growth that contributes to sustainable development and poverty reduction, but if not managed properly, can create negative economic and social impacts.
2. We affirm that management of natural resource wealth for the benefit of a country's citizens is in the domain of sovereign governments to be exercised in the interests of their national development.
3. We recognize that the benefits of resource extraction occur as revenue streams over many years and can be highly price dependent.
4. We recognize that a public understanding of government revenues and expenditure over time could help public debate and inform choice of appropriate and realistic options for sustainable development.
5. We underline the importance of transparency by governments and companies in the extractive industries and the need to enhance public financial management and accountability.
6. We recognize that achievement of greater transparency must be set in the context of respect for contracts and laws.
7. We recognize the enhanced environment for domestic and foreign direct investment that financial transparency may bring.
8. We believe in the principle and practice of accountability by government to all citizens for the stewardship of revenue streams and public expenditure.
9. We are committed to encouraging high standards of transparency and accountability in public life, government operations and in business.
10. We believe that a broadly consistent and workable approach to the disclosure of payments and revenues is required, which is simple to undertake and to use.
11. We believe that payments' disclosure in a given country should involve all extractive industry companies operating in that country.
12. In seeking solutions, we believe that all stakeholders have important and relevant contributions to make – including governments and their agencies, extractive industry companies, service companies, multilateral organizations, financial organizations, investors and non-governmental organizations.

*The EITI Substantive Requirements*⁷³⁴

A review of the EITI process led to the conclusion that its narrow focus did not systematically deliver on the Principles above⁷³⁵ and that more was achievable if the platform encouraged broader improvements to natural resource management. Thus the Board undertook an extensive review of its strategy to ensure that EITI would provide more intelligible, comprehensive and reliable information (i); national dialogue on EITI would be lodged in broader natural resource governance by linking it to government tax collection, extractive policy, budget arrangements (ii); and incentivizing progress

⁷³⁴ EITI, *The EITI Standard*, pp. 10-34 <https://eiti.org/eiti/requirements> [Last visited September 13, 2015]

⁷³⁵ Shortly after the 2011 Paris Conference, an [evaluation of the EITI](#) by Scanteam was published. It recognized exciting innovations from many of the implementing countries – e.g. Liberia had included forestry and agriculture; Nigeria's reports included physical and process audits, as well as financial audits, etc.

beyond Compliance. By recommending the addition of *contextual information* in EITI Reports, this makes them more understandable⁷³⁶ and improves the relevance of EITI implementation in each country's context. The new requirements define the work plan for achieving desired objectives; comprises better and more accurate disclosures of payments⁷³⁷ (also electronic copies); recognizes countries that go beyond the minimum; and adopts a clearer set of EITI rules by condensing all previous 21 requirements and policy notes into seven concise requirements. These efforts resulted in the launching of a new EITI Standard in May 2013 that sets out the following EITI requirements:

1. Effective oversight by the multi-stakeholder group
2. Timely publication of EITI Reports
3. EITI Reports that include contextual information about the extractive industries
4. The production of comprehensive EITI Reports that include full government disclosure of extractive industry revenues, and disclosure of all material payments to government by oil, gas and mining companies
5. A credible assurance process applying international standards
6. EITI Reports that are comprehensible, actively promoted, publicly accessible, and contribute to public debate
7. That the multi-stakeholder group takes steps to act on lessons learned and reviews the outcomes and impact of EITI implementation.

Each implementing country has to adhere to these EITI requirements first as a '*Candidate*' and latter as '*Compliant*'. EITI Candidature is a temporary state during which a country aspiring to the EITI Association, is expected to satisfy *four sign up steps*, grouped together in the First Requirement relating to *effective oversight by the multi-stakeholder group*. As per this requirement a country is required to: (1.1) issue an unequivocal public statement of its commitment to implement the EITI; (1.2) appoint a senior individual to lead implementation of the EITI; (1.3) commit to work with civil society and companies, within a multi-stakeholder group that oversees implementation of the EITI; and (1.4) maintain a fully costed work plan with clear objectives that align to reporting and Validation deadlines established by the EITI Board (1.6-1.8). If the country completes these steps and wishes to be recognized as an EITI Candidate, it submits an EITI Candidate Application to the EITI Board that assesses whether the aspirant has demonstrated implementation of all these steps. If the outlined steps are met, then the country is admitted as an EITI Candidate.

⁷³⁶ Production data, description of the fiscal regime and how extractive industry revenues are recorded in national budgets, overview of relevant laws and of licenses and license holders, and a description of the role of state-owned companies. Countries are encouraged to publish contracts and details of the beneficial owners of companies.

⁷³⁷ By revenue streams, companies and eventually projects

Once a country qualifies as an EITI Candidate, the next implementation target is to become EITI Compliant. It is from this point that the Second Requirement sets in, the focus of which is the *timely publication of EITI Reports*. Reports are useful and relevant if published regularly and contain timely data. This requirement thus establishes deadlines for timely EITI Reporting. For example, an implementing country is required to produce its first EITI Report within 18 months of being admitted as an EITI Candidate, and to thereafter do so on an annual basis (2.1). Reports must cover data no older than the second to last complete accounting period, thus, a Report published in calendar/financial year 2014 must be based on data going back to no later than calendar/financial year 2012 (2.2). Finally, steps need to be taken to ensure every year is subject to EITI reporting and that the multi-stakeholder group agrees the accounting period covered by the EITI Report (2.3). The EITI Board could suspend a country that fails to publish its Report within the agreed deadline.

It is also important as per the Third Requirement that EITI Reports include *publicly available contextual information about the extractive industry* in order to be comprehensible and useful to the public. Issues to be covered in these reports include a summary description of the legal framework and fiscal regime (3.2); an overview of the extractive industries (3.3); contribution to the economy (3.4); production data (3.5); state participation in the extractive industries (3.6); revenue allocations and the sustainability of revenues (3.7-3.8), license registers and allocations (3.9-3.10); and, applicable provisions related to beneficial ownership (3.11) and contracts (3.12). It is the responsibility of the multi-stakeholder group to agree on who prepares the contextual information (3.1).

The Fourth Requirement outlines steps that stakeholders should take to ensure production of comprehensive EITI Reports, including full government *disclosure of extractive industry revenues and disclosure of all material payments to governments* by oil, gas and mining companies. The EITI requires a comprehensive *reconciliation* of company payments and government revenues from the extractive industries. This comprises specifics as to the types of payments and revenues to be covered in the EITI Report (4.1), and which companies and government entities/state-owned enterprises, are required to provide these data (4.2). An understanding of these payments and receipts is important in informing public debate regarding the governance of these industries.

Under the Fifth Requirement, *credible assurances* need to be provided that the EITI Report contains reliable data and that *international standards are applied*. Existing audit and assurance systems in government and industry should be built on the adherence to international best practices and standards. In this regard, the multi-stakeholder group needs to appoint an Independent

Administrator to reconcile data submitted by companies and government entities (5.1). Both the Independent Administrator and multi-stakeholder group are to be guided by certain considerations in agreeing the terms of reference for the reconciliation with *assurances provided by reporting entities* (5.2). Importantly, the Independent Administrator is empowered to assess the comprehensiveness and reliability of data and to recommend future improvements (5.3). Finally, the multi-stakeholder group has the mandate to endorse the EITI Report (5.4).

Further, EITI Reports should be *comprehensible, actively promoted, publicly accessible, and contribute to public debate* as per the Sixth Requirement. The hope is that regular disclosure of revenue streams and payments from extractive companies is of little practical use without public awareness, understanding of what the figures mean, and public debate about how resource revenues can be used effectively. This ensures that stakeholders get hold of information needed to engage in dialogue about natural resource revenue management.

The multi-stakeholder group in accordance with the Seventh Requirement is expected to take steps to *act on lessons learned and to review the outcomes/impact of EITI implementation*. Considering that Reports are designed to fulfill the EITI Principles by notably contributing to wider public debate, it is vital that lessons learnt during implementation of this process are acted upon. Therefore, it is important that discrepancies identified in EITI Reports are explained and addressed. Likewise, it is necessary that EITI implementation take place on a stable and sustainable footing.

*The EITI Validation Procedure*⁷³⁸

Within two and a half years of a country being admitted as an EITI Candidate it is required to commence Validation,⁷³⁹ the purpose of which is to assess compliance with EITI Requirements. Validation is EITIs quality assurance mechanism for judging country level performance and is overseen by the International Secretariat. It is as such an independent evaluation mechanism that safeguards the integrity of EITI by holding implementing countries to the same global standard, thus providing all stakeholders with an impartial assessment of whether EITI implementation in a country is consistent with the EITI Standard. Validation Reports address the impact, lessons, concerns and recommendations of EITI implementation. It is the bases on which the Board determines whether a country is compliant with the EITI Standard.

If the Board concludes from the Validation Report that compliance with EITI Requirements 1-

⁷³⁸ EITI Standard, supra note 755 at p.35

⁷³⁹ On 22 May 2013, the EITI Board agreed the revised [EITI Standard](#) including amended [Validation](#) procedures.

7 is demonstrated, it moves to designate such a country as EITI Compliant. Under current rules, EITI Compliant countries must undergo validation every three (3) years, or upon request from the EITI International Board. Validation is thus an essential element of the EITI process given that it provides an external assessment of EITI implementation, and serves to identify ways to strengthen the process. A Validation methodology that emphasizes the importance of dialogue and stakeholder consultation has been developed as basis for pursuing the Validation procedure ranging from procurement of the Validator to release of the Validation Report.

The International Secretariat informs the multi-stakeholder group of the initiation of the Validation process and its Terms of Reference. It procures an accredited Validator through a competitive bidding process, informs the multi-stakeholder group of the schedule for Validation, oversees the process in consultation with the multi-stakeholder group, and agrees to a timetable for completing the Validation process. A contract is signed between the Secretariat and the approved Validator clarifying its responsibilities and obligations of the EITI Board and Secretariat, at which point the implementing country would undergo Validation in accordance with the agreed schedule.

The Validator via a consultative process in which it meets with the multi-stakeholder group, Independent Administrator and other key stakeholders, assesses compliance with the seven EITI requirements. It consults documentation like the EITI work plan and planning documents, the multi-stakeholder group's Terms of Reference and minutes of meetings, EITI Reports and supplementary information, communication materials, annual activity reports, and other relevant information. The multi-stakeholder group is central in ensuring that the Validation process is thorough and comprehensive. EITI stakeholders have an opportunity throughout the process to comment on the effectiveness of EITI implementation, to opine on the fulfillment of EITI Requirements, and to make suggestions for strengthening the process.

The Validator then produces its draft Validation Report assessing whether EITI Requirements have been met, are unmet with meaningful progress, or are unmet with limited progress. The assessment should conform to the standard template provided by the International Secretariat comprising an introduction addressing key features of the extractive industries in the country, overall progress in implementing the EITI work plan, and a summary of government, civil society and industry engagements. Its findings are included in the report and a judgment is proffered on whether the country satisfies all of the EITI Requirements. In order to ensure comprehensiveness of the Validators draft Report in terms of providing adequate basis for establishing a country's compliance with EITI

requirements; the multi-stakeholder group and the EITI Board's Validation Committee review and comment the work. It thereupon submits to the EITI Board's Validation Committee a final Validation Report that comprehensively addresses comments from both the Committee and the multi-stakeholder group. The multi-stakeholder group is again invited to provide detailed comments on the Validator's final report, both of which are published on EITI's website.

Lastly, the EITI Board analyzes the final Report and decides on the basis of requirements 1.6 – 1.7 the status to give the implementing country. The Board may make recommendations for increasing the wider impact of the EITI. In the event that the final Validation Report does not provide sufficiently detailed information regarding compliance with the EITI Requirements, the Board may task the Validator with providing supplementary information. It is possible that there might be disagreement between the government, the multi-stakeholder group or the EITI Board over the Validation Report. These should first be dealt with by the Validator working in tandem with these groups to resolve disagreements, and for the Validator to make appropriate amendments in the Validation Report. If it isn't possible to resolve disagreements, mention is to be made in the Validation Report. However, serious disagreements concerning the Validation process are to be presented to the EITI Board for a solution to be found. The Board could reject complaints that are deemed trivial, vexatious or unfounded (Requirement 1.8).

It is worth noting that the Validation process is not complete until the Validation Committee resolves that the final Validation Report is comprehensive and provides an adequate basis for establishing the country's compliance with the EITI Requirements.

The Contribution of EITI in Tackling International Tax Avoidance

EITI undoubtedly encourages greater transparency in countries rich in extractive resources and its implementation sends a clear signal to investors and international financial institutions that a country is committed to accountability and good governance. Transparency in terms of tax payments to governments can also help to demonstrate the contribution that corporate investments make to a country. A great deal of data on revenue payments and collections is gotten from both government and companies, and put in the public space as a means of enriching debate on the issue. It can also be argued that the EITI has been a step change in extractive transparency,⁷⁴⁰ playing host to topics like beneficial ownership, production and consumer subsidies, the role and behavior of state owned

⁷⁴⁰ <http://progrep.eiti.org/2015/glance/lessons> [Last visited September 13, 2015]

companies, secretive contracts, aggressive transfer pricing, non-payment of taxes, smuggling and fraud that were hitherto considered to be politically sensitive subjects to release to the public. The debate is shifting and transparency in the extractive industry is no longer seen as an aspiration, but an expectation that is now being achieved through accountability and collective governance.

From an international tax perspective however, the EITI process is not specifically designed to respond to tax avoidance schemes in its current form. Therefore, it cannot be seen as an effective platform for achieving international tax anti-avoidance. However, the type of data gathered during the EITI process can significantly contribute in broader efforts to tackle tax avoidance schemes like TPM. For example, the new EITI Standard introduced in 2013 has significantly improved the reporting landscape with respect to the scope and depth of disclosures. Reports now *disclose disaggregated* data on revenues, breaking them down into individual companies, revenue streams and sometimes on a project-by-project basis. In some countries information on *licensing, production* and “*beneficial ownership*” of extractive companies operating in the country are disclosed. A look at Iraq’s report reveals a description of the process by which crude oil was sold to the 43 accredited buyers that, in 2012, purchased nearly 887 million barrels of crude oil worth US \$100 billions from the country. Further, template contracts for sales, technical services and development and production services are also annexed to the report. This kind of information could be very useful to tax auditors/officials who are working to reconstitute intragroup transactional flows.

Notwithstanding these benefits, the design of EITI remains limited when looked at from the prism of tackling international tax avoidance, as it is limited to assessing transparency over tax payments and collections. Compared to the JTPF that is designed to specifically promote cooperation in tackling TPM at the level of tax assessments, the EITI for its part seeks to enhance cooperation at the level of extractive industry stakeholders disclosing actual tax payments and tax receipts in a transparent and accountable manner. It is purposely limited to reconciliation of both company and government disclosures and does not go underneath the figures declared, to examine whether such payments were actually made on the appropriate/correct basis.⁷⁴¹ Whilst one easily understands the reasons for having this limitation,⁷⁴² it nonetheless remains a major shortcoming in terms of using the EITI as a viable cooperation platform for tackling international tax avoidance.

⁷⁴¹ Nigeria has taken steps to remedy this limitation by going a step further. One of the major findings of its EITI Report (second audit 2005) was that the state-owned Nigerian National Petroleum Corporation had failed to pay taxes and royalties to the government estimated in the range of \$US4.7 billion. (EITI Newsletter, Aug 2009, p. 2.)

⁷⁴² It takes time, trust, and experience to undertake the EITI program and as stakeholders grow used to each other and

If the EITI process is to have any meaningful impact in terms of revenue collections⁷⁴³ priority shouldn't be given to the simple objectives of getting the EITI process launched and publishing reconciliation reports. Whilst reconciliation reveals discrepancies in the declarations of companies and governments, it is unlikely to reveal the kind of gaps or vulnerabilities that invites corruption/mismanagement,⁷⁴⁴ or such cases where tax payments are substantially understated. For example, in countries where government institutions are weak and where perceptions abound that companies are not paying their fair share of taxes or royalties, or that the government is not fulfilling its obligation to effectively collect these taxes from the sector, there exists a strong reason to consider broadening EITI's scope. In these cases, it wouldn't be difficult to build consensus around having auditors test the accuracy of calculations of taxes and royalty payments by companies on a sampled basis. Such random "test checks" can uncover regulatory ambiguities or verify whether taxes and royalties are indeed being collected and paid with accuracy and on tax basis that are correct.

Hence, the EITI multi-stakeholders group may want to consider broadening and deepening EITI implementation on the bases of specific issues of importance to a country. Doing so would make the initiative more comprehensive and reliable, serving its core objective to improve the management of fiscal proceeds gotten from extractive industry operations. Indeed, Africa could draw from the combined experiences of the JTPF and EITI to build a cooperation platform that suits its needs.

8.2.3 Global Cooperation -*Base Erosion and Profit Shifting*

There has recently been a global focus on the need to cooperate in tackling issues of international tax avoidance, which is largely a consequence of rising fiscal deficits and austerity measures taken by some countries due to insufficient tax collections to cover public expenses. The precarious state in which state revenues have been recently plunged has attracted the attention of tax authorities, politicians and the media with respect to the contribution of taxes by business.

deepen their understanding of the industry, and achieve the objectives of the EITI a need emerges to take the EITI program a step further into carrying out a more in-depth inquiry. It is expected therefore that the EITI multi-stakeholder forum would be seen as only one component of wider efforts to promote transparency and anti-corruption measures in the extractive industries. It is technically a tool, not an end in itself and a voluntary method of gathering stakeholders together

⁷⁴³ Note that the reasons for which countries adopt the EITI differ. Some are looking to get started on transparency and accountability of governments and companies (i); and others focusing on ensuring that the country is realizing value for money (ii), building national trust (iii), improving a country's reputation (iv), creating a more competitive investment climate (v), maximizing tax and royalty collections (vi), educating the public about state and local spending (vii).

⁷⁴⁴ In order to makeup for this weakness, the Nigeria government used the EITI as a means to build trust by subjecting both government agencies and companies to an extensive audit of the extractive industries—from the production of oil to its fiscalization to where the money went to benchmarking all the major industry processes (such as licensing) against international standards. This resulted in significant systemic weaknesses being identified.

Background to the BEPS Project

These concerns pushed world leaders to start taking steps towards reversing the situation. In the final declaration of the 2013 G8 submit for example, members expressed amongst others their commitment to the following: that tax authorities should automatically share tax information to fight the scourge of tax evasion (i); countries should change rules that allowed companies shift their profits across borders to avoid taxes, and that the type of taxes and place of payment should be reported to tax authorities by MNEs (ii); companies should know their owners and tax collectors/law enforcers should be able to obtain this information easily (iii); developing countries should have the information and capacity to collect the taxes owed them, with other countries having a duty to help (iv); and extractive companies should report and publish tax payments to all governments (v).⁷⁴⁵ This last commitment is a clear endorsement of the EITI process discussed in subsection 8.2.2 [supra].

At the level of the G20 measures taken include endorsing the development of a new global tax standard for the automatic exchange of information with a challenge to get all jurisdictions to commit and implement the standard. Secondly, it was identified that collective efforts would be needed to also address base erosion and profit shifting (BEPS) resulting from international tax planning (ii). The main goals of BEPS were to focus on double non-taxation (or less than single taxation), facilitated by “cracks” between domestic tax systems and the perception that profits steadily being divorced from the geographical location where activities are really taking place. In response to the G20 mandate, the OECD Secretary-General produced a report in February 2013 outlining BEPS related issues, and presenting a comprehensive Action Plan to address them. The Action Plan sets forth an ambitious agenda to examine 15 fundamental issues in the international taxation regime including: the gaps between different countries' tax systems, whilst respecting the sovereignty of each country to design its own rules (i); examination of existing international tax rules on tax treaties, permanent establishment -*PE*, and TP to ensure that profits are taxed where economic activities occur and value is created (ii); establishing greater transparency via a common template to be used by companies to report their global allocation of profits and taxes to tax administrations (iii); and a timeline of between 18 to 24 months to deliver on these actions (iv).⁷⁴⁶

⁷⁴⁵The 2013 UK G8 Presidency Report entitled *Trade, Tax & Transparency*, p.2 at www.gov.uk/government/uploads/system/uploads/attachment_data/file/248907/130925_DP_progress_rpt.pdf. [Last visited: Sep. 6, 2014].

⁷⁴⁶ See *Tax Annex to the Saint Petersburg G20 Leaders Declaration*, pp.1-8 at <http://www.g20.utoronto.ca/2013/2013-0905-tax.html> [Last visited: Sep. 6, 2013].

Actions Proposed by the OECD to Address BEPS

The OECD's Action Plan for the BEPS project covers the following fifteen topical areas: the digital economy (1); hybrid mismatch arrangements (2); Controlled Foreign Companies (3); financial payments (4); harmful tax practices (5); treaty abuse (6); PE status (7); TP and intangibles (8); TP and risks/capital (9); TP and other high risk transactions (10); data and methodologies (11); disclosure of aggressive tax planning (12); transfer pricing documentation (13); dispute resolution mechanisms (14); and a multilateral instrument (15). Although all fifteen points on the BEPS Action Plan are tremendously important to efforts aimed at developing fairer, transparent and efficient rules to tackle international tax avoidance, five are particularly important to the present study and ongoing work on these issues are hereinafter reviewed.

BEPS Action Plan: Action 11 - Establish Methodologies to Collect and Analyze Data on BEPS⁷⁴⁷

The need to develop recommendations on the indicators and necessary tools for monitoring and evaluating the effectiveness of actions taken to address BEPS on an ongoing basis was noted in the Action Plan. This involves assessing a range of existing data sources and identifying new types of data that should be collected. It further entails developing methodologies based on both aggregate (FDI and balance of payment data) and micro-level (from financial statements and tax returns) data, taking into consideration the parallel imperatives to protect confidentiality of taxpayer's information and costs to be borne by tax administrations and businesses in the process.

In spite of difficulties linked to achieving this goal, it seems the OECD has not given up on the idea of continued economic analysis of existing data to determine the scale of BEPS. The goal now is to establish methodologies to collect and analyze data on BEPS and to focus on actions to address it. In this regard the discussion draft published on 16 April 2015, whilst noting as 'severely constrained' any assessments of the extent of BEPS, proposes indicators to be used in making this assessment. These BEPS assessment indicators proposed in the draft include: the relative concentration of net FDI to GDP (i); high profit rates of low-taxed affiliates of top global MNEs (ii); high profit rates of MNE affiliates in lower tax countries (iii); profit rates compared to effective tax rates (ETRs) for an MNE's domestic and foreign operations (iv); ETRs of MNEs compared to comparable domestic firms (v); relative concentration of royalty payments relative to R&D expenditures (vi); and interest expense to income ratios of top global MNE affiliates in high statutory tax rate countries (vii).

⁷⁴⁷ Tax Annex to the Saint Petersburg G20 Leaders Declaration 8/28/14 5:44 AM
<http://www.g20.utoronto.ca/2013/2013-0905-tax.html> Page 7 of 8 [Last visited September 9, 2015]

The two alternative approaches proposed to measure BEPS are *extrapolation* from studies assessing the impact of tax rate differentials on the movement of profit from one location to another (i), and *adding the amounts* identified for each separate BEPS channel (per the Action Plan) with an adjustment for interactions between them (ii). Doubt nonetheless abounds as to whether existing and other data sources are adequate basis for performing reliable analyses. The draft does not propose new tools for monitoring and evaluating the effectiveness and economic impact of the actions taken to address BEPS. Neither does it propose new types of data that might be helpful analyzing BEPS, nor whether business should be asked to provide that data.⁷⁴⁸ Nonetheless, this is work in progress in relation to which the OECD has requested inputs (*from targeting academics*) and public comments in its efforts to establish methodologies to collect and analyze data as relates to this BEPS action.

BEPS Action Plan: Action 12 – Disclosure of Aggressive Tax Planning Arrangements

The OECD also proposed to develop mandatory disclosure rules designed for aggressive transactions or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. It provides maximum consistency and country specific needs, for example exploring the use of a wider definition of "tax benefit" in order to capture all international tax schemes. This would be coordinated with work on cooperative compliance, and the putting in place enhanced models of information sharing for international tax schemes between tax administrations.

The OECD on March 31, 2015 released a discussion draft dealing with mandatory disclosure rules or regime (MDR) for international tax schemes.⁷⁴⁹ Whilst the need to identify mass marketed pre-packaged schemes is legitimate⁷⁵⁰ the real challenge however, is to effectively target such schemes without creating an enormous compliance burden for the vast majority of MNEs and intermediaries whose commercial affairs happen to need cross-border advice. It can be argued that simultaneous efforts outside the BEPS project to change international tax standards, to increase cooperation between jurisdictions, and alternative methods for addressing avoidance activities are enough to cause the OECD to seriously review the costs and potential benefits of recommending any new disclosures for international tax arrangements since these could be addressed elsewhere.

⁷⁴⁸ <http://www.pwc.com/gx/en/services/tax/tax-policy-administration/beps/the-digital-economy.html> [visited Sept 13, 2015]

⁷⁴⁹ Other elements including coordination with work on cooperative compliance; and enhanced models of information sharing between tax administrations, will be addressed in due course, partly under BEPS and partly in other initiatives.

⁷⁵⁰ Examples of these are designed to rely on limited or no disclosure and which aim to provide absolute tax benefits or cash flow advantages from delays in paying the tax due

BEPS Action Plan: Action 13 – Re-examine Transfer Pricing Documentation

Asymmetries in information on TP between taxpayers and tax administrations theoretically enhance opportunities for BEPS since the ‘big-picture’ view of a taxpayer’s global value chain is often not available. Coupled with the significant costs to business of countries adopting different TP documentation requirements, work is ongoing to develop new rules that enhance transparency for tax administration whilst taking into consideration costs of compliance. The aim is to ensure that MNEs use a *common template to provide all relevant governments with needed information on their global allocation of income, economic activity and taxes paid among countries*. Whilst there is potential for this kind of information to be used inappropriately by tax authorities or accessed and used anti-competitively, it is for tax administrations a useful tool for risk assessment providing the Fisc with adequate information to better allocate limited resources by focusing on risk proven areas.

The OECD released a Memo in October 2013⁷⁵¹ providing clear indications of the type of information that would likely be required in the country-by-country reporting template. In its Working Party 6 (WP6) the OECD addressed *country-by-country reporting* and broad issues surrounding the master/local file. It proposed a “two-tiered approach” comprising: the preparation of detailed global and country specific files as part of a risk assessment process (i), and information to be reported on a country-by-country basis as part of enhancing transparency for tax administrations (ii). In a discussion draft on the issue,⁷⁵² the OECD proposed to increase reporting obligations through a mandated list of documents to be included in a TP documentation package, including the country-by-country information. It also noted its intention to give further consideration to whether information relevant to other (non-transfer pricing) aspects of tax administration and the BEPS Action Plan would be included in the common template. This would expand documentation requirements to well beyond TP risk assessment. Whilst the desire of tax authorities around the world to have access to relevant tax reporting information is legitimate, the proposed rules present two main concerns.

Firstly, the two-tiered approach for documentation could result in significant implementation and compliance burdens on taxpayers in a way that is disproportionate to any benefits it seeks to secure. Secondly, it was not clear from the draft how the OECD intended to secure the treatment of

⁷⁵¹ The OECD’s memorandum of 3 October 2013 on transfer pricing documentation and country-by-country reporting as part of Action 13 forms...

⁷⁵² *A discussion draft released on 30 January 2014 poses a number of difficult questions, that should have been answered by 23 February 2014*

what could be proprietary and sensitive information.⁷⁵³ These and other concerns led the OECD in its second BEPS update webcast on the country-by-country (CbC) to clarify that:

- CbC will not be part of the master file, **but a separate document**
- Financial data reporting will be on an aggregate countrywide basis not entity by entity (including revenues, profit before tax, cash tax paid, current year tax accrual, numbers of employees, tangible assets, capital and retained earnings);
- The transactional reporting requirement – for interest, royalties and other intercompany payments – will be removed from CbC (and will only be in the local file for entities doing business there)
- The list of entities and permanent establishments (PEs) in each country will be required with the proposed nature of business codes
- There will be an option to build from either statutory or other financial reporting so long as the method is applied consistently across the group and from year to year
- There will be flexibility as to whether the master file is on a group-wide basis or by line of business
- The intention will be made clear in plain language that the master file is for high level reporting, and
- The need to report the 25 highest paid employees will be removed from the master file.

The OECD further clarified in its webcast of May 2014 that CbC information would be reported to tax authorities at a very high level and for risk assessment only.⁷⁵⁴ It scheduled to release in January 2015 an implementation 'tool' on how the master file and CbC template would be shared. It is worth noting that the G20 has since agreed proposals on TP documentation relating to the *master file* and *local file* broadly on the basis of what was already announced.

As concerns CbC reporting, it is now confirmed that the data points required to be reported for each country will include: revenues from both related and unrelated party transactions (i); profit before income tax (ii); income tax paid on a cash basis (iii); current year income tax accrual (iv); stated capital (v); accumulated earnings (vi); number of employees (vii); and tangible assets excluding cash and equivalents (viii). Further, the template has been designed to highlight low-tax jurisdictions where significant amounts of income are allocated without some “proportionate” presence of qualified employees to make a “substantial contribution” to the creation and development of intangibles. Concerns regarding the confidential handling of this data and the potential that it could also be used by tax administrations to perform formulary apportionment (instead of the ALS) with

⁷⁵³ On this issue PwC suggest that more stringent confidentiality regime - i.e., requiring the master file and CbC template to be submitted to the parent company's home tax authority and distributed only through relevant provision and upon request (together with real sanctions for countries that violate confidentiality provisions);

⁷⁵⁴ This is a quantitative exercise and not a qualitative one- so, for example, information on intangibles - which often not valued – would be required only in the master and local files as it was too much of a burden to require it compared to the benefit for risk assessment purposes; See [OECD's webcast today](#)

respect to TP adjustments were noted. Likewise, some countries (Brazil, China, India, and other emerging economies) indicated their desire to have further data points added to the template (royalty, interest, related party service fees). As a compromise the OECD agreed to review implementation and to decide whether there should be reporting of additional or different data before 2020. OECD has not secured absolute consensus on the arrangements for the sharing of the master file and CbC information (confidentiality) although its inclination is to finalize arrangements along the lines of such information being exchanged only pursuant to treaty or tax information exchange agreements.

In June 2015, it released a “Country-by-Country Reporting Implementation Package” comprising *model legislation* that it hopes countries could use to mandate filing of *country-by-country reports* (CbCRs). It is worth noting that the model legislation proposed does not attempt to address the filing of the so-called *master file* or *local file* reports. The implementation package further includes *three model competent authority agreements* that could be used by each country to exchange CbCRs namely via the “Multilateral Convention on Mutual Administrative Assistance in Tax Matters” (i), the exchange of information article of a bilateral tax convention (ii), or a bilateral tax information exchange agreement (iii). Additional guidance is not given in both the model legislation and model competent authority agreements on exact data that MNEs are expected to provide in the CbCRs.⁷⁵⁵ Instead, the model legislation describes data in general terms and provides that it is to be provided in a form identical, and applying the definitions and instructions contained in the “standard template” set out either in the OECD Transfer Pricing Guidelines, the final report on BEPS Action 13, or an appendix to the legislation once adopted. It is likely that the “standard template” referred to will look like the CbCR template set forth in the OECD’s first report on Action 13 released on 16 September 2014. As a next step, the implementation package indicates that, a “schema” and “related User Guide” will be developed in order to accommodate the electronic exchange of CbCRs.

Great emphasis is now being placed on the need for countries to protect tax information confidentiality. The proposed solution is for CbC reporting to be done by the MNE’s parent entity in the country of its tax residence, which information can then be exchanged on an automatic basis with relevant jurisdictions in which the MNE group operates. A secondary mechanism being considered is using local filing or by moving the obligation for requiring the filing of the CbC Reports and automatically exchanging these reports to the next tier parent country. The OECD country-by-country implementation package requires MNEs with a turnover above EUR 750 million in their countries of

⁷⁵⁵ PWC (2015), *Supra* note 749

residence, to start using the reporting template for fiscal years beginning on or after 1 January 2016 such that tax administrations will begin exchanging the first country-by-country reports in 2017.

BEPS Action Plan: Action 14 – Make Dispute Resolution Mechanisms More Effective

This action addresses obstacles that prevent countries from solving treaty-related disputes under the mutual agreement procedure (MAP) or arbitration provisions, and the fact that access to MAP and arbitration may be denied in certain cases. The OECD's discussion draft of 18 December on this issue recognizes that actions to counter BEPS should be complemented with improvements to the MAP. However, the OECD notes that it is unlikely that global consensus on mandatory binding arbitration can be achieved in the near term and therefore proposes that MAPs be improved as basis of a three-pronged framework comprising: (i) political commitments to effectively eliminate taxation that is not in accordance with the tax treaty in question; (ii) a monitoring mechanism *-peer review by competent authorities-* to ensure proper implementation of the political commitment; and (iii) new measures to improve access to MAP and arbitration procedures.

However, the MAP process is known to be lengthy, inefficient and unpredictable and many tax authorities lack sufficient resources to sustain them. The introduction of BEPS and government unilateral actions will only place further strain on administrative processes in relation to which the draft proposes administrative best practices such as allocating *sufficient resources autonomous from tax audits* and *incentives to resolve cases* as basis for mitigating this eventuality. The four principles adopted with a view to implementing these best practices include: (i) ensuring that MAP-related treaty obligations are fully implemented in good faith, that is, an obligation for competent authorities 'to seek to resolve' cases in a 'practical, fair and objective manner'; (ii) authorities should promote prevention and resolution of treaty-related disputes; (iii) taxpayers can effectively access MAP when eligible; and (iv) that cases are resolved once they are in MAP. Further, the OECD is encouraging the use of alternative dispute resolution options, such as bilateral Advance Pricing Agreements (APAs), which proactively increases certainty whilst decreasing risks of double taxation.

Reflections on How Effective BEPS will be

Considering the scope and importance of issues being considered under the BEPS project, it is observable that the timeframe proposed for completing the BEPS Action plan is quite tight. It was projected that at least half of the BEPS Action Plan would be completed by September 2014, and the remainder by September-December 2015. The phases of monitoring and additional/on-going actions

would commence from 2016 onwards. The OECD has been struggling to meet these deadlines. This limited timeframe notwithstanding, there is hope of the OECD achieving its stated objectives.

Firstly, much of the important reforms to international tax rules being proposed (*threshold PE changes and beneficial ownership*) are the result of work that has already been agreed by the OECD in the run up to BEPS. Further, some material work was already in progress pre-BEPS on certain themes that are now central BEPS Actions including IP and TP, and transparency and disclosure measures. Far from BEPS being the driving force to such changes, it is observable that clear behavioral shifts by tax authorities had already been observed in this area and on many of these issues. Above all there is unprecedented political backing for these reforms, which provides an added incentive to to finalize the BEPS package of international rules. Besides, the risk of reverting to unilateral tax reforms is high since the specter of continuous unilateralism looms in the air should the package falter. This gives an impetus for stakeholders to find consensus in its development with an overall material impact envisaged as the OECD begins firming these reforms.

8.3 Proposed Platform for Cooperation in Africa

As African countries move to develop a cooperation-based platform for tackling TPM, they have to address challenges linked to set creating the TPSF (8.3.1) and its institutional outlook (8.3.1).

8.3.1 Challenges Linked to Creating the TPSF

Instituting the proposed platform requires engineers to address **substantive** issues linked to its structure, composition and competence. Two key challenges are likely to be faced by governments looking to cooperate on the issue of improving the collective effectiveness of tax anti-avoidance regimes in Africa. Firstly, it is to be expected that most governments would concomitantly aim to *retain tax sovereignty whilst achieving cooperation*.⁷⁵⁶ Secondly, an *acceptable format of cooperation* designed to enhance both these objectives (sovereign and cooperation) would have to be found.

Tax Sovereignty as a Challenge

State sovereignty is the result of historic normative processes codified in the Treaty of Westphalia (1648), Congress of Vienna (September 1814 to June 1815) and the Vienna Convention

⁷⁵⁶ Examples include information sharing, joint international audits, mutual enforcement of foreign tax laws to name a few

on the law of treaties (1969). The principle of sovereignty gives states the right to political self-determination, to control their people and territories, and to handle governance of its economic affairs. Faced by globalization and the growing influence of international organizations however, the notion is in crisis as the agency to act on a significant range of cross-border issues is no longer the exclusive preserve of states. It's even argued ('realists') that these institutions are increasingly proving to be avenues by which powerful states usurp and exercise the sovereign competences of weaker ones. Unless states stay prudent during the design phase it is likely that they would inadvertently cede certain important sovereign powers to institutions, only to be wielded by others in the pursuit of goals that they might not have intended. This partly explains the reluctance by many states to grant these institutions agency over a range of strategic issues, or to support designs that result in the creation of centralized international authority.⁷⁵⁷ In cases where institutions have proven to optimize the interest of its members, states have often been willing to cooperate on certain international issues.⁷⁵⁸

Taxation is an important aspect of sovereignty and states have historically tended to resist all forms of cooperation that limit their authority to exercise unbounded powers to tax economic activities within (or sometimes even beyond –USA) their borders. This is mainly explained by the reliance of governments on taxes to fund the bulk of public expenditures and to regulate economic activities. Unless cooperation is meant to optimize tax revenues and to tackle international tax avoidance, it is unlikely that states would accept to cede parts of sovereign authority on tax issues under domestic laws⁷⁵⁹ or tax treaties. They are likely to prefer “cooperation under anarchy” where the possibility of centralized enforcement is ruled out.⁷⁶⁰ This approach is rooted in the *revenue rule* by which one state would not assist another to enforce its tax laws. Examples include investment treaty frameworks in relation to which governments are for economic and political reasons unwilling to limit their ability to act or react on issues of taxation.⁷⁶¹ This has effectively limited the ability of states to cooperate on

⁷⁵⁷ Koremenos, et al. (2001), supra note 690 at p.771

⁷⁵⁸ For example, some EU members have ceded monetary policy to the ECB, and fiscal policy to the Commission.

⁷⁵⁹ For example, through granting partial or total tax relief if it opts to

⁷⁶⁰ Oye K.A. (Ed.), *Cooperation Under Anarchy*, Princeton University Press, 1986. He worked on why, given the anarchy between states, cooperation emerges in some cases and not others. His two main questions were: “What circumstances favor the emergence of cooperation under anarchy?” and “what strategies can states adopt to foster the emergence of cooperation by altering the circumstances they confront?” The three “circumstantial dimensions” that explain or promote cooperation are: payoff structure, shadow of the future (Axelrod's term), and **number of players**.

⁷⁶¹ There is an investment law perspective to the issue of tax sovereignty. Normally, only the extreme case of ‘confiscatory expropriation’ via use of taxation has been opened to arbitration, although recent developments in the area of direct investor-state arbitration, has opened new possibilities to examine taxation matters that is clearly not dependent on domestic adjudication systems. See Walde, T. & Kolo, A., *Investor-State Disputes: The Interface Between Treaty-Based International Investment Protection and Fiscal Sovereignty*, INTERTAX, Volume 35, Issue 8/9 # Kluwer Law International

closing actual loopholes in existing tax regimes. The reticence can be eased by building any emerging *cooperation platforms* around the ALS that is less likely, unlike UT, to require states to cede their sovereign powers on taxing multinationals to any such institution.

Alternative Formats of the Proposed Platform

The story of international institutions in Africa has been unsettling with many prior initiatives proving unsuccessful,⁷⁶² often for reasons of inadequate funding and asymmetrical interests.⁷⁶³ This record would have to be considered in deciding the format to give to any proposed platform. The options available are to either develop it *from scratch* or to *extend already* existing platforms.

Firstly, while empirical evidence suggests little prior inclination in Africa to cooperate on pressing taxation issues, this is now gradually changing as the realization sets in that international tax challenges can only be effectively tackled through genuine collectivization of efforts. This requires major changes to the way existing international taxation challenges and the institutions created to address them are perceived. The proposed institutional reforms are aimed at ameliorating performance on issues of data gathering, information exchange, enforcement of tax claims, and technical assistance. In principle, these goals could be achieved in Africa by creating an entirely new cooperation-based platform. This option is not ideal given the costs involved.

A second approach is to simply expand already existing institutional frameworks to accommodate aspects of the proposed cooperation-based platform. Two organizations in Africa already operate viable platforms on basis of which the TPSF can be built, namely, the AU's Economic Affairs Department and ATAF. The AU's mission is to forge "an efficient and value-adding institution" that drives Africa's integration and development processes in close collaboration with AU member states, Regional Economic Communities and African citizens. It has agency on issues of trade and industry, infrastructure and energy, social affairs, rural economy and agriculture, human resources, science and technology, and **economic affairs**. The last of these agencies is handled by the Economic Affairs Department (EAD) which comprises four divisions: *Economic Integration and Regional Cooperation* (i);⁷⁶⁴ *Economic Policies and Research* (ii);⁷⁶⁵ *Private Sector Development/*

2007, pp.424-449

⁷⁶² Replacement of the OAU with the African Union is a good illustration of this point.

⁷⁶³ However, some institutions in Africa already cover aspects of the ATPSS's proposed scope.

⁷⁶⁴ Responsible for implementing the Abuja treaty on the African Economic Community; This would be achieved via coordination and harmonization of activities of regional economic communities. The AU recognizes 8 REC's including ECOWAS, COMESA, ECCAS, EAC, SADC, CEN-SAD, IGAD and UMA

Investment and Resource Mobilization (iii);⁷⁶⁶ and *Statistics* (iv).⁷⁶⁷ These divisions are not focused on tax issues and cannot be relied on to lead tax policy and implementation reforms in Africa given its present structure. It doesn't provide the kind of platform that is needed for states to cooperate on TP issues thus making it likely that a fifth division would be required to achieve this objective. Given, however, notable bureaucratic hurdles bedeviling the AU's institutional complex, it is doubtful if this approach is the appropriate one to adopt.

ATAF for its part was created to drive Africa's tax reform agenda, and already has elements of cooperation built into its vision, mission, mandate and objectives.⁷⁶⁸ It aims to grow into a well functioning international organization that provides a needed platform to enhance efficiency and effectiveness of tax administrations in improving living standards in Africa. ATAF's agency is to build capacity of African tax administrations, improve the role of taxation in Africa's governance, give Africa's tax administrations a voice, and develop and support sustainable partnerships between Africa and its development partners. Its institutional framework comprises a *general assembly*,⁷⁶⁹ *council*⁷⁷⁰ and *secretariat*. It is worth noting that although ATAF already incorporates the tax cooperation philosophy into its institutional framework, it has not as yet created a facility to support members on **transfer pricing** issues. It is arguably the most appropriate platform to host the proposed TPSF.

8.3.2 Institutional Outlook of the Transfer Pricing Support Facility

Countries often participate in international institutions to advance individual and eventually collective goals,⁷⁷¹ such that institutional designs are hardly random but the result of rational

⁷⁶⁵ That hosts the conference of African Ministers of Economy/Finance and financial institutions like the African Central Bank, African Investment Bank, and African Monetary Fund

⁷⁶⁶ That oversees mobilization of development financing, improves conditions for private sector activity and Africa's share of global investment flows as a means to realize growth, job creation and poverty alleviation, <http://ea.au.int/en/PrivateSector%20> [Last Visited: September 7, 2014].

⁷⁶⁷ That generates timely, reliable and harmonized statistical information, covering all aspects of political, economic, social and cultural integration of Africa

⁷⁶⁸ ATAF was inspired by deliberations at the International Conference on Taxation, State Building and Capacity Development in Africa that held in Pretoria South Africa August 28-29, 2008. Senior Tax administrators and policy makers of 28 African countries resolved to work together to establish the forum

⁷⁶⁹ It is a platform for strategic dialogue between members and stakeholders. Membership is open to all African states, and international organizations are associate members. The GA currently comprises 36 African countries.

⁷⁷⁰ The council is made up of 10 members responsible for the supervision of ATAF's day-to-day business and implementation of the GA's recommendations. The Council comprises 3 governance committees. These are the governance and organizational development committee that reviews ATAFs strategic direction; the finance and audit committee that handles financial planning, management and reports; and the committee on capacity building, research & development and Technical assistance that directs ATAFs work on these issues.

⁷⁷¹ Based on the rational functionalism approach, grounded in the rational choice theory discussed in Chapter 2.2

purposive choices by states. In this context, expected distributional outcomes between countries might substantially differ thus increasing the range of outcomes to be negotiated by parties and for which consensus needs to be found. If the subject of cooperation were streamlined to cover a specific issue of common interest only, for example transfer pricing, then the burden on the systems design of apportioning distributional outcomes would be significantly diminished. The issue turns to finding an appropriate platform within which African countries making rational purposive choices, can cooperate to produce satisfactory mutual outcomes for all participants. Considering the historical precedence of failed institutions on the continent and the resistance that centralized formats of cooperation are likely encounter, it is more plausible to envisage creating cooperation platforms that are consultative and/or advisory in nature.⁷⁷² This has the advantage of providing long-term sustainability. The TPSF platform that is hereinafter proposed adopts this approach. The paragraphs that follow successively examine the *institutional outlook* and the *scope of competences* of the proposed TPSF.

Institutional Outlook/Framework

Until recently, efforts in Africa to tackle increasingly complex international tax avoidance schemes have been given a domestic orientation and have traditionally made very little provision for broad-based interstate cooperation. This approach is disadvantageous in that unintended loopholes are created in the tax gathering system that has been extensively exploited by MNEs. This has led mounting pressures on governments worldwide to reform the system. Aspects of such an institutional framework that is proposed in this study (TPSF) are presented below. These include an overview of its structure and agency, its composition/membership, and a picture of its stakeholder matrix.

The TPSF's Structure, Agency and Voting Rights

The **structure** proposed for the TPSF is pretty modest considering it was earlier proposed that it could be hosted by an already existing organization in Africa (**ideally by ATAF**). This is akin to the EU-JTPF format previously discussed. Under this format there isn't need to create a permanent secretariat, council, board, or even an Assembly since such institutions already exist within the host organization. It suffices to appoint an **Advisory Group of Transfer Pricing Experts** to serve as the

⁷⁷² International organizations are of different types. Some are global with open membership, while others are regional with restrictive membership. Voting rights also differ. In some equal voting rights are given while in others such rights are weighted. Decisions could also be made on the basis of a unanimous vote, in other cases a simple majority vote, or in yet others on a supermajority vote. Some have significant operating capabilities and responsibilities while others a basically consultation forums. And, in others relations are not even organized in the form of an organization but simple bilateral codification of relations between participating states in treaties: See Koremenos, et al., supra note 7 at p.2

focal group for reforms and reflections on enhancing Africa's reforms on transfer pricing. It is worth noting that a less stretched version of what is currently being proposed is being pursued by ATAF on basis of a mandate by its members following a consultative conference on the New Rules of the global tax agenda held in March 2014. ATAF was asked to establish a *technical team* to examine the various BEPS actions and also to develop viable mechanisms via which African countries would input the BEPS process. It has since constituted a technical committee to advise members on issues of base erosion in Africa, to input the perspective of African countries at the OECD and to facilitate training and write-ups on new developments in the tax arena.⁷⁷³

Under the current proposal however, it is envisioned the TPSF would be a dedicated platform assigned the **mandate to advise** African countries on the challenging task of reforming the policy and legal landscape in Africa relating to TP. Short or long-term advice on TP issues would be provided automatically or following requests from participating countries. The aim is to materialize effective intergovernmental cooperation –*with input from non-state stakeholders*– on issues of TP policy and implementation in ways that optimize revenue mobilization efforts in Africa. The essence of its work should be directed at collectivizing efforts to improve the legal architecture and engineering of domestic and international TP frameworks, and to further enhance through tested recommendations the capacity and effectiveness with which newly adopted frameworks are administered. Naturally, the proposed framework would cover all key aspects of the BEPS initiative as far as they relate to tackling transfer pricing [see 8.2.2 supra] and the mechanisms for disseminating its work⁷⁷⁴ to tax administrations and other stakeholders would also be developed.

Further, members need to agree **voting arrangements**. Issues that should be considered include whether all members should have equal voting rights, or some should be given more control of the process over others. The likely outcome of the latter is that non-influential members would often be presented with *fait accompli*, forcing them to accept outcomes that might leave them worse-off than they were before joining.⁷⁷⁵ In due course, such imbalances are untenable and are likely to create tensions in the TPSF. To avoid this possibility, it is proposed that the first option namely equal voting rights and a simple majority voting system be adopted as basis for the decision-making process. This option accommodates the legitimate interest of all participants by consolidating the need for consultations, negotiations and compromises as the basis for cooperation.

⁷⁷³ <http://www.ataftax.org/en/TaxPrograms/Pages/BEPS.aspx> [Last visited: August 27, 2015]

⁷⁷⁴ Notably through publications, seminars, workshops, conferences, or other available avenues

⁷⁷⁵ Carlsnaas, W., Kisse, T. & Simmons, B., *Handbook on International Relations*, p. 195 (2000)

The TPSF's Composition and Operational Engagement

Membership of the facility is to be limited primarily to African states and a number of non-state actors selected mainly on the basis of their expertise. It is proposed that the TPSF should comprise: an independent chairperson to head it, representatives from tax administrations of each member state, and experts on international TP issues who are appointed to input the private sector perspective. Others including NGOs, international institutions/agencies could be invited to meetings on an *ad hoc* basis. As with the EU-JTPF it is worth considering whether it might be necessary to designate **alternates** to assist sitting members of the facility. This membership configuration optimizes the chances of effective **consultation** and **cooperation** on TP issues not only amongst governments but also between governments, companies and civil society. Given that all members of the facility are technocrats on the issue of TP, it is unlikely that such a broad membership would result in the collective action problem.

Further, it is proposed that the TPSF should move to take ownership of Africa's fiscal policy and implementation agenda by defining issues of debate and driving proposed reforms in the area. The platform should strengthen cooperation and coordinate efforts with other stakeholders (IMF's regional technical assistance offices) and international aid agencies (UK's DFID, US's USAID, Germany's GIZ) so as to avoid duplicity of engagements. With experts from governments and non-state actors being well placed to envision needs of the continent on issues of taxation, it is important that the platform weighs in on policy and implementation recommendations that would be shaping the continent's legal and administrative frameworks on TP going forward.

Issues Requiring the TPSF's Contributions

Good tax policy and implementation encourages business development in effect ensuring sustained government revenues. However, it has been difficult in recent years to predict tax policies in some resource rich African countries since steps have been taken to renegotiate unfavorable tax terms in operational agreements.⁷⁷⁶ Further, as seen in chapter 5 and 6 some African countries are starting to introduce tighter rules in dealing with the TP problem. Therefore, the TPSF provides a platform for promoting collaboration and dialogue between businesses and tax administrations in Africa via which the former, going forward, could input perspectives in the policy formulation and

⁷⁷⁶ For example Niger's insistence that France-based AREVA (uranium company) renegotiate the tax provisions of its concession to comply with the country's new Mining Code.

implementation processes. It is thus designed to give private business a voice in shaping Africa's tax policy. It is further proposed that the facility should work to recommend improved changes regarding existing rules that are being applied in each of the areas, classified as attributes of the TP regime in chapter 2. These include: clarifying rules regarding the ALS (i), improving compliance *-documentation & disclosures* (ii), strengthening adversarial procedures *-audits & penalties* (iii) and dispute resolution *-traditional & alternative* (iv). The TPSF can draw valuable lessons from the EU-JTPF, the EITI and OECD-BEPS projects on topical issues that could be addressed as it establishes its work program.

Collective Effort to Improve Implementation of the ALS

Effective implementation of the ALS remains a major challenge in Africa and it is unavoidable that the TPSF's work plan would include this attribute of anti-avoidance regimes. Issues that could be looked into include amongst others compensating adjustments, low value adding intra-group services, cost contribution arrangements, and the special nature of Small and Medium Enterprises (SMEs). The OECD and EU-JTPF have been leading efforts to enhance policy and implementation of rules in these and other areas, but there is still some room for the proposed TPSF to weigh into the debate by adding an African perspective to future developments on these issues.

Without cooperation of the type proposed by the TPSF, it is to be expected that African countries would individually adopt different practices in their efforts to tackle TPM. However, the coordination of efforts in the adoption of rules *-such as compensating adjustments-* eliminates the possibility of double taxation and double non-taxation. Such coordination does not exist at the moment and there is an opportunity here for the TPSF to fill the gap by elaborating conditions under which compensating adjustments initiated by taxpayers can be accepted if reasonable effort is made to comply with the ALS, amongst other issues. Similar work is needed in handling *'low-value-adding intra-group services'* given that tax administrations in most African countries are short on resources needed to pursue audits of intra-group transactions and to resolve TP disputes. There is an urgent need to find less resource-intensive ways to ascertain compliance with the ALS in these cases. Coordination of the type proposed under the TPSF should be able to achieve this objective.

Another area where tax administrations face a serious challenge is that of *cost contribution arrangements (CCAs)*. There is need to ensure that costs are shared amongst group members on the basis of their respective potential benefits from the venture, that is, costs should be adjusted and shared amongst participants on an ALS basis. Equal attention would have to be given to the problem

of applying ALS to *small and medium enterprises (SMEs)*. SME's represent the bulk of African enterprises that are now expanding their operations and trading with associated companies outside of home countries. This is such a big issue that requires urgent attention since the size, lack of knowledge, experience, resources are factors which make implementation of *standard TP rules* by this category of enterprises challenging. In order to facilitate and to ease the administrative burden of this category of businesses complying with the ALS, it seems that new specific rules developed on the *principle of proportionality* would be required. Coordinated efforts within the proposed TPSF could be ideal in achieving an accelerated broad-based simplification of rules.

Collective Effort to Improve International Compliance

As shown in chapter 6 [supra], certain issues impair the effective compliance with TP rules in Africa, the likes of which are best addressed through broad-based cooperation. These challenges cut across countries and include: frequent imposition of onerous and diverse documentation, high compliance costs and unavailability of appropriate comparables. The TPSF is a suitable platform for examining recent international trends in resolving compliance related challenges with respect to the standardization of documentation requirements. As seen earlier standardization ensures that all MNE group entities resident for tax purposes in a country disclose detailed information on their operations in the forms of a *masterfile*⁷⁷⁷ and *local file*.⁷⁷⁸

Asymmetries on TP information existing between MNEs and tax administrations in Africa make it hard for these companies to be taxed effectively. Efforts by African countries to narrow the information gap with MNEs could be considerably aided by drawing lessons from the two-layered approach for preparing documentation (master and local files) that is endorsed by the OECD and EU-JTPF. The proposed TPSF could examine effective ways to adapt these file requirements to the African context. It could further explore how to link benefits derived from these files with those of EITI Reports, given the known importance of hydrocarbons to many African economies. *EITI's* twelve *principles* are built on the concept of disclosure of payments and revenues in extractive rich countries, and its *implementation requirements* contain *contextual information*⁷⁷⁹ of the country's extractive

⁷⁷⁷ Common standardized information on all group members. It is a 'blueprint' of the MNEs the MNEs global structure, its TP system aligned to the economic reality of the business and provided to all states in which it operates; See 8.2.1

⁷⁷⁸ Contains country-specific information separately prepared for each member state hosting a portion of the MNE's activity. It supplements information provided in the 'masterfile' via a detailed description of the business and business strategy, country-specific controlled transfers, comparability analysis, processes to select and apply TP methods; information on internal or external comparables, and the group's inter-company TP policy

⁷⁷⁹ Issues covered in these reports include a summary description of the legal framework and fiscal regime (3.2); an

industry. Although this collective disclosure standard is unlikely to play a major role in detailing the kind of information needed for TP detection purposes, it enables the gathering of partial country-specific information on the oil sector that could be helpful in understanding the local file.

Further, the information gap can be closed by the TPSF working to elaborate and advice African countries on effective ways for implementing the proposed *country-by-country reporting (CbC)* under *BEPS Action 13*, on the basis of which MNEs would use a common template to provide all relevant governments with information on their global allocation of income, economic activity and taxes paid among countries.⁷⁸⁰ This is designed to enhance transparency for tax administrations. The CbC is an important new instrument which covers the type⁷⁸¹ and nature⁷⁸² of financial data to be reported, reporting requirements for certain transactions,⁷⁸³ possibility of being flexible on whether the master file should be on a group-wide basis or by line of business, and the precision that the master file is for high level reporting. On this issue the TPSF could explore ways to: (i) ease access to CbC information, and to (ii) identify which of *three model competent authority agreements* is suitable for African countries to adopt in exchanging CbCRs. This is urgent given that OECD is now proposing to have the MNEs parent entity⁷⁸⁴ report this information only in the country of its tax residence, instead of through local filing when the first CbCRs are exchanged in 2017. How does Africa access this information considering the continents staggeringly weak tax treaty network?

Finally, it could also lead reflections in Africa on how tax administrations might compel MNEs to *disclose aggressive tax planning arrangements* as proposed under *BEPS Action 12*. The use of mandatory disclosure rules (MDRs) to oblige reporting of mass marketed pre-packaged international tax schemes is legitimate. However, there is an imperative to balance this with the need to avoid creating enormous compliance burdens for compliant MNEs and intermediaries. From this standpoint MDRs should specifically target aggressive transactions or structures. Any attempts to adapt these rules to Africa's specific needs could be handled by the proposed TPSF which could be tasked with

overview of the extractive industries (3.3); contribution to the economy (3.4); production data (3.5); state participation in the extractive industries (3.6); revenue allocations and the sustainability of revenues (3.7-3.8), license registers and allocations (3.9-3.10); and, applicable provisions related to beneficial ownership (3.11) and contracts (3.12). The multi-stakeholder group needs to agree on who prepares the contextual information (3.1).

⁷⁸⁰ The OECD's memorandum of 3 October 2013 on *transfer pricing documentation and country-by-country reporting* as part of Action 13; See section 8.2.3 p. ... supra for enumeration of data points required to be reported for each country

⁷⁸¹ Including revenues, profit before tax, cash tax paid, current year tax accrual, numbers of employees, tangible assets, capital and retained earnings

⁷⁸² Aggregate countrywide or entity by entity basis

⁷⁸³ E.g. interest, royalties and other intercompany payments – will be removed from CbC (and will only be in the local file for entities doing business there)

⁷⁸⁴ For reasons of ensuring tax information confidentiality

examining the experience of an increasing number of countries that have adopted such rules.

Collective Efforts to Improve Audits and Penalties

TP audit and penalty procedures in Africa are an area requiring serious improvements. Firstly, the TPSF needs to work on improvements to audit frameworks on the continent by advising on the introduction of *secondary adjustment rules* as means to avoid double taxation and developing and proposing criteria for ascertaining whether a taxpayer's behavior suggests intent to avoid withholding tax. There is equally need to develop ways to *manage transfer-pricing risks* that MNEs might not comply with the ALS or that tax administrations might not allocate scarce resources in an efficient manner during the initial, audit and resolution phases. The OECD's and JTPF's work on this issue are reference materials that could serve as the starting point for engaging meaningful reflections on developing an African tailored perspective.

Further, it is possible that EITI's independent evaluation mechanism of country compliance can play a role in improving the effectiveness of TP audits. The Validator consults an enormous amount of documentation,⁷⁸⁵ which might be useful in identifying *aggressive transfer pricing* or *non-payment of taxes*. The platform could examine how aspects of EITI audits (data gathering) might enhance broader audit efforts to tackle TPM. For example, improved reporting since 2013 reinforces the scope and depth of disclosures. Data on revenue payments is now *disaggregated* with some going as far as disclosing information on *licensing, production, and "beneficial ownership"* of IOCs operating in the country. Nigeria has gone a step further by testing on the basis of samples the accuracy of tax computations and royalty payments by companies. A major finding of its EITI Report for tax year 2005 was that the state-owned Nigerian National Petroleum Corporation had underpaid taxes and royalties to the government estimated at some US \$ 4.7 billion.⁷⁸⁶

The need also exists to recommend improvements to penalty regimes that are presently applied in many African countries to MNEs⁷⁸⁷ and SMEs.⁷⁸⁸ In cases of secondary adjustments, the logic under the EU-JTPF is to apply penalties in principle only to the initial TP adjustment and not to secondary ones. The TPSF needs to lead reflections on these issues.

⁷⁸⁵ Including EITI work plan and planning documents, the multi-stakeholder group's minutes of meetings, EITI Reports and supplementary information, communication materials, annual activity reports, and other relevant information.

⁷⁸⁶ EITI Newsletter, Aug 2009, p. 2.

⁷⁸⁷ TP documentation related penalties to improve on the processes of preparing, maintaining, filing

⁷⁸⁸ Avoiding documentation penalties if the company relies on and complies with streamlined pre-audit requirements

As concerns *data collection and information sharing*, it is understood that the adoption of enhanced models of information sharing between tax administrations for international tax schemes would be more effective. There is natural reluctance on the part of MNEs to share information likely to result in higher tax liability, at a time when governments are operating huge budget deficits partly blamed on tax avoidance practices. In this context, governments are more open to the idea of sharing with states information on MNE operations that they hold. The OECD and ATAF have already taken steps to make this happen by adopting conventions on information exchange and assistance. Another recent example is OECD efforts under BEPS *Action 11 to establish methodologies to collect and analyze data on BEPS*.⁷⁸⁹ The TPSF could work with *stakeholders, academics* and the public to reinforce these efforts by proposing ways to gather relevant aggregate and micro-level data on the continent. As documentation, information exchange helps to close the information gap between stakeholders and eases access to comparables for TP adjustments. The main challenge at this level is that existing databanks for sourcing comparable information like the *NYMEX, LME, LPE and Rotterdam; or others like Platts, Amadeus, InfoGrefe, Bureau Van Dijk's Diane and Bloomberg* hardly contain straightforward information on African comparables.

Therefore, the TPSF is potential platform for reflecting on idea and collectively pushing through reforms to create the necessary infrastructure to effectively fill this gap by proposing an information gathering system. Two options can be considered. The first is to (i) directly create a *Pan African databank* in which member states feed in data via *local databanks*; or (ii) outsourcing the work on doing so to private entities with experience handling this kind of business. The TPSF's aim should be to create an effective framework and functioning institution that is tasked with gathering data on extractives and non-extractive activities⁷⁹⁰ or liaising with other third party data sources to get it.

Collective Effort to Improve Disputes Resolution

Finally, dispute resolution (*MAP, Arbitration*) and prevention (*APA*) mechanisms in Africa are weak. Under *BEPS Action 14* an intention is expressed to make dispute resolution mechanisms more effective by addressing obstacles that prevent countries from solving treaty-related disputes under the MAP or arbitration provisions. Given however, that there isn't going to be global consensus on

⁷⁸⁹ Tax Annex to the Saint Petersburg G20 Leaders Declaration 8/28/14 5:44 AM
<http://www.g20.utoronto.ca/2013/2013-0905-tax.html> Page 7 of 8 [Last visited September 9, 2015]

⁷⁹⁰ See Chapter 7.2.2.2 where we propose the creation of domestic databanks as part of the package of domestic solutions to the problem of information asymmetry and comparables for TPM adjustment purposes.

mandatory binding arbitration in the near term, and in spite of the MAP being lengthy, inefficient, unpredictable and requires enormous resources; the OECD sees improved MAPs as the immediate future of effective dispute resolution. To this end, it adopts four principles⁷⁹¹ that fully adhere to MAP best practices. Rules could also be elaborated for triangular cases including *African triangular cases* or *non-African triangular cases*. Further, it would be quite helpful to institute an *African Arbitration Convention* to apply to issues of international taxation designed to also cover cases where tax administrations adjust taxable profits of group companies that engage in cross-border transactions. It should cover a range of procedures including the starting points of deadlines for filing complaints with the relevant tax administration, for these tax administrations to resolve disputes and to eliminate double taxation; and on the modalities for suspending or maintaining collection of contested taxes while the dispute resolution procedure is running.

Finally, TPSF should consider creating an appropriate framework for improving the appeal of *Advance Pricing Agreements* (APAs) in Africa. It could elaborate best APA practices drawn from already operational APA frameworks around the world as a means of simplifying and rendering more certain the process of selecting TP methodologies. The aim is to encourage countries to avoid costly and time-consuming TP examinations, disputes and double taxation in the future by using APAs. Recommendations could also be considered to provide tax administrations with the mechanisms to fast track dispute resolution and to unilaterally resolve claims to relief from double taxation in noncomplex low value SME cases. Furthermore, reflections should be carried out on appropriate rules allowing for the application of quite innovative alternative approaches to resolving disputes, including, the promotion of direct cross-border auditor-to-auditor contact.

8.4 CHAPTER CONCLUSION

Given shortcomings of existing international anti-avoidance frameworks discussed earlier, consensus is building around collectivizing efforts to tackle TPM. The present chapter proposes an alternative framework that is based on *international cooperation*, in respect of which the rationale for such an approach was discussed in section 8.1, recent international developments in this direction (EU-JTPF, EITI, BEPS) were examined in section 8.2 and the proposed institutional framework of the

⁷⁹¹ Include (i) implementing MAP treaty obligations in good faith resolving cases in a 'practical, fair and objective manner'; (ii) promote prevention and resolution of treaty-related disputes; (iii) ensure effective access of eligible taxpayers to MAP; and (iv) resolve cases once in MAP. Encourages the use of alternative dispute resolution options, such as bilateral APAs, which proactively increases certainty and decreases risk of double taxation.

proposed *African Transfer Pricing Support Facility* designed to coordinate and advise on efforts to tackle TPM in Africa was elaborated in section 8.3.

On the Rationale and Challenges of the Proposed TPSF:

It was noted that two main factors justify adoption of the TPSF in Africa. The first is a need to coordinate both the policy and implementation of international tax anti-avoidance rules. This was also expressed in the Seoul Declaration (2006) and declarations of the 2013 G8 and G20 submits. The second is the need to create a broad-based African platform for synergizing dialogue between all stakeholders, as international tax avoidance schemes grow in complexity. Hopefully, this should narrow perceptible differences in stakeholder approaches to tax matters, align their interests, diminish risks of conflict, and improve the effectiveness of TP anti-avoidance regimes.

However beneficial the proposed TPSF promises to be architects are likely to face two main challenges if they move to set up the platform. Firstly, it is hard to tell the extent to which states would be willing to cede sovereign competences to such an international platform. This lack of willingness to cede aspects of tax sovereignty could in fact limit TPSF's effectiveness in tackling TPM. It was argued that architects should aim for a system that provides solid basis for cooperation without necessarily encroaching on the sovereign rights of states to tax MNEs operating within their borders. Secondly, the difficult decision has to be made regarding which format of cooperation to adopt in establishing the facility. The view was ultimately taken that expand existing institutional frameworks would be more feasible than creating an entirely new one. It would be helpful to draw lessons from existing models of international cooperation such as the EU-JTPF, EITI and BEPS in developing a platform that is capable of effectively supporting African countries in their effort to tackle TPM and other international tax avoidance schemes.

On the Institutional Outlook of the Proposed TPSF:

It was proposed that the TPSF platform should be hosted by an existing organization such as **ATAF**⁷⁹² and conceived more as an **advisory group of transfer pricing experts** that is tasked with leading reflections on policy reforms on this issue in Africa. Hopefully this would materialize effective intergovernmental cooperation in optimizing revenue mobilization efforts in Africa, whilst at the same

⁷⁹² More in line with the EU-JTPF format

time creating an opportunity for *non-state stakeholders* to input the process. This would strengthen cooperation through consultations and the effective coordination of stakeholder efforts.

Finally, the proposed institution should work to propose policy and implementation reforms on practical issues concerning all four attributes namely ALS, compliance, adversary and disputes. Specific issues affecting African countries that could be covered include reforms to ALS rules such as *compensating adjustments, low value adding intra-group services, cost contribution arrangements and SMEs*; reforms in the area of international compliance such as standardization of documentation (*masterfile, local file, country-by-country reporting*); reforms regarding adversarial procedures such as audits and penalties (*secondary adjustments, management of transfer-pricing risks*); and reforms to disputes resolution procedures covering *MAPs, Arbitration* and *APAs*. In conclusion therefore, the proposed TPSF is built on the cooperation-based philosophy and intended to provide member states with a viable platform to think through and propose concerted policy and implementation actions on the issue of TPM and other unnamed avoidance schemes.

GENERAL CONCLUSION

The research broadly set out to develop an alternative TP anti-avoidance regime to be used by governments in preventing MNEs from creating undue tax advantages for themselves by illicitly transferring abroad, profits that should be taxed in the GoG under international tax law. Its specific objective is to **fill an existing gap** in the literature regarding the issue of TPM in the GoG oil industry (1). This, it was explained, would be achieved by presenting available evidence of TPM in both the international and GoG oil industries, and then assessing the effectiveness of existing anti-avoidance regimes in tackling the practice. If existing GoG transfer pricing anti-avoidance regimes were found to be defective, a further objective would be to propose certain **policy and regulatory upgrades** to make them effective (2). This entails recommending an alternative approach and potent composition of rules that are capable of responding to the problem more effectively. With these objectives in mind, three research questions were formulated to guide our investigations. The **main question** focused on the extent to which GoG anti-avoidance regimes were effective in tackling TPM. It would be recalled that **two incidental** questions were derived from the main one, the first of which inquired as to whether evidence existed that IOCs manipulate transfer prices, and the second inquired into lessons that GoG governments could learn from other select jurisdictions in improving their own TP regimes.

The thesis began with discussions on **oil taxation** and a review of the **given-regime-state** of TP anti-avoidance regimes in four select countries. On the first issue, it was concluded that both profit and non-profit fiscal instruments often used in the oil industry to *share* resource wealth (R/T or PSCs) are vulnerable to such mispricing schemes. However, the requirement by resource rich countries that IOCs use as basis for tax computation in *cases of intrafirm transfers*, only arm's length benchmark prices (*WTI, Brent*) sourced from spot markets has somewhat mitigated recourse to TPM.⁷⁹³ As concerns the second issue, it was concluded that the given-state of TP regimes in all four select countries comprised key anti-avoidance **attributes** notably the *ALS, compliance, adversarial and tax appeals*. Of the two main competing standards, that is, **ALS** and UT, it was found that all four countries adopt the former in s.482 (US), s.15 (Nigeria), Art.57 (France) and s.19 (Cameroon) of their tax laws. Further, IOCs are allowed to use either the "best method" (US, Nigeria) or "any method" (France, Cameroon) to determine transfer prices, with tax examiners manifesting a preference for profit-based methods. In terms of approaches that have been used to tackle TPM, it was noted that

⁷⁹³ Even if settlement of fiscal liabilities is to be done in cash or in kind

countries adopt different tactics. Procedural aspects of the US's regime are **tight** (specific rules). Nigeria's is light with somewhat early indications that it is moving towards the tighter approach.⁷⁹⁴ However, it is observed that the approach currently adopted by France and Cameroon is **light** (general rules). Differences in the approaches adopted by these countries are reflected in the areas of *documentation, reporting or filing, audits, penalty* and even *disputes resolution*. While the US (and increasingly Nigeria on some issues) adopt specific rules, France and Cameroon continue to treat TPM as they would most other avoidance schemes and in tackling the practice apply mostly generic rules. For example, the US has incorporated into its legislation audits and penalties that are specific to TP, which France and Cameroon do not have. Excepting *binding domestic arbitration* that is unique to the US, the mechanisms broadly used to resolve TP disputes are more or less common to all four select countries -*administrative, litigation, MAP* and *APA*. Noting finally the importance of oil to GoG economies⁷⁹⁵ and also the current structural disposition of the industry, even the slightest possibility of IOCs engaging in TPM is quite disturbing.⁷⁹⁶ The initial comparative findings on all these issues further served as bases for analyzing and responding to our main research question, and the two other incidental research questions stated in Chapter 1 of the thesis.

On the Gap Filling Objective: Questions One and Two

Question 2: *To what extent, if any, do international oil companies manipulate transfer prices?*

In response to this question, the analyses of available contemporaneous, case law and other empirical evidences indicate that both income shifting (sale of crude oil) and cost allocations (technical assistance, royalty payments, financing) are avenues used by IOCs to erode domestic tax basis. Firstly, a few researchers⁷⁹⁷ using *empirical methods* to investigate TPM in the oil industry variously concluded in the 1980's that IOCs either manipulated or did not manipulate transfer prices in the USA and Canada. More recently, there has been a mounting body of *contemporaneous claims* by experts into oil industry intra group practices suggesting that IOCs are "notorious abusers" of TP. These range from claims by Prof. Hudson, to more recent ones concerning the merger of Shell's UK and Dutch operations (2005) and claims in The Guardian that oil traders also manipulate data that is

⁷⁹⁴ This is evidenced by its issuance of TP Regulation №1

⁷⁹⁵ Bulk of state revenues approximately 90% in Equatorial Guinea, 28% in Cameroon, 79% in Chad and 70% in Nigeria

⁷⁹⁶ That is, extreme dominance of foreign-based IOC's, high levels of intragroup transfer of crudes by these companies, high profitability, huge reserves, and long production periods;

⁷⁹⁷ Bernard & Weiner, R.J. Bertrand, Rugman and McIveen

fed into benchmark databases like Platts (2013). Although some of these claims have been or are being tested in the law courts, it can be strongly inferred that oil-producing countries in the GoG cannot continue to neglect or treat them as mere distractions. Likewise, *case law evidences* confirm that some IOCs did manipulate transfer prices. Notable examples include Russia's *Yukos Case* (2000); the US cases of *U.S. ex rel. Johnson et al. v. Shell Oil Co., et al* (1996) and *Alaska Tax and Royalty Cases* (1977). With respect to the GoG, conjectural and reported evidences were found that MNEs mispriced intragroup transfers in both the oil and other industries (brewery). In light of preceding analyses it is compelling that some IOCs are engaged in TPM globally and within the GoG, the aim being to minimize their overall tax liability. However, there is also case law evidence rebutting this proposition: *Irving Oil* (1988) and *Aramco Advantage* (1993) cases. Although it is hard to estimate fully the extent to which IOCs deploy TPM schemes, the body of available evidence suggests that the risk to oil rich countries of this happening is quite significant. Therefore, at a time when oil revenues are badly needed in these GoG countries to drive genuine economic transformation, tax authorities need to closely monitor schemes designed to erode domestic tax basis.

Question 1: *To what extent, if any, are anti-avoidance regimes within the Gulf of Guinea designed to effectively tackle transfer price manipulation by IOCs?*

On whether anti-avoidance regimes in the GoG are effective in deterring, detecting and remedying TPM, it was found that the **architecture** (*composition and arrangement of concepts*) of these regimes is broadly effective. However, a similar assessment cannot be made of the engineering and administrative frameworks as certain important defects have been found to exist. As concerns the **engineering** of these regimes, it is observed that the *upstream sub-framework* is designed to mostly conform anti-avoidance attributes of the system to baseline canons of taxation. However, much of the *downstream sub-framework* is largely defective.⁷⁹⁸ For instance, it is observed that in tackling TPM most GoG countries adopt the light approach that hasn't been particularly effective in detecting, remedying or deterring TPM given the context in which they apply.⁷⁹⁹ For example, *general audits, non-mandatory documentation and filing, placing the burden of proof on the fisc and pretty short statutes of limitation* are arguably maladapted to prevailing circumstances existing in the GoG. Given that the engineering of these anti-avoidance regimes reveal significant defects in terms of providing tax authorities with appropriate tools with which to detect TPM, it is highly unlikely that they

⁷⁹⁸ That is, the interval between attributes and performance criteria

⁷⁹⁹ Dearth in capacity, information asymmetry amongst others

would be effective in deterring abuse. Likewise, most penalty regimes in the GoG, whilst severe, are largely generic in nature. Unlike the US's regime that provides TP specific penalties, the greatest flaw of this GoG approach is that it fails to draw the attention of IOCs to specific penalty risks the company faces by deciding to engage in TPM. It might not as such be an effective tool to use in remedying or deterring TP abuses. Besides, disputes resolution is often long and costly with little guarantees of obtaining quality of rulings for disputes that go all the way up to litigation. Lastly, the **administration** of TP regimes in the GoG is unlikely to deter non-compliance since enforcement is defective. Firstly, certain dysfunctionalities caused by poor *institutional design* are likely to mar effective assessment and collection of oil revenues in many GoG countries. Likewise, the lack of specialized TP teams or limited information exchange and joint investigation platforms, effectively limit the ability to detect or deter noncompliance. Similar shortcomings are observed with *human resources*, where the number of tax examiners and policymakers with a combined understanding of international and oil taxation is small. Coupled with the high levels of corruption and bureaucratic rent seeking that the GoG oil sector is known for, this results in a defective administrative framework that is weak on detecting, remedying or deterring TPM. Broadly, it is concluded that existing TP anti-avoidance regimes in the GoG that adopt the **light approach** as basis for engineering and administration are to a large extent defective.

On the Policy and Regulatory Upgrade Objective: Question Three

Question 3: *What lessons, if any, can governments in the GoG learn from other jurisdictions?*

Noting these shortcomings and having examined US and French anti-avoidance regimes, it is observed that attempts to improve the effectiveness of existing GoG regimes would require profound policy and regulatory upgrades based on lessons drawn from select comparator regimes. This entails adopting potent domestic and international measures to close existing gaps in the engineering and administration of these regimes. From a **domestic** standpoint, it is recommended that GoG countries maintain the ALS as basis for building TP anti-avoidance regimes. Notwithstanding criticisms that ALS is *unrealistic, mythical* and *isolationist*, it is quite convenient, practical and easier implemented than UT given the circumstances that currently exist in the GoG. It is also recommended that these countries reorient TP policy and regulations from the *light approach* (sometimes *blindly* copied from developed countries) to a *tighter one* that is arguably more suitable to their needs and more likely to respond robustly to challenges posed by the practice. It is therefore feasible for GoG countries to

achieve effective detection, remediation and deterrence by adopting comprehensively tight upgrades to existing engineering⁸⁰⁰ and administration⁸⁰¹ frameworks of domestic TP anti-avoidance regimes.

An equally important need exists to upgrade **International** policy and institutional frameworks used to tackle TPM. That is, moving the consensus framework away from one that focuses more on countries adopting *domestic measures*, to one that is centered on promoting greater *international cooperation*. In spite of likely challenges to be faced in materializing this objective,⁸⁰² there is actually a strong case for African governments to work together to upgrade international policy and response systems along the lines of *international cooperation*. The rationale for this approach is largely based on the growing consensus of benefits to be derived should states move to collectivize their efforts to tackle international tax avoidance. That is, the need to ensure collective coordination of policy and implementation responses, and to synergize dialogue between stakeholders as a means of increasing avenues and available tools with which to effectively deter, detect and remedy TPM. Going forward, it is proposed that African countries create a **Transfer Pricing Support Facility**⁸⁰³ to serve as the platform for enhancing genuine *international cooperation*⁸⁰⁴ between their governments and other non-state actors on the subject of tackling TPM. As the case is with the EU-JTPF and OECD's work on BEPS, the facility should aim to enhance the now widely accepted cooperation framework by providing all key stakeholders on the continent avenues through which to input the process of shaping Africa's TP policy. Ideally, the approach should be to adopt a system that promotes cooperation but leave to states their traditional prerogative of the exercise of sovereignty in matters of taxation.

⁸⁰⁰ Clarifying rules, creating domestic databanks, introducing mandatory filing, TP audits, TP penalties, shifting the burden of proof to taxpayers, and increasing statutes of limitation

⁸⁰¹ Reinforcing staff numbers, capacity, governance, coordinate institutions

⁸⁰² Such as, the lack of willingness to cede components of tax sovereignty, what structure to adopt

⁸⁰³ Should be preferably hosted within ATAF's institutional framework.

⁸⁰⁴ Also includes practical support in the areas of information gathering and sharing; see proposals to create an African Databank for information gathering purposes.

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