

Illicit Financial Flows, Abusive Transfer Pricing and Trade Mispricing

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Presentation Outline

- **Overview: Illicit Financial Flows, Illicit Economy and the Linkages with Abusive Transfer Pricing, Trade Mispricing, BEPS and Tax Evasion**
- **Abusive Transfer Pricing**
- **Trade Mispricing**
- **Problem Statement and Points to Consider**
- **Conclusions**

OVERVIEW: Illicit Financial Flows, the Illicit Economy and the and the Linkages with Abusive Transfer Pricing, Trade Mispricing, BEPS and Tax Evasion



Overview of the Problem: A Global Problem

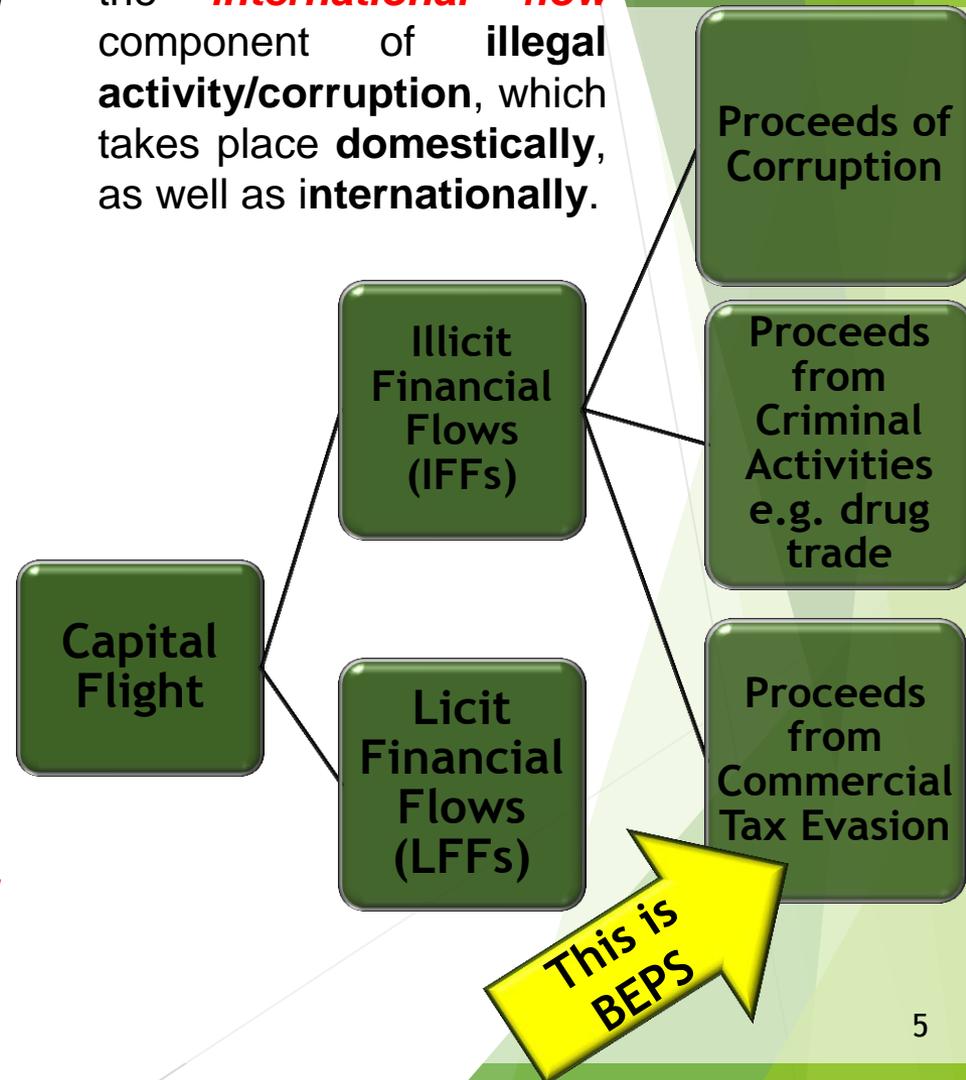
- **Organised crime, the illicit economy and Illicit Financial Flows (IFFs) affect democracies and the functioning of financial markets in an economy and across the globe.**
- Illicit traders generate vast amounts of **cash** that need to be **laundered by morphing cash into instruments** that enable the movement of the funds into global electronic financial systems.
- Money laundering, tax evasion, secrecy jurisdictions and IFFs are seen as **developmental obstacles.**
- Globally the annual average flow of IFFs is in excess of **\$1 trillion** (2007-09). Global IFFs have grown at an **annual rate of 8%**; doubling between 2001-10.
- Africa's share is $\pm 6\%$, or \$60 billion annually (or \$450 billion over a 9 year period). **South Africa's share** of the total **African** proportion of IFFs for the period is **13%**.
- **Trade mispricing** occurs in countries dominated by **extractive industries – like South Africa**
- Main components (globally):
 - **60%** is in the form of **commercial transactions**, involving multinational enterprises, including **tax evasion** through **transfer and trade mispricing**;
 - **35%** is through **criminal activities**, such as **trade in drugs**, and **smuggling of weapons and people**; and
 - **5%** is **corruption** and the **theft of public funds.**

What are IFFs: Definition

Defining Illicit Financial Flows

- Dev Kar, lead economist at **Global Financial Integrity (GFI)**, defines IFF or illicit money as “money that is illegally earned, transferred, or utilised. Somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit.”
- **United Nations Development Programme (UNDP)**, definition: “include, but are not limited to, cross-border transfers of the proceeds of tax evasion, corruption, trade in contraband goods, and criminal activities such as drug trafficking and counterfeiting.”
- In **extractive sectors**, these flows mostly originate from **corruption, illegal resource exploitation and tax evasion (including smuggling and transfer mispricing)**.

- IFFs are understood as the **international flow** component of **illegal activity/corruption**, which takes place **domestically**, as well as **internationally**.



Linking the IE to IFFs and ML

Shadow Goods and Services Economy – Comprising the Informal Sector

Illicit Economy

Production & trade of goods & services through Criminal Activities including:

- Drugs
- Human trafficking & organs
- Illegal arms trade & Terror Financing
- Smuggling (agricultural, mineral, animal etc. ...)
- Racketeering
- Counterfeit goods & currency
- Bribery and Corruption***
- Commercial Activities***
- Mispricing
- Abusive transfer pricing
- Fake transactions
- ...

Licit Economy

Production & trade of goods and services in the formal commercial & non-commercial sectors including:

- Private/individual
- Small, medium and large scale enterprises
- Public organisations and entities
- NGOs, CBOs
- ...

Real sector of the economy

represents the goods & services sector or the productive economy

Illicit proceeds (tax evasion)

Licit proceeds

Money market

represents the financial sector of the economy, which is the proceeds of financial flows stemming from the production & trade of goods and services

Illicit Financial Flows: Money Laundering (commercial purchases & real estate)

Illicit Financial Flows: Tax avoidance & Tax Evasion (including mispricing of goods & services; unreported, unrecorded & unobserved activities)

Illicit Monetary Market

Licit Monetary Market

Illicit Cross-border Flows (tax evasion through tax havens, trade mispricing etc...)

Shadow Financial Economy

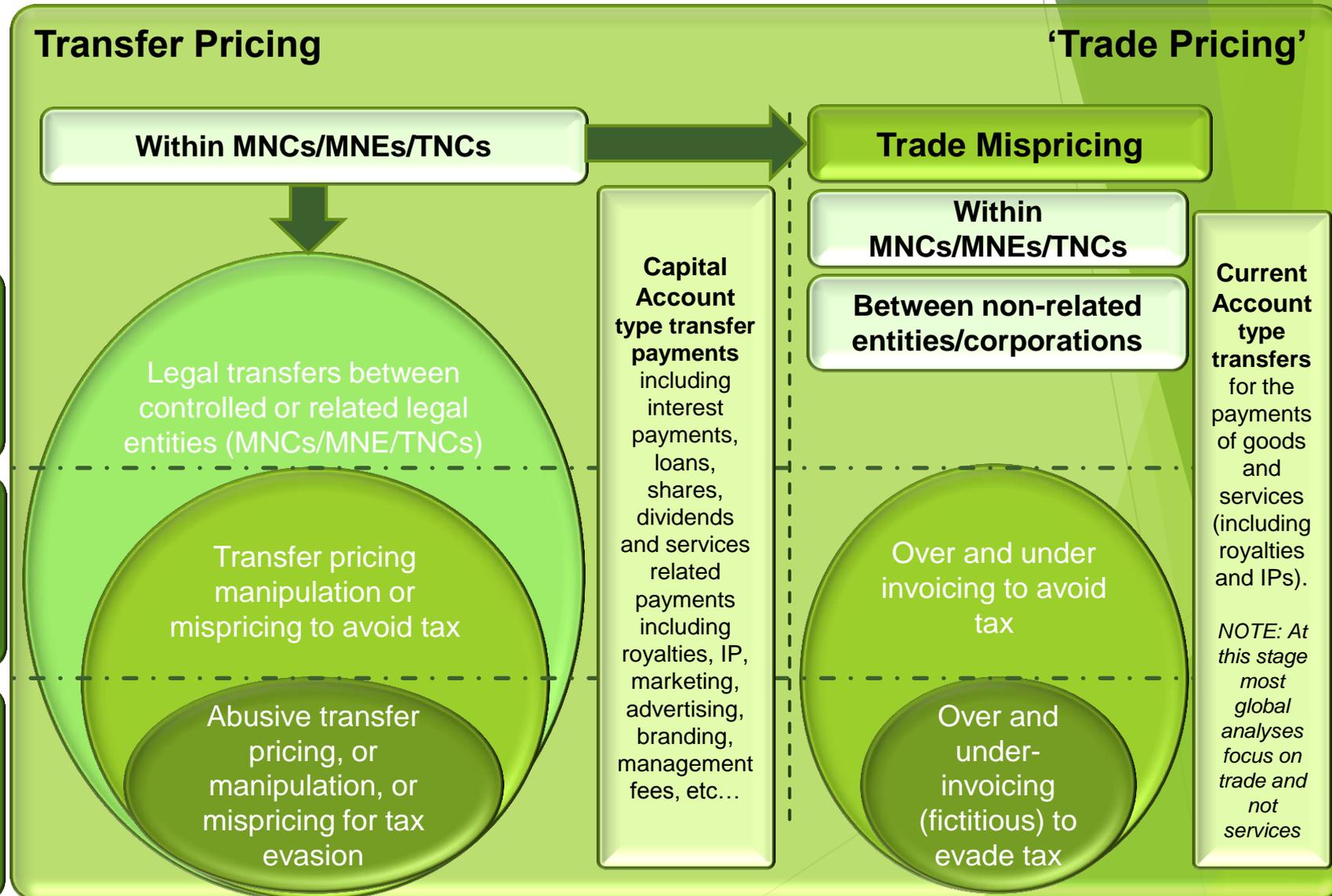
Enablers and Drivers

- IFFs are driven by a number of “push” and “pull” factors.
- The most obvious push factor is a desire to **hide illicit wealth**, i.e. to hide the proceeds away from the public eye and law enforcement agencies; conceal the ways and means by which illicit wealth is created and that make it difficult to trace the associated money flow.
- The following push and pull factors **enable** IFFs:
 - Poor governance, corruption, weak enforcement and regulatory institutions and structures;
 - Double taxation agreements (DTAs);
 - Tax incentives especially if abused or used in conjunction with tax holidays (by exploiting the rules relating to the change of ownership that results in base erosion of a country’s wealth and asset base); and
 - The existence of financial secrecy jurisdictions and/or tax havens.
- NOTE: *Financial secrecy jurisdictions* have elaborate frameworks aimed at attracting financial resources regardless of their origin (or manner generated, i.e. legally or illegally). *Tax havens* on the other hand exploit the differences in tax rates across jurisdictions.
- NOTE: these are the same factors driving BEPS

Key Definitions

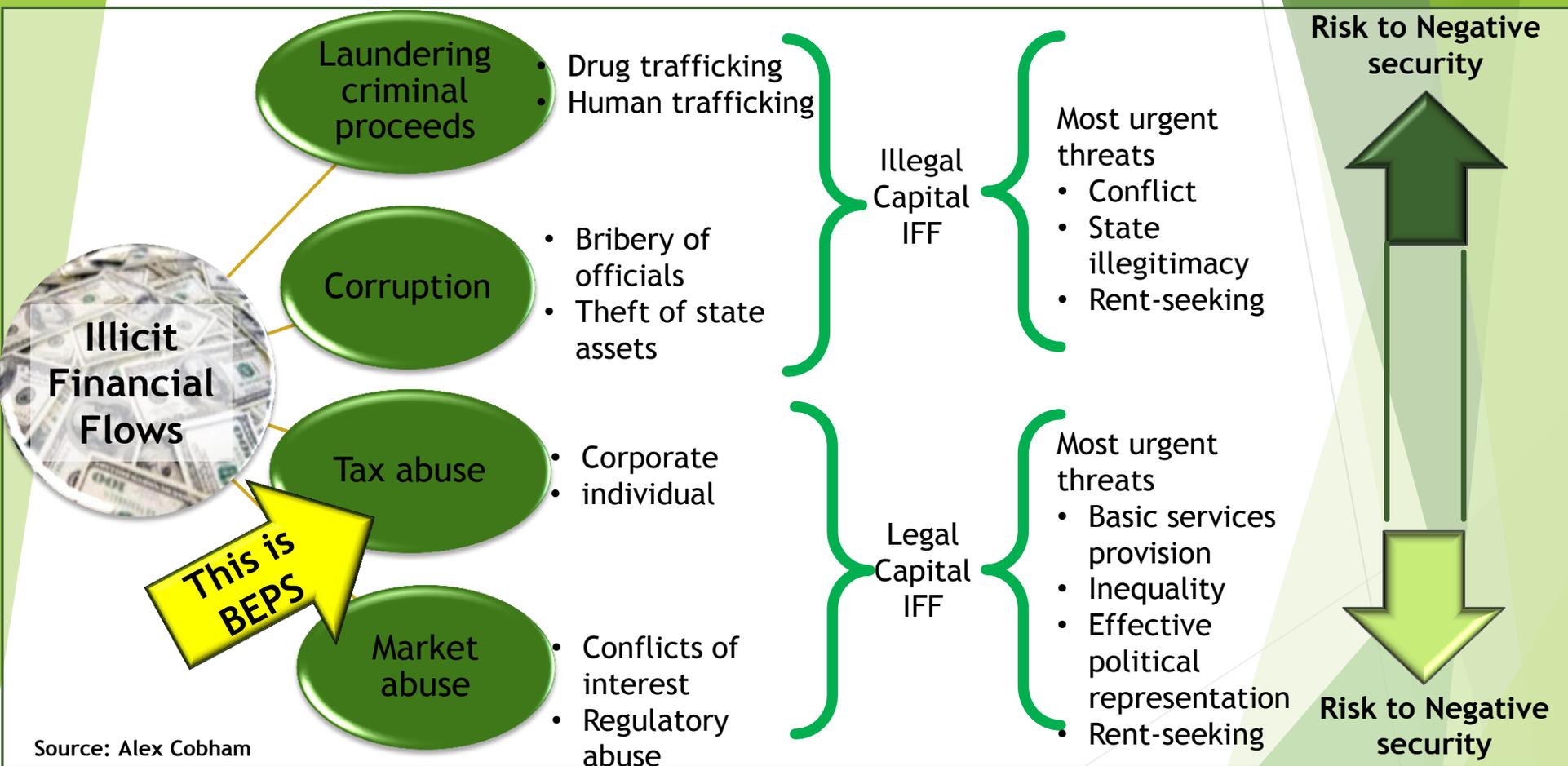
Term	Definition
Illicit Financial Flows	Money that is illegally earned, transferred, or utilised. Somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit.”
Transfer Pricing (LEGAL)	Transfer pricing is the setting of the price for goods and services sold between controlled (or related) legal entities within an enterprise . For example, if a subsidiary company sells goods to a parent company, the cost of those goods is the transfer price.
Abusive Transfer Pricing (or Transfer Mispricing)	Transfer mispricing is a form of a more general phenomenon known as trade mispricing (which is the trade between unrelated or apparently unrelated parties) within multinationals/same group of companies across national boundaries. FORM OF TAX EVASION <ul style="list-style-type: none">• <i>Transfer (mis)pricing utilises legitimate accounting mechanisms to facilitate the transfer of revenues, profits or investment returns (or fictitious management and overhead costs), to secrecy destinations, through complex smurfing arrangements between subsidiaries and their holding companies.</i>
Trade Mispricing (Trade Pricing Manipulation or Fraudulent Transfer pricing)	It refers to trade between unrelated parties at prices meant to manipulate markets or to deceive tax authorities. It includes the deliberate over-invoicing of imports and the under-invoicing export usually for the purpose of tax evasion. FORM OF TAX EVASION

Inter-relationships between Transfer Pricing, Transfer Mispricing and Trade Mispricing: Overview

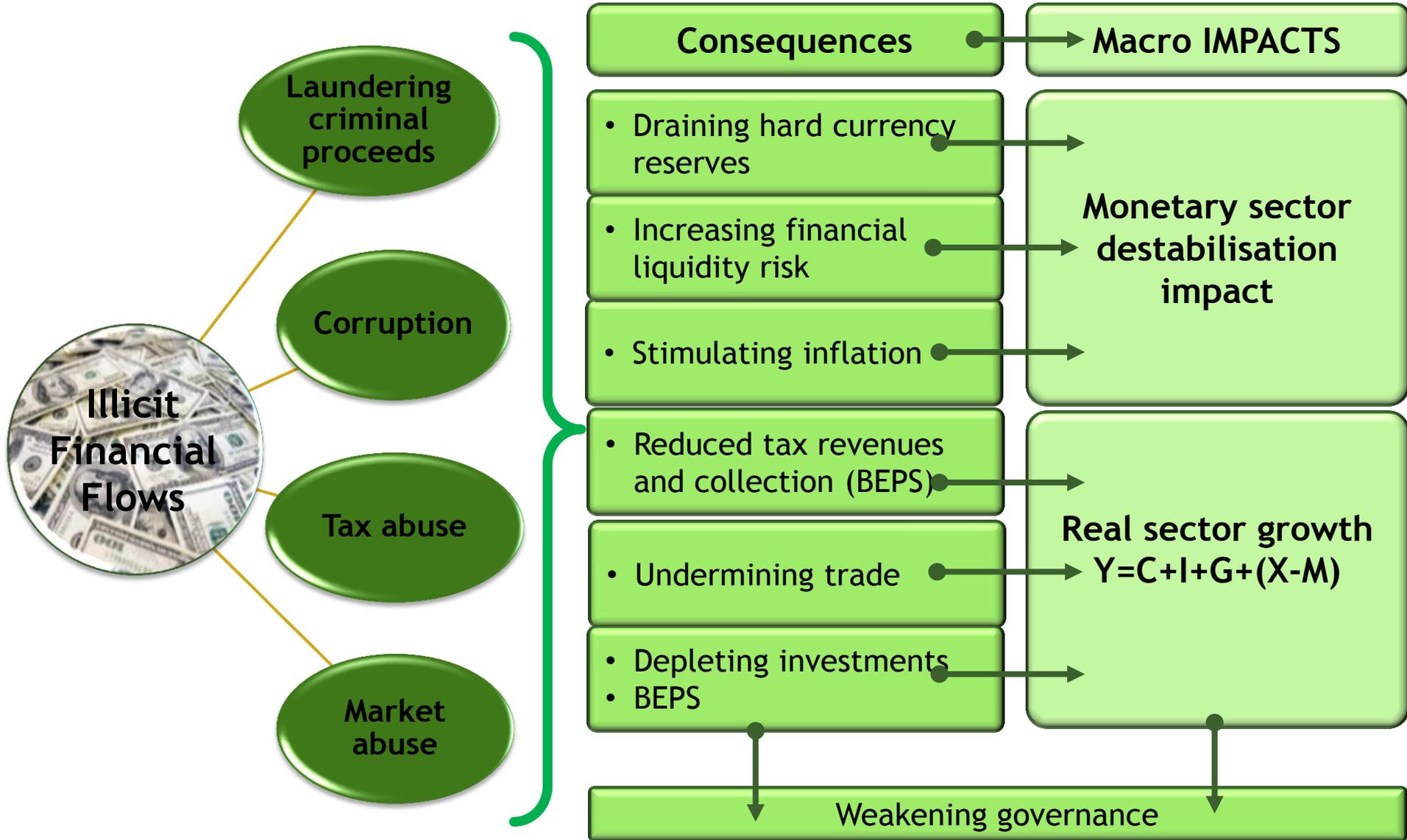


The Impact of IFFs on the South African Economy

- IFFs are an important part of the policy coherence agenda in **international development**, featuring prominently in the G20, G8, OECD, NEPAD, UNCAC, UNECA, etc...



Understanding the Linkages and Impacts



Problem Statement and Strategic Questions



Problem Statement

- **South Africa experienced IFFs totalling more than \$122 billion between 2003 and the end of 2012. In 2012 alone, \$29.1 billion left the country undetected.**
- **South Africa's IFF's account for nearly 7.6 percent of GDP representing nearly twice the average for developing countries.**
- **Trade Mispricing and Abusive Transfer Pricing for South Africa account for approximately 65 percent of IFFs. This is the BEPS focus...**
- **Proceeds from criminal activities represent approximately 35% of IFFs**
- **Corruption represents approximately 5% of IFFs**

PROBLEM STATEMENT: Illicit Financial Flows (of which BEPS is only one component) flow into tax haven destinations or secrecy jurisdictions: drain South Africa's wealth and natural resource base; reduce domestic investment; hamper economic growth; and stifle socio-economic development. These risks and threats undermine economic and financial integrity and stability and ultimately the national security of the country through conflict, state illegitimacy and rent seeking.

What legislative and policy measures can be put in place to ensure that the rents from South Africa's factors of production remain within the South African borders, preventing the erosion of our wealth and resource base, while promoting growth and development?

Strategic Questions or Points to Ponder

QUESTIONS

- **Should the position paper/policy measures/intervention take a more holistic approach, tackling IFFs (a broader mandate)? Or should the focus be on BEPS (Tax Evasion through Abusive Transfer Pricing) only?**
- **What is the intended outcome of the strategy, policy and legislation to be developed? Is it aimed at:**
 - **Curbing tax evasion?**
 - **Preventing capital flight (EFF argument)*?**
 - **Preventing Transfer Pricing (EFF argument)*?**
 - **Preventing IFFs and ensuring that the productive resources in South Africa retain their earnings, thus promoting investment and growth?**
 - **Promote growth and development?**
 - **Prevent the demise of various sectors as per IPAP?**
 - **Raise fiscal revenues?**
 - **Monitor the problem? Or develop a pro-active, holistic strategy and approach?**
- **What are the policy tools and levers to tackle the problem and achieve its intended outcome?**
- **If a holistic approach is planned, how will this be phased over time?**

Strategic Questions

- **What existing pieces of legislation and policy tools can be amended for quick wins in the Short-run?**
- **Which pieces of legislation need to be amended, recrafted for a longer-term approach? What are the time-lines? Is this a feasible option?**
- **Which role-players are critical in developing, legislating and implementing such a strategy?**
 - **Who will coordinate?**
 - **Who will sit in the core/steering committee?**
 - **Who are the peripheral departments that are necessary to participate in this process?**
 - **What (phased) workstreams need to be established?**
- **Is there a clear understanding of the problem and its value chain? And at which stage the flow is likely to become illegal?**
- **Is the same approach going to be developed for all sectors (Primary, Secondary and Tertiary)?**
- **Are the current measures appropriate:**
 - **Beneficial ownership**
 - **Country-by-country reporting by MNC (including EITI)**
 - **Automatic exchange of Tax Information**
 - **Trade Mispricing**
 - **Anti-money laundering**

POINTS TO CONSIDER

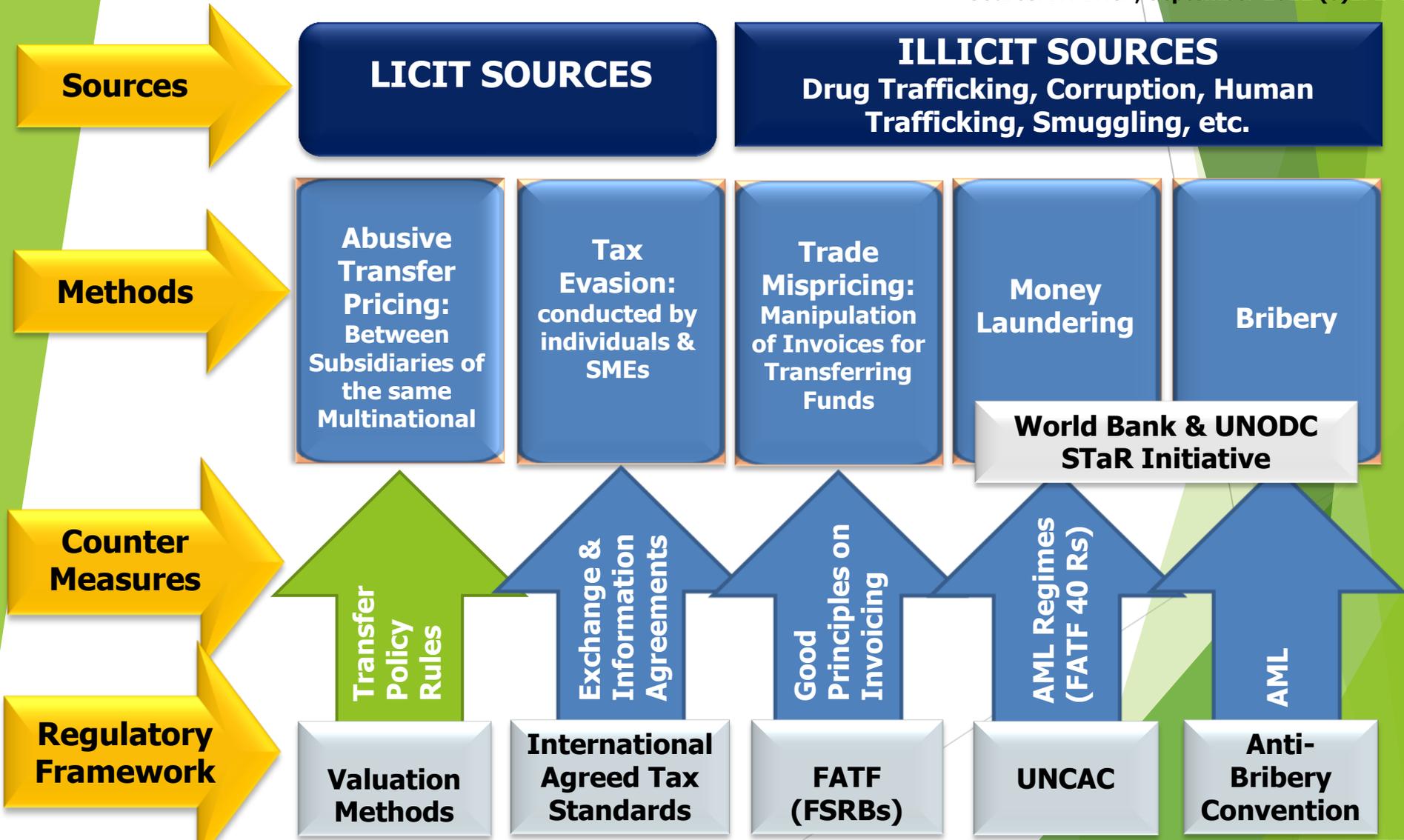
- It is important to distinguish between the legal, illicit (but not illegal) and illegal nature of the problem at hand. Only the **ILLEGAL** component of the problem can be addressed. However, this is not the case for **MONITORING**
- Legislative and policy changes need to be implementable with reasonable state capacity. Any measure implemented will have operational and capacity implications on the state.
- **Measuring Abusive Transfer Pricing and Trade Mispricing** (to a lesser extent) is fairly complex and it is not always possible to separate the two. The **Abusive Transfer Pricing** is complex and uses legal processes to hide revenues from the state.
- Measures should encourage **FDI and growth**.
- It is important to consider the problem from the following perspectives: legislative(strategic), Policy and Operational.
- This means separate roles for policy and oversight departments and law-enforcement or line departments
- The **BEPS** work is very policy oriented and detailed. While this is at a more strategic level as little has been done to address it.

Departmental Responsibilities and Levers to Curb IFFS

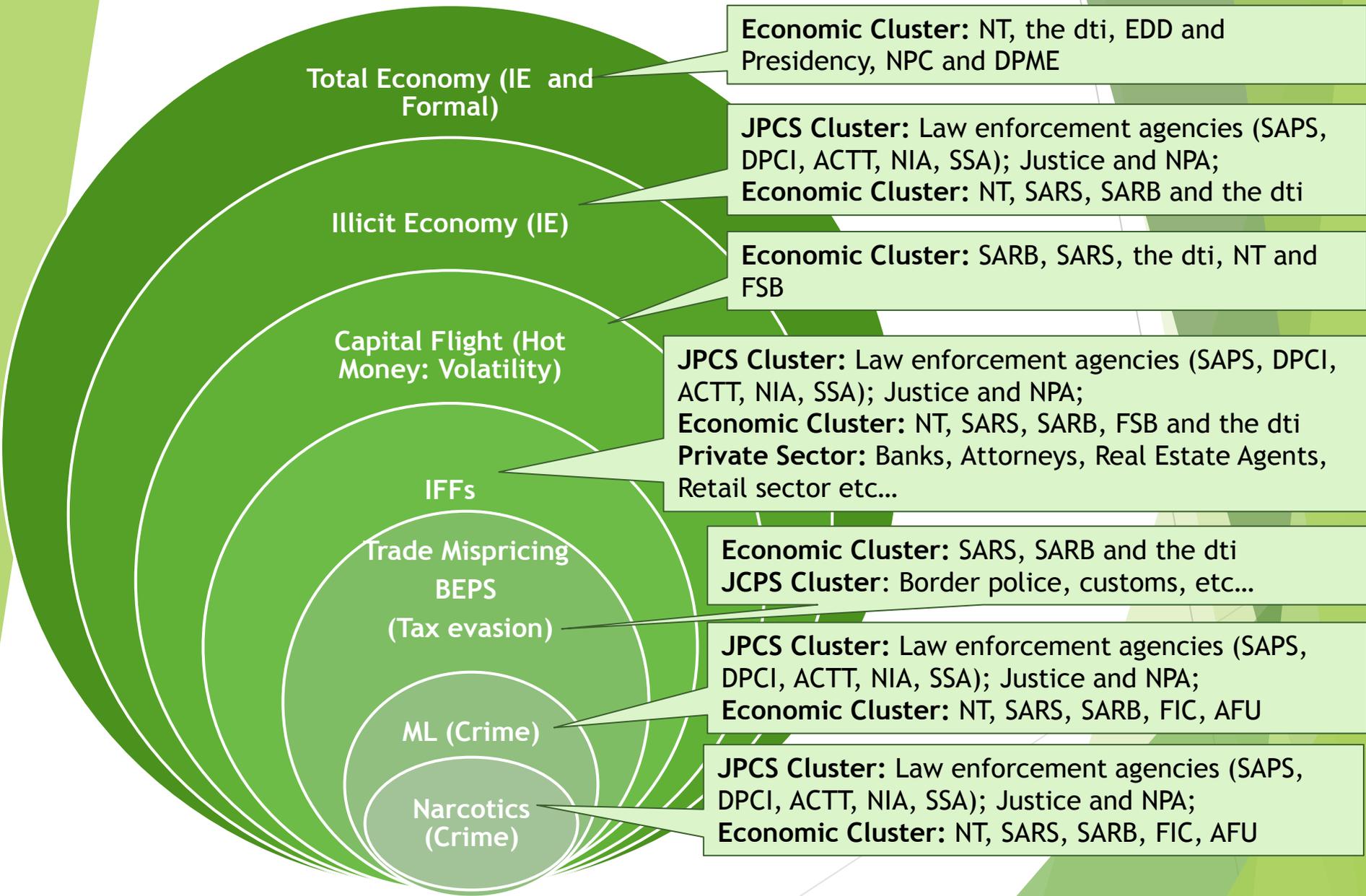
Department	Responsibility to IFFs	Lever/Intervention
NT	Overarching role regarding financial stability, integrity and economic growth	Oversight over all the finance family entities, legislation and regulation Financial regulation, Twin Peaks
SARS	Responsible for tax policies and tax collection Responsible for Customs and Excise	Income Tax Act VAT, Corporate Tax Customs and Excise, Mineral and Petroleum Royalties Act
FIC	Responsible for the proceeds of crime, AML and CTF	FIC Act, POCA
SARB	Responsible for Capital Flows, Foreign exchange, bank supervision, etc...	Currency and exchanges act, Banks Act, National Payments Act
DTI	Responsible for industrial development, protection and development of local sectors and trade, including export incentives	Companies Act Credit extension Act/Promotion and Protection of Investment Bill, Competition Act International Trade Act IPAP
Minerals	Protection of South Africa's extractive sectors	Minerals Act, Mining Charter Mineral and Petroleum Royalty Act, Mineral Resources development Act
Economic Development	Responsible for growth and development	National Growth Path ITAC
Science and Technology	Research, IP (royalties etc...) and innovation around renewables	Intellectual property laws: Copyright Act, Trade Mark Act and Patents Act

Recommendations: Implementing an Integrated IFF Agenda

Source: A4 Brief , September 2012 (8)1. 1-4.



Coordinated Government: IFFs, Abusive Transfer Pricing, Trade Mispricing, BEPS



Conclusions



Conclusions

- **This is a complex area confounded by a large number of terms, definitions and concepts that overlap/ are inter-related, which link IFFs or dirty money (financial flow) to economic activities in the black, grey and white markets.**
- **A position is required and there are leakages from the economy that exclude MNCs and TNCs (BEPS). These should also be considered... Hence a broader approach is required and not just a BEPS approach**
- **Measures to address Transfer pricing, capital flight, IFFs, etc.. Need to distinguish between LEGAL, ILLICIT (but LEGAL) and ILLEGAL elements.**
- **Only the ILLEGAL elements are enforceable. Care needs to be taken not to render licit elements illegal which will becomes too onerous and costly to enforce and scare foreign investors, having the adverse desired effect.**
- **International standards are being developed by the OECD, FATF, UNCAC, EITI, Online real-time pricing tools for customs etc... However, as South Africa we need to assess there and whether they are appropriate for our environment.**