TRADE MISPRICING

DO COUNTRIES FETCH THE RIGHTFUL VALUE ON EXPORTS?

TAX JUSTICE NETWORK AFRICA

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1.0 Background

International trade has been poised to play a very vital role in catalysing economic development for many developing and developed economies. International trade facilitates exchange of know-how, technology, investment in research and generation of employment opportunities in the participating economies. International trade may on the other hand exacerbate human rights abuses, and labour and environmental disputes where sufficient performance standards, social and environmental legislation and protection does not exist. Combined with the growth in the use of technology, e-commerce and the need to ensure tax compliance, the aspects of international trade especially the reported value of transaction are increasingly complex each day.

With this development most countries in Africa have faced a challenge in fetching the right values for their exports especially on the value of commodities, services and intangible assets (also known as intangibles) which form a huge component of their trade. The main challenge has been associated with manipulation of exports values with either under valuation or non-disclosure of some export transactions (including misreporting quality or quantity of exports). This has resulted in a mismatch of the values reported for the same transaction in different countries and subsequently contributing to huge losses in tax revenue which is a critical component of sustainable development.

Trade Mispricing or Trade Misinvoicing is described as a deliberate or systemic manipulation of value of exports or imports. The practice involves intentional misstatement of the prices of goods and services (management, insurance, or other financing services) with different motivations. Some of the drivers towards transfer mispricing as mainly pointed towards the intent to conceal money in another jurisdiction especially in form of money laundering, avoiding and evading corporate taxes, withholding taxes, as well as export duties and extractive industry royalties by deliberately misreporting the value of imports or exports. Further, the desire to smuggle goods out of the country may be motivation to engage in trade mispricing.

According to a GFI report, illicit financial flows were estimated at about USD 1.4 to USD 2.5 Trillion as at 2014. Most of these outflows are from developing countries and mainly as a result of Trade Mispricing, with hot money flows as the secondary data source for analysing this risk of illicit financial flows. These statistics denote an increase in the estimated loss of about USD 800 billion annually through illicit financial flows (GFI, 2015). According to the High Level Panel on Illicit Flows from Africa, 2015 commercial activities account for about 60% of the illicit financial flows in Africa. Trade Mispricing as a commercial practice contributes to economies losing precious foreign exchange earnings, and revenues in form of tax, that is necessary in availing public services to its citizens. This has been evident in the recent developments in United Republic of Tanzania, where the President set up a review committee to dig into the allegations of tax evasion in the mining industry.

The committee produced a report popularly known as The Osoro Report of 2017. The report estimated that the United Republic of Tanzania lost about USD 84 billion for the period 1998 to 2016 in unpaid mining taxes as a result of trade mispricing practices. The report equally points out stabilisation clauses contained in mining agreements signed by the government, and lack of government shareholding as the key challenges that hindered the government in taming some of these practices. The challenges facing Tanzania are not in isolation as similar instances have been reported in other countries like Zambia, Ghana, Kenya, Mozambique and Uganda. It has been estimated that these countries have lost huge sums in revenues annually as a result of complex corporate structures and trade mispricing of commodities and services (Mark, 2015; Christine, Dev, Brian, Raymond, & Joshua, 2014).

2.0 How Trade Mispricing Arises

Various avenues create room for trade mispricing. However, in most cases all the avenues are interlinked as detailed in the figure below:

Figure 1: Instances of how trade mispricing arises

- **Harmonisation Commodity Descriptions and Coding System (HS Codes)** – Lack of harmonised classification of commodities between national departments has led to mismatches in the classification of commodities for custom purposes. Subsequently it contributes heavily to aspects of Trade Mispricing such that commodities are often categorised differently between the trading partners. Excessive normal and perverse discrepancies often arise from inconsistent classification of products across partners and over time these inconsistencies flow into the customs classification and the harmonised tax codes (UNCTAD, 2016).

- **Trade Misinvoicing** – This happens when companies deliberately represent different invoices in the country of export in comparison with the country of import. The practice is illegal in the country where the wrong invoice is presented, but not necessarily in the country where the right invoice is presented. The motivation is usually linked to evading customs duties, Value Added Tax or royalty payments, or quotas that are often calculated on the basis of quantity and quality of goods. The practice may also be linked to 'double invoicing' where two invoices are presented that together add to the market value, but only one invoice is presented at the other side of the border where import or export taxes are present. The second invoice often is made using a secrecy jurisdiction, where a service charge or other charge is applied to the export value.

- **Transfer Pricing** – Companies that are susceptible to aspects of misinvoicing in most cases are what has been defined as related parties. It is perceived that at least 60 per cent of international trade takes place between multinationals and their subsidiaries across the world. Due to the tax differentials in the various jurisdictions related trading partners may be tempted to engage in trade misinvoicing by adopting prices that are influenced by their relationship (i.e. not at arm's length). This will happen by either under/over invoicing, targeted at taking advantage of the anticipated tax benefit as demonstrated in the flow chart below. This aspect has persisted in some developing countries which are facing challenges in establishing fully functional and resourced transfer pricing units within their revenue authorities to provide guidance on how related parties

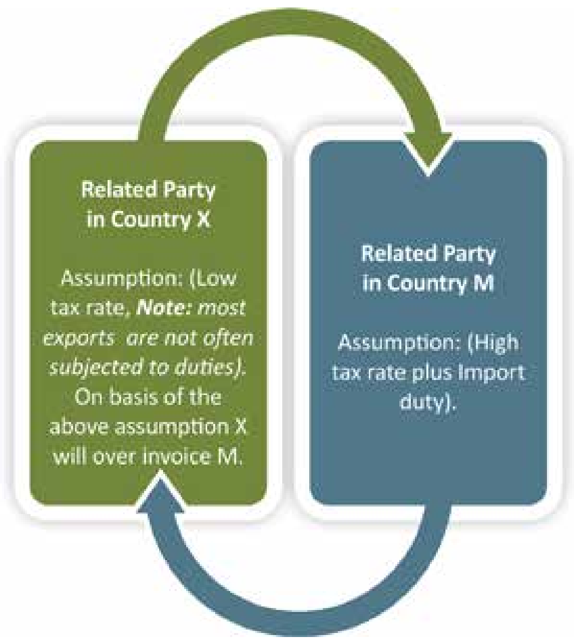

Figure 2: Trade Mispricing in Action

should price related party transactions. Based on the flow chart above it will mean that the operating entity in Country X will overstate its sales and subsequently pay low taxes. On the other hand, M will report overstated cost of sales and subsequently low turnover which result in minimised tax or no tax in case it reports losses. There can be more complicated schemes, where offshore entities provide conduits between two related parties to shift profits offshore.

- **Stabilisation Clauses** – These refer especially to trade in commodities, where governments sign contracts that are not subject to changes over a given period of time irrespective of any economic dynamics. This arises in situations where companies include in the contract stabilisation clauses. This limit any adjustments that may need to be made with any changes in the market prices. This has been pointed out as one of the challenges confounding the mining industry in Tanzania by the Osoro Report.

3.0 Trade Mispricing and Illicit Financial Flows

Trade Mispricing is a harmful and illegal business practice which contributes to the menace of illicit financial flows through the erosion of the local tax base and facilitation of money laundering. Jain (2013) underscores the fact that trade mispricing is the most commonly used method of facilitating capital flight illicitly. This follows the difficulties experienced to verify each transaction and its value between the participating jurisdictions. The manipulation of trade values mostly involves related firms that are related and operate in different countries, however, in some instances it may be

perpetrated by independent parties.
The value of goods exported is often understated or the value of goods imported is often overstated, and the proceeds are shifted illicitly across the jurisdictions involved. This is done with a motivation to evade customs duties and other taxes, circumvent quotas or launder money.

Some commodity-dependent developing countries are losing as much as 67% of their exports worth billions of dollars to trade misinvoicing, according to a study by UNCTAD. Trade mispricing is a key form of money laundering with a view of shifting money illicitly across borders especially where triangular trade i.e. trade involving three (3) parties in different countries is practiced. In this scenario the importer on record receives goods through a trader in a different country without much information on the trading terms between exporter and distributor. This kind of arrangement often provides room for deliberate manipulation of the transaction values and subsequently trade mispricing.

Trade mispricing carries direct costs in the form of foreign exchange that is not repatriated and surrendered to exporting countries' authorities, lost government revenues from the taxes and other levies not paid on the associated exports and imports, or from export tax credit issued on inflated values of exports. On the other hand unfair distribution of the gains from trade form the highest indirect costs of trade mispricing. (UNCTAD 2017).

The High Level Panel Report found that commercial tax evasion, including under valuation of exports from Africa and other practices by multinational corporations constitute the largest component illicit financial flows from Africa. This findings reiterate the fact that manipulation of trade values is a worrying trend in most developing countries.

4.0 Conclusions and Policy Recommendations

Trade mispricing is a great component of illicit financial flows and subsequently affects the financing for development agenda of most developing countries. To cap this practice trading partners ought to put in place high levels of transparency. In line with the forgoing conclusion we propose some of the following policy recommendations:

- The adoption of a well-structured and framed free trade area may offer relieve to the motivation behind trade mispricing especially where it tax motivated. In this regards the efforts in place by the African Union in establishing a functional continental free trade area[1] should be encouraged as it may minimise instances of trade mispricing on intra Africa trade. This will offer way to economic integration through the adoption of commonly agreed standards for tax co-operation, tax and customs information exchange, and public transparency to promote accountability and representation also towards citizens on benefits of a single continental market.

[1] https://au.int/en/ti/cfta/about

- Global adoption of common Harmonisation Commodity Descriptions and Coding System (HS Codes[2]) as proposed and reviewed by World Customs Organisations to take into consideration the trade dynamics in the various jurisdictions[3]. Adoption of common HS codes will promote universal understanding in the classification of exports. With minimal ambiguities in the classification there is limited room for trade mispricing that is linked to misclassification of commodities at the time of export. Also importantly information exchange and e-customs platforms on customs invoicing between export and import countries to enable comparing customs prices declared at both ends.

- Country-by-Country Reporting[4] – In order to promote high levels of transparency between MNEs, country by country reporting has been identified as necessary. This has been fronted by OECD under BEPS Action Plan 13 as vital towards minimising instances of profit shifting. In addition to OECD Efforts, it is critical to ensure to have public CBCR so that other stakeholders and authorities can have access to this vital information. Also the thresholds for carrying out CBCR should be much lower than the OECD proposed threshold of USD 750 million in turnover, as there are few companies in developing countries that meet this threshold to make it also an effective tool for increasing transparency within companies that trade regionally. Putting this in place will contribute positively towards minimising trade mispricing that is motivated by the trade between related parties.

- Corporate financial transparency is important in general, in order to enable public access to company annual accounts which under most jurisdictions need to provide information concerning major related party transactions to monitor transfer pricing relationships. It is also important to have full access to all beneficial owners of companies and other legal entities without any threshold, and access information concerning corporate structures to know which companies belong to the same group for tax and wider accountability purposes.

- Judicial transparency, through full public access online to court decisions and rulings concerning companies in any jurisdiction, is also important. This would also include international arbitration that currently mostly happens behind closed doors in commercial courts. Tax rulings, adjustments and fines should also be made public, so that it would be easier to know if a company has been given an administrative tax adjustment by a revenue authority in any part of the world – even when this arises from a settlement with a revenue authority

[2] HS codes are required in the permit declarations of goods. They are used to determine the tariffs, controls and rule of origin applicable to the goods. They are also used for the collection of trade statistics.

[3] http://www.wcoomd.org/en/topics/nomenclature/instrument-and-tools/hs-nomenclature-2017-edition/hs-nomenclature-2017-edition.aspx

[4] Action plan on country by country reporting - http://www.oecd-ilibrary.org/docserver/download/2315381e.pdf?expires=1514364831&id=id&accname=guest&checksum=648803ACAAF4CD7A527EBA76345E2041

rather than as a result of litigation or court decision. In some territories stock market authorities require this information to be made public by the company on an annual basis.

- Capacity building of Customs officers- Training of the customs officer on the fair market value which will form as reasonable benchmarks, where the officers have knowledge on the commodities and their corresponding market prices the curbing incidences of trade mispricing will be minimised. Also capacity building on customs e-invoicing, and information exchange between customs authorities is important so to prevent trade mispricing where different invoices are presented at opposite sides of the border. This is usually easier on land borders.

- Automatic exchange of information between trading partners- this will ensure that the trading countries can easily share trade information. There is need to encourage trading partners to exchange information on the value of transaction executed in their respective custom territories. Further, countries will be encouraged to sign into information exchange conventions such as the OECD's convention on exchange of information[5] and the one proposed by ATAF[6]. This will make it easy for countries to share information on various transactions which may help in curtailing the transfer mispricing practices. There is need for more countries to sign and ratify the information exchange agreements.

[5] http://www.oecd.org/ctp/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm

[6] https://www.ataftax.org/en/products-services/technical-assistance/exchange-of-information

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TAX JUSTICE NETWORK AFRICA

ISBN 978-9966-1898-4-4

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Tax Justice Network Africa (TJNA)
George Padmore Ridge, 2nd Floor, Wing 'B'
George Padmore Lane, Kilimani
P. O. Box 25112 - 00100 GPO, Nairobi, KENYA
Telephone: (+254) 20 24 73373, (+254) 728 279 368
Email: infoafrica@taxjusticeafrica.net
www.taxjusticeafrica.net