Symposium on IFFs: Bridging Tax Treaty Gaps for SDG Success: Unraveling the Impact of Illicit Financial Flows

By:

Oladiwura Eyitayo-Oyesode

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Introduction

The escalating concentration of global extreme poverty is particularly pronounced in Africa, where the continent presently accounts for 55% of the total worldwide poverty. Reports indicate that these numbers are expected to rise due to the enduring impacts of climate change, the COVID-19 pandemic, and the conflict in Ukraine. As we hit the six-year mark before the designated milestone for achieving the Sustainable Development Goals (SDGs), it is apparent that African nations are still notably behind in making substantial strides toward the specific targets outlined in the SDG Agenda.

Expanding upon the United Nations Millennium Development Goals (MDGs), which concluded in 2015, the SDGs underscore the commitment to addressing a broad spectrum of global challenges. The SDG Agenda tackles 17 pivotal development challenges, spanning areas such as poverty, health, gender equality, crucial aspects of economic growth, urgent global warming issues, social justice, and the promotion of peaceful and inclusive societies. Globally, there is a recognition that countries bear the primary responsibility for addressing systemic issues leading to revenue loss, and global cooperation is essential to supporting national efforts in achieving the SDGs.

Within the African context, there have been calls to African leaders to address structural barriers impeding domestic resource mobilization as a key to the successful implementation of development projects aimed at enhancing the lives of African citizens. This is viewed as a sustainable solution to confront the severe and multidimensional nature of poverty in African nations, requiring concerted efforts from leaders to reshape policies that currently facilitate capital outflows.

Beyond Legality: The Multifaceted Nature of Illicit Financial Flows

IFFs from African countries are estimated at around US$88.6 billion annually, constituting approximately 3.7% of their gross domestic product (GDP). Concerning the impact of IFFs on the realization of the SDGs, the SDG Agenda incorporates a commitment to significantly diminish tax evasion and reduce opportunities for tax avoidance. This commitment involves ensuring that multinational corporations contribute their fair share of taxes in jurisdictions where they conduct economic activities, adhering to both national and international laws and policies. It is recognized that IFFs encompass more than practices leading to violations of national laws, such as tax evasion, and also include tax avoidance practices by multinationals, along with the phenomenon termed as base erosion and profit shifting (BEPS) by the Organization for Economic Co-operation and Development (OECD).

Advocates for a narrower definition, however, contend that IFFs should specifically pertain to the cross-border outflow of capital conducted illegally. An example of this narrow definition is provided by the United Nations Office on Drugs and Crime (UNODC), which defines IFFs as "financial flows that are illicit in origin, transfer, or use; that reflect an exchange of value (instead of a pure money transaction); and that cross country borders”. This restrictive definition of IFFs excludes other types of capital outflows that may not necessarily be illegal but contravene standards widely accepted on an international scale.

On the other hand, proponents of a broader definition argue against confining the term to illegal activities. They base their arguments on the broader interpretation of "illegality" to include actions that are morally wrong or against societal norms. Other justifications include limited enforcement capacity, making it challenging for revenue authorities with constrained resources to effectively address illegal activities, the blurred distinction between tax evasion and tax avoidance, and the prevalent assumption that there is global consensus including tax avoidance in the definition of IFFs.

This article asserts that the worldwide recognition of combatting IFFs goes beyond addressing infringements of national laws, like tax evasion. It underscores the importance of implementing effective rules to ensure that multinational corporations pay their equitable taxes in jurisdictions where they engage in economic activities, following both national and international laws and policies.

Grounded in the acknowledgment by world leaders, this article asserts that endeavors to curb IFFs should encompass rectifying various structural deficiencies that lead to the misalignment of profits declared by multinational corporations and actual economic activity. This perspective goes beyond the narrow definition of "illicit" and focuses on the impact of capital outflows on countries, hindering their efforts to mobilize domestic resources. In line with this perspective, the article identifies specific instances of source-restricting provisions and examines their impact on capital outflows in African countries. Additionally, it explores potential measures that these nations can adopt to address the issue effectively.

The Unseen Costs of Tax Treaties: Assessing Impact, Implications, and the Need for Reform

The foundation of allocation rules in existing tax treaties can be traced back to the 1920s, marked by the decision of four economists from capital-exporting countries. They proposed that source countries relinquishing their taxing rights would solve the issue of double taxation. Initially justifiable as a matter of administrative convenience, this policy was conceived during a period when income flows among treaty countries were relatively balanced. However, in the context of contemporary global dynamics, source restricting provisions lead to substantial revenue losses for capital-importing countries, particularly in instances where capital flows are uneven. Within the African context, tax treaties facilitate the transfer of revenue from African countries, where the funds are crucial for socio-economic development. To address these challenges, there is a compelling need for a re-evaluation of these rules to align with present realities and acknowledge the valuable contributions that African countries make to global trade.

Take, for instance, the taxation of business profits under tax treaties. The criteria for source taxation of business profits from non-resident taxpayers hinge on the presence of a permanent establishment (PE), a fixed place of business where the non-resident taxpayer conducts their business. Tax treaties explicitly define a PE and enumerate activities that qualify as constituting a PE. When no PE exists in the source country, tax treaties grant exclusive taxing rights to the residence state. The higher the PE threshold specified in a tax treaty, the more restrictive the source taxing rights on business income become. In addition to the PE threshold, tax treaties stipulate rules for determining the profits of a PE. Generally, the broader the permissible deductions and the narrower the base for PE taxation, the lower the taxable income in the source state. The implication of these PE-related thresholds and profit determination rules is that business profits resulting from substantial economic activities conducted in African countries may avoid taxation.

Another critical aspect involves the nominal withholding rates applied to the source taxation of passive or investment income, encompassing dividends, interest, and royalties, earned by non-residents in source countries. This approach effectively curtails the tax revenue generated for the source states from investments made by non-residents within their jurisdictions. Recent analyses reveal that, in certain scenarios, the withholding rates outlined in tax treaties signed by African countries for incoming investments are lower than the corresponding domestic rates. In other cases, the rates stipulated in tax treaties are higher than domestic rates, but this does not grant the country the authority to impose taxes beyond the domestically prescribed rate, as tax treaties cannot extend a country's taxing rights. The misalignment in both instances, whether due to lower or higher rates in treaties compared to domestic rates, ultimately leads to the same consequence – impeding the ability of African countries to effectively tax investment income. Therefore, there is a need for amendments to tax treaties and laws to increase the withholding tax rate for investment income.

Another crucial area for intervention by African leaders lies in the taxation of digital services. In an era dominated by significant digital business activities, only a handful of African countries have implemented a digital services tax, including Kenya, Nigeria, Tunisia, Zimbabwe, and Uganda. Ongoing discussions, spearheaded by the OECD, involve unified solutions to the tax challenges arising from the digitalization of the economy, as expressed through Pillar 1 and Pillar 2. Pillar 1 focuses on allocating taxing rights in the digital economy, especially for large and highly profitable multinational corporations. At the same time, Pillar 2 introduces a global minimum tax with the aim of preventing the erosion of tax bases by setting a minimum threshold for taxation of multinational corporations. However, the OECD rules for taxing digital services have faced notable criticism, especially concerning African countries.

A significant area of concern revolves around the perceived inadequacy of the rules in guaranteeing an equitable distribution of tax revenue for countries where digital services are utilized. As digital markets continue to expand in African nations, it becomes imperative that the rules are structured to ensure these countries receive a fair portion of the tax revenue generated from digital services within their territories. In addition, the implementation of these rules will impose an additional burden on African countries with limited administrative and enforcement capacities.

Conclusion

In essence, when foreign companies engage in economic activities within Africa and generate income, it is imperative that the resulting income is subject to taxation by African governments. Achieving this objective necessitates urgent structural adjustments in the tax laws and treaties of African countries. The imperative for African nations to reconsider their tax treaties is underscored by the absence of clear evidence supporting the positive impact of such treaties on Foreign Direct Investment (FDI). Arguments suggest that unilateral mechanisms could effectively prevent double taxation without necessarily relying on tax treaties.

To tackle the challenges in effectively taxing digital services, African countries need to proactively address existing loopholes arising from the absence of rules governing digital service taxation. Taxation laws designed for conventional brick-and-mortar activities, which presently necessitate physical presence, should be reevaluated. This review should encompass enabling the taxation of digital services without the requirement of a physical presence in host countries. Through these measures, African nations can establish a more equitable and efficient taxation framework suitable for the digital era.

These modifications are critical to ensuring that African nations secure their equitable share of cross-border trade and effectively capture the value derived from the exploitation of resources within their borders. According to estimates by the United Nations Conference on Trade and Development (UNCTAD), African countries require $200 million to fulfill the Sustainable Development Goals (SDGs) within the next six years. However, this aspiration faces a significant threat from IFFs if gaps in tax treaties and tax laws contributing to revenue loss are not fixed.

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