POLICY BRIEF

Are we getting the right prices and returns from our wealth?

Issues of transfer pricing manipulation in Sierra Leone

August 2017

Budget Advocacy Network (BAN)

Supported by:

OSIWA

1.0 Background and context

For over a decade, Sierra Leone's domestic revenue as a percentage of Gross Domestic Product (GDP) - averaging 10.9 percent[1] - has continued to remain below the average of 15 percent for Sub-Saharan Africa (SSA). Low revenue performance implies less resources available to be spent for development without direct donor involvement. Two studies on Sierra Leone, (Budget Advocacy Network 2013) and (Jibao, 2014), have shown that tax incentives granted to specific taxpayer groups through targeted tax deductions, credits, exclusions and tax holidays are responsible for such relatively low revenue-to-GDP ratio. The findings from BAN (2013) confirm that revenue loss from customs duty and Goods and Services Tax (GST) exemptions amounted to US$224 million (8.3% of GDP) in 2012. In addition, estimated annual average loss over a three year (2010-2012) period was US$199 million. The analysis further projected an annual average revenue loss of US$131 million in the form of corporate income tax incentive granted to mining companies from 2014 to 2016.

In addition to the challenges of tax incentives to revenue performance, transfer mis-pricing and other forms of tax avoidance practices remain channels through which developing countries lose huge tax revenue annually. Over the past decade Multinational Corporations (MNCs) have taken a prominent position in global international businesses. They have expanded their businesses beyond their local territories with branches, subsidiaries and stakes in businesses across the globe. Whilst transacting businesses with others, it has often become necessary for MNCs to do so with their subsidiary or part of their vertically integrated chain, either domestically or internationally.

The prices set for such transactions are referred to as the transfer price determined for tax purposes. Transfer mis-pricing, as distinct from transfer pricing, is the over- or under-invoicing of related party transactions in order to avoid government regulations (e.g. under-invoicing to avoid paying the Goods and Services Tax or to exploit cross-border differences in these rates - for example, shifting deductible expense to the high tax location and revenues to the low tax location in order to reduce overall corporate tax payments). In the extractive industry, mis-pricing can occur in the form of understating the value of minerals sold to related parties or independent intermediaries. Such practice in the extractives industry would lead to potential reduction in Royalties (where linked to transaction value; Corporate Income tax; Excess Profit Tax; and Withholding Tax).

Owing to the paucity of data, and the secrecy surrounding the operation of mining companies, as well as the non-availability of comparable transaction data, it is difficult to estimate transfer mis-pricing using the input method.[2] However, in this study we used two broad approaches to provide an estimate of trade and transfer mis-pricing. Firstly, we used the trade mis-invoicing model to estimate tax revenue losses from illicit capital flight. The trade mis-invoicing model looks at trade mis-pricing, namely the overpricing of imports and underpricing of exports on customs documents, which allows the illegal transfer of money abroad. Data for the computation is collected from the Global Financial Integrity report (2015).

1 Author's computation using data from the NRA database and IMF

2 .Estimating the extent of shift of profit from Sierra Leone to possible tax havens thereby lowering corporate revenue is difficult because of paucity of data on the volume of transaction (input purchases) of mining companies in Sierra Leone with other related subsidiaries companies registered in tax heavens.

2.0 Objective

This study attempted to assess and quantify the domestic revenue loss through transfer mispricing by Multinational entities (MNEs) in Sierra Leone; it also attempts to identify institutional and policy changes geared towards addressing transfer pricing in Sierra Leone.

3.0 An overview of the role of multinational activity in Sierra Leone

Foreign Direct Investment (FDI), it has been argued, is very relevant in boosting the development agenda of developing countries. Proponents of the FDI-development nexus argue that Multinational Corporations (MNC) and their affiliates have over the years helped create millions of jobs, transferred technology, upgraded skills, fostered competition, and contributed to the fiscal standing of many economies.

Through capital spillovers, FDI has encouraged the adoption of new production technologies; and foreign investment has also helped break up cozy local oligopolies and cartels (World Bank, 2010). Critics of FDI however argue that its impacts are often limited and in some cases detrimental owing to the consequences of crowding out local competition, enclave production with limited forward and backward linkages, and "race to the bottom" effects often related to labour and environmental issues (World Bank 2010). Whilst it is beyond the scope of this study to analyse in detail the pros and cons of FDI, it is noted that the dominant role of multinationals in developing economies makes the region mostly vulnerable to transfer pricing manipulation.[3] In Sierra Leone the importance of FDI has grown over the years from as low as US$8.62 million in 2003 to as high as US$950.5 million in 2011 before declining to US$225.1 million in 2012 and US$144.1 million in 2013. But it started increasing again in 2014 (Figure 1). Year-on-year since 2008 FDI doubled and between 2010 and 2011 it actually quadrupled. In terms of GDP, the net FDI increased from 3.1% in 2003 to a high 38.7% and 32.9% in 2011 and 2012 respectively before declining sharply to 12.9% and 5.8% in 2013 and 2014 respectively (IMF, 2014). When compared to total FDI in the Economic Community of West African States (ECOWAS), Sierra Leone's share of FDI also increased from as low as 0.2% in 2003 to 4.7% in 2011 before plummeting to 1.3% and 1.0% in 2012 and 2013 respectively; its shares however increased to 3.1% in 2014. The significant growth of FDI in 2011 is due to the massive injection of foreign funds by the African Mineral Limited resulting from the Iron Ore renaissance.[4]

4.0 Overview of transfer pricing architecture in Sierra Leone

The ability of tax administrations to identify and address transfer pricing risks is highly dependent on the existence of commensurate legislation and sufficient expertise backed up with adequate capacity within the revenue administration. Sierra Leone has basic provisions in place dealing with transfer pricing in Section 95 (1)[5] of the Consolidated Income Tax Act 2000 (as amended).

3 The study does not however conclude categorically that an increased activity of MNCs immediately leads to increased transfer mispricing, but argues that such dominance of MNCs could pose a risk of transfer which requires policy makers to strike the right balance between FDI and tax losses.

4 With the rebirth of Iron ore in 2011, the country realized a huge inward investment as well as the significant rail and port infrastructure investment to support the operation of the project, via its subsidiary African Rail and Port Services (SL) Ltd.

5. The section states that in any transaction between taxpayers who are associates, the Commissioner may distribute, apportion or allocate assessable income, deductions or credits between the taxpayers as is necessary in an arm's length transaction.

vary by mining companies. For instance, the previous MLA with African Minerals Limited (AML), now Shandong Company, requires royalties to be calculated consistent with the market value; the former agreement with London Mining goes further to specify that the "market value" shall be the sale value receivable by LMC in an arm's length transaction, free on board (FOB). The MLA with Sierra Minerals also specifically referenced the OECD Transfer Pricing Guidelines as a basis for calculating the arm's length price on transactions with affiliates (Readhead, 2015).

Despite these provisions in the different pieces of legislation and agreements, the country does not have in place appropriate and functional transfer pricing documentation rules[6] and until the enactment of the Finance Act 2016 the country had no rules or regulations requesting MNCs to submit the following documents that could aid transfer pricing implementation.

Estimation of magnitude of transfer mispricing in Sierra Leone

Owing to the paucity of data, and the secrecy surrounding the operation of mining companies, as well as the non-availability of comparable transaction data it is difficult to estimate transfer mispricing using the input method.[7] In this study therefore we have used two broad approaches to provide an estimate of trade mispricing. Firstly, we have used the trade mis-invoicing model to estimate tax revenue losses from illicit capital flight. The Trade mis-invoicing model looks at trade mispricing, namely the overpricing of imports and underpricing of exports on customs documents, which allow the illegal transfer of money abroad. Secondly, we have also used the arm's length principle to estimate transfer mispricing for three main mining products for the period 2013 and 2014. The products include: Iron ore, Rutile, and Bauxite. We have used the comparable uncontrolled price (CUP) method to establish whether the declared sales price for these minerals for the purpose of royalty payment satisfies the arm's length principle.

Key findings

It is revealed in the study that the country has seen a strong growth in Foreign Direct Investment in recent years from as low as US$8.62 million in 2003 to as high as US$950.5 million in 2011 before declining to US$225.1 million (in 2012) and US$144.1 million (in 2013). However, this growth in FDI seems to have come with much stronger illicit financial outflows and trade mis-invoicing outflows. It was observed that the average Illicit Financial Flows (IFFs) between 2004 and 2014 more than doubled (i.e2.5 times higher) that of FDI for the same period.

The study estimates that an average of US $83.7 million was forgone as corporate tax between 2004 and 2014 through traade mis-pricing. And with the iron ore production since 2011, revenue loss from such practices actually increased from as low as US$ 14.1 million to US$ 205.95 million between 2010 and 2013. This estimated loss is considered conservative since it does not capture other IFF channels such as thin capitalisation.

Specifically, the study also estimates that between 2013 and 2015 a total of US$3.69 million was lost in respect of mis-pricing of iron ore sales, whilst US$1.28 million was lost due to mis-pricing in Bauxite trade for the same period. And for 2015, mis-pricing in Rutile trade resulted in a loss of US$0.773 million in respect of royalty payment.

6. The Finance Act 2016, has however, sets out basic documentation requirements for MNC to follow, repealing sections 95 of the ITA 2000. Modalities to enforce the implementation of these documents requirements are yet to be put in place.
7. Estimating the extent of shift of profit from Sierra Leone to possible tax havens thereby lowering corporate revenue is difficult because of paucity of data on the volume of transaction (input purchases) of mining companies in Sierra Leone with other related subsidiaries companies registered in tax heavens.

Development forgone

The study argues that despite the figures being conservative, the estimates highlight the magnitude and extent of the issue of trade and transfer mis-pricing on the mobilisation of domestic revenue in Sierra Leone. If fiscal authorities had been able to control such a practice, additional revenues would have been collected between 2010 and 2013 (US$ 205.95 million) to fund over half of the financing gap of US$ 381 million to implement the five-year education sector plan.[8] Or alternatively, saving this amount would have been sufficient to implement the Health Strengthening Strategic Plan for 2015 with estimated cost of US$126.64 million to implement the five pillars in the plan for 2015.

In terms of development forgone, US$3.96 million loss in respect of mis-pricing of iron ore is 5 times the cost of procuring text books and teaching and learning materials for all the pre-primary and primary schools in 2015. The mis-pricing in bauxite (US$1.28 million) is more than the amount required to construct a water supply system in Tiama Njala (as stated in the 2016 Budget). The mis-pricing in Rutile can improve Mile 91/ Yoni Bana water supply source system hence reducing the challenges citizens in that area are facing to access water. Alternatively, the combined losses can procure new ferries to ply between Freetown and Lungi hence easing the huge challenges citizens are facing to and from the airport town and its environs.

Recommendations

We recommend that:

➢Civil society should push for the fiscal authorities to require multinational corporations to publicly disclose country reports which should entail their revenues, profits, losses, sales, taxes paid, subsidiaries, and staff levels, as a means of detecting and deterring abusive tax avoidance practices.

➢They should support civil society and legislators in their efforts to participate in tax dialogue, to monitor the operations of tax administrators, and to hold government to account for their revenue and expenditure policies.

➢The NRA should create and capacitate a transfer pricing unit within the Domestic Tax Department (DTD). This will require building the audit capacity in specialised sectors such as mining, finance and banking, telecommunications, etc.

➢Efficiently implement the transfer pricing provisions in the Income Tax Act and issue transfer pricing regulations to clarify what approach companies should follow in complying with provisions in the Act. ATAF strongly encourages the strengthening of domestic tax laws and tax policy to expand the Africa tax base against international harmful tax practices and Transfer Pricing practices. In South Africa, the introduction of new a Transfer Pricing Rule in 2012 resulted in a USD 3.2 billion increase in revenue by 2013. In Zimbabwe in 2015, changes in the domestic rules and transfer pricing resulted in USD 105 million of tax revenue.

➢The Government of Sierra Leone should boost customs enforcement by providing appropriate training and equipment to better detect the intentional mis-invoicing of trade transactions with support from Development Partners. One particularly important tool for stopping trade mis-invoicing, as it happens, is access to real-time, commodity-level world market pricing information. This would allow customs officials

8. The cost of implementing the Government of Sierra Leone Education Sector Plan (ESP) is Le 4.1 trillion (US$951 million over five years. Of this amount Le1.8 trillion (US$76 million) is required to achieve universal access and quality primary level education over five years. Of the total amount budgeted for the ESP, government has identified a revenue source of US$570.1 million with a funding gap of US$381 million (Education sector Plan 2014-2018

to tell whether a good is significantly underpriced or overpriced in comparison to its prevailing world market normal price. This variance could then trigger an audit or another form of further review for the transaction.

➢To institute a process of verifying the quality and quantity of exports from the major mining sites, particularly that for iron ore, in order to counter trade mis-invoicing.

➢As the price of a ton of iron ore varies significantly depending on quality, it is very important to ensure a fair valuation, otherwise it might be tempting for some exporters to continuously declare lower grade in order to evade taxes.Ensure that fiscal authorities are able to actively participate in the G20 and OECD-endorsed global movement toward the automatic exchange of financial information (i.e. Global Forum on Transparency and Exchange of Information for Tax Purposes) with support from development partners. This will require technical assistance in data management and use.

➢ As an entry point, the African Tax Administration Forum (ATAF) has developed a practical manual providing guidance on how African countries can implement effective exchange of information, which fiscal authorities in Sierra Leone can benefit from given that the country is a member of ATAF.

➢Make country-by-country reporting public, thereby ensuring that the National Revenue Authority, civil society and other stakeholders get access to relevant information which can expose risks of profit shifting.

➢Ensure that an intergovernmental body on taxation is established under the auspice of the UN to lead on reforming international taxation .This will give the Government of Sierra Leone a seat at the table instead of the current situation where the OECD leads on international taxation.

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