University of Pretoria

An Evaluation of Tax Policy Measures Required to stem Illicit Financial Flows in the Diamond Value Chain

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CERTIFICATE OF ORIGINALITY

I hereby certify that the work in this thesis has not previously been submitted for a degree nor has it been submitted as part of requirements for a degree except as fully acknowledged within the text.

I also certify and declare that this thesis and the work reported herein was composed by and originated entirely from me. Information delivered from the published and unpublished work of others has been acknowledged in the text and references are given in the list of references.

Bernd Otto Schlenther

ABSTRACT

Developing countries are hard-pressed to spend more on public services and infrastructure, if they want their economies to grow and to achieve the Sustainable Development Goals (SDG). As such, they need to increase their tax effort by increasing tax revenue as a percentage of GDP. Tax policy formulation faces many complexities in developing countries and is continuously challenged by macro-economic volatility and an ever-changing risk environment.

So-called "illicit financial flows" (IFFs) from developing countries in Africa are said to be pervasive and detrimental to African economies, because they pose risks to macro-economic stability, tax revenues and governance. Literature identifies various reasons for IFFs. These may include tax evasion, smuggling, people trafficking, abusive transfer pricing and customs fraud, currency exchange violations, money laundering, corruption and terrorist financing – or a combination of these. Broad consensus exists that IFFs are ill defined, and this in turn implies that different policy handles may be available to address the problem. I focus on tax policy as a key component to address IFFs: aside from its revenue mobilization properties, it is an important tool for good governance, democracy and the basis for the social fiscal contract between governments, on the one hand, and citizens and corporations, on the other.

I apply the social sciences theory of "wicked problems" to the concept "IFFs," in order to ascertain whether IFFs meet the criteria of wicked problems as set by Rittel and Webber in *"Dilemmas in a General Theory of Planning"* (1973), and whether the concept "IFFs" qualifies as a wicked problem. This requires that, as a minimum, the prominent inter-connected subsets of problems which cut across multiple policy domains and levels of government are identified before a solution can be framed. I use the diamond industry value chain to illustrate how inter-connected subsets of problems and policy overlaps related to IFFs, manifest. I choose the diamond industry because it can be viewed as a microcosm that is illustrative of the pervasiveness of IFFs. In framing a solution, I explore whether action strategies or collaborative approaches, such as knowledge networks or other forms of horizontal government initiatives, for example the whole of government approach, are feasible solutions to address IFFs. I identify the main types of risks in the diamond value chain and action strategies to address these risks. I find that tax policy on its own, no matter how well developed, is insufficient to address IFF concerns and that sound anti-money laundering and anti-corruption policies are equally important. I find that a "whole of government approach" supported by sound risk management practices, is best suited to address wicked problems such as IFFs.

LIST OF ABBREVIATIONS AND ACRONYMS USED

AEIO	Automatic Exchange of Information
AML	Anti-money laundering
AMLCTF	Anti-money laundering and counter-terrorist financing
APSC	Australian Public Service Commission
ATAF	African Tax Administration Forum
AUSTRAC	Australian Transaction Reports and Analysis Centre
BEPS	Base Erosion and Profit Shifting
CIT	Corporate Income Tax
CRS	Common Reporting Standard
CRS MCAA	Multi-lateral Competent Authority Agreement for the Common Reporting Standard
CTF	Counter Terrorist Financing
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FIC	Financial Intelligence Centre
GFI	Global Financial Integrity
HMRC	Her Majesty's Revenue and Customs Service
IFFs	Illicit Financial Flows
IIA	International Investment Agreement
IMF	International Monetary Fund
IRS	Internal Revenue Service
KPCS	Kimberley Process Certification Scheme
MAA	Mutual Assistance Agreement
MCMAA	Multi-lateral Convention on Mutual Administrative Assistance
MNE	Multi-national Entity
NPA	National Prosecuting Authority
OCDETF-FC	Organised Crime Drug Enforcement Task Force Fusion Centre
OECD	Organisation for Economic Co-operation and Development
OFCs	Offshore Financial Centres
PIT	Personal Income Tax
SADC	Southern African Development Community
SARS	South African Revenue Service
StatsSA	Statistics South Africa
TIEA	Tax Information Exchange Agreements
TJN	Tax Justice Network

UN	United Nations
UNECA	United Nations Economic Commission for Africa
VAT	Value-added Tax

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CHAPTER 1:
INTRODUCTION

1.1 Background

So-called “illicit financial flows” from developing countries in Africa are said to be pervasive and detrimental to African economies.[1] Estimates are that the developing world lost USD 1 trillion to illicit financial flows in 2013, with Asia losing the most in USD value. However, sub-Saharan Africa tops the list when illicit financial flows are scaled as a percentage of gross domestic product (GDP), with illicit financial outflows averaging 6.1 per cent of the region’s GDP.[2]

The concept of illicit financial flows (IFFs) was popularised by Raymond Baker in 2005,[3] and since then Global Financial Integrity (GFI), the Organisation of Economic Cooperation and Development (OECD), the World Bank, the United Nations (UN) and the United Nations Economic Commission for Africa (UNECA), the Thabo Mbeki Foundation and the Tax Justice Network (TJN) – to name but a few international organisations and NGOs – have raised the issue and the level of debate surrounding IFFs.[4] These institutions and organisations argue that IFFs can negate potential growth from attributes of the African continent, such as its vast natural resources and its demographic dividend of a youthful labour force.[5] In this context, it is argued that IFFs exacerbate income inequality and undermine a nation’s fiscal capacity. IFFs also impact the degree to which the government can credibly enact and implement revenue, expenditure and monetary policies to achieve socially desirable outcomes.[6]

Various estimates have been produced as to the size of the problem. In 2004, Transparency International estimated that “the top ten most corrupt heads of state in developing countries have siphoned off an estimated USD 60 billion during their tenure in office.”[7] In 2005 Raymond Baker put illicit flows at an estimate of USD 540 billion, due to tax evasion, trade mispricing, drug

[1] IFFs are on the agenda of all major international institutions, civil society movements and governments, e.g. the United Nations (www.un.org/.../illicit-financial-flows-africa-track-it-stop-it-get-it); African think tanks (www.uneca.org/iff; http://www.oecd.org/tax/exchange-of-tax-information/joint-statement-on-the-fight-against-illicit-financial-flows-by-angel-gurria-and-thabo-mbeki.htm); the African Union (https://www.covafrica.com/2015/02/au-un-report-reveals-startling-illicit-financial-flows-in-africa/); the IMF (www.imf.org/external/pubs/ft/survey/so/2010/NEW031210A.htm); NGOs (www.gfintegrity.org/issue/illicit-financial-flows); local and international media (mg.co.za/article/...25-illicit-financial-flows-costing-africa-billions; www.theguardian.com/.../may/29/illicit-financial-flows-africa-creditor); the OECD (http://www.oecd.org/corruption/Illicit_Financial_Flows_from_Developing_Countries.pdf) and the World Bank (live.worldbank.org/illicit-financial-flows).
[2] GFI (2015).
[3] Baker R (2005) 118.
[4] TJN (not dated); UNECA (2012); GFI (not dated); World Bank (2016); OECD (2014).
[5] Kar (2015).
[6] Kar (2015).
[7] Transparency International (2004).

trafficking and corruption. Baker estimates that 60 per cent of total illicit flows arise from "legal commercial activity" and the remaining 40 per cent is ascribed to illegal activities. In 2017, GFI estimated that an average of 87 per cent of illicit financial outflows were due to the fraudulent mis-invoicing of trade.[8] According to some estimates,[9] approximately USD 991.2bn was funneled out of developing and emerging economies through corruption, tax evasion and other crimes in 2012 alone, whereas from 2003 to 2012, developing countries lost USD 6.6 trillion to illicit outflows.[10] In 2014, UNECA puts illicit flows from Africa at roughly USD 50 billion per annum.[11] This is approximately double the official development assistance which Africa receives and the estimate may not be realistic, as accurate data does not exist for all transactions and for all African countries.[12] In 2017, GFI estimated that sub-Saharan Africa is leading all other regions for illicit outflows (estimated at between 7.5 per cent and 11.6 per cent of total trade on average over the period 2005-2014), whilst illicit inflows were estimated at between 6.3 per cent and 13.1 per cent of total trade.[13]

Whilst these aggregated estimates are quite useful for advocacy purposes, they need to be disaggregated for policy and research purposes.[14] Reuter argues that from a policy perspective, IFFs need to be addressed because "they drain capital and tax revenues" from high tax developing countries to low tax jurisdictions.[15] Measuring the scale and impact of IFFs accurately is therefore of significance, since activities underlying IFFs, such as tax evasion or money laundering, promote criminality in that perpetrators of crime are allowed to retain the benefits which they acquired through their criminal acts. In addition, increased efforts in combating tax evasion and money laundering involve compliance costs in the form of an increased cost of enforcement and an increased administrative burden.[16] For tax administrations, "measures of the performance of the administration through the comparison of actual collections against the compliance or tax gap" are essential in determining where to direct resources; and "in the same vein, a measure of how much money is laundered is required to determine the effectiveness of the AML regime and the reduction of money laundering in targeted areas."[17]

[8] GFI (2017) vii.
[9] Kar & Spanjers (2014) 1.
[10] Kar & Spanjers (2014) 1.
[11] UNECA (2014) 13.
[12] UNECA (2014).
[13]GFI (2017) 7, 11. GFI estimates that over the period between 2005 and 2014, IFFs potentially accounted for approximately 14 per cent and 24 per cent of total developing country trade, on average, with outflows estimated at 4.6 per cent to 7.2 per cent of total trade, and inflows between 9.5 per cent to 16.8 per cent. GFI further estimates that total IFFs grew on average, between 8.5 per cent and 10 per cent per year over the ten-year period. Outflows are estimated to have grown at an average annual rate of between 7.2 per cent and 8.1 per cent and inflows at a slightly faster pace, of between 9.2 and 11.4 per cent per year (2017:vii).
[14] Reuter (2017) 2.
[15] Reuter (2017) 1-2.
[16] Schlenther (2014) 18.
[17]Schlenther (2014) 20. Schlenther argues that "predicate crimes are typically targeted in AML regimes for obvious reasons – if the predicate crime is addressed, there are fewer proceeds to launder. Since tax crime is a predicate offence to money laundering in many jurisdictions, an understanding of the volume and value of tax evasion may allow some measurement of the scale of money laundering – or at least a component thereof."

Keeping these sizeable estimates in mind, the next question one can pose is: what is the cause of these illicit financial inflows and outflows? The OECD recently identified tax crime as "one of the top three sources of dirty money which is hidden in the financial system."[18] It is also common cause that tax crimes, money laundering and violations of exchange controls are "primary threats to the economic stability of developing countries."[19] 2010 estimates in one of the leading economies in Africa, namely South Africa, put the value of illegally acquired money as a result of money laundering as high as USD 5 billion annually.[20]

Aside from the high losses associated with IFFs, the terminology used is problematic. The term "illicit" means "not allowed by the law" and/or "not approved of by the normal rules of society".[21] It therefore includes both an illegal aspect and an immoral aspect (which may be legal but is morally frowned upon). In reviewing available literature, organisations have followed an approach of (a) either limiting the scope of illicit to mean illegal (legal interpretation) or (b) to use the term inclusive of illegal and immoral (normative approach).

Irrespective of which approach is followed, the outcome of the research by different institutions has provided ample information on the core underlying issues of IFFs. From an OECD perspective[22] it is highlighted that:

a) IFFs that originate from developing countries and end up in OECD countries can consist of money laundering, tax evasion[23] and bribery.
b) It is important to address tax evasion (as a major source of IFFs) on a global level, especially since the average revenue mobilization of tax revenues in sub-Saharan Africa

[18] OECD (2012) 74.
[19] OECD (2012) 74.
[20] Van Jaarsveld (2011) 4.
[21] Oxford Dictionary & Cambridge Dictionary.
[22] OECD (2014a) 11 - 12.
[23] Tax evasion or tax fraud is "a criminal offence and is punishable by criminal sanction. Tax evasion represents illegal and intentional actions by which evaders fail to pay legally due obligations" [Thuronyi (2003) 154 and Cordes, Ebel and Gravelle (2005) 401]. Specifically, what behaviour constitutes tax evasion depends on the criminal laws of each country. According to Thuronyi, "tax evasion is characterized by fraud and deceit. It refers to all those activities deliberately undertaken by a taxpayer to free himself from the tax that the law charges upon his income, for example, the falsification of returns, books and accounts and the conclusion of sham transactions. Tax avoidance refers to any activity aimed at reduction of tax that is not criminal in nature, or it denotes a situation where the taxpayer has arranged his affairs in such a perfectly legal manner that he has either reduced his income or that he has no income on which tax is payable" (Thuronyi 2003: 152). Thuronyi points out that the term is used to connote tax minimisation behaviour that skirts the limits of the law, or that is in fact legally ineffective in reducing the taxpayer's liability. Tax avoidance transactions are structured transactions by means of which a taxpayer qualifies for favourable tax treatment under the literal language of the law. The taxpayer could argue that because the statutory language is clear, it entitles him to the treatment sought. The counter argument is that the taxpayer's actions are inconsistent with fairness in taxation and that courts may therefore be inclined to disallow the benefits if there is a sound legal basis to do so. Thuronyi also points out (2003) 152 that tax law often treats transaction differently, which are similar in economic terms. Taxable transactions are legally defined events. By manipulating the transactions that they engage in, taxpayers can legally reduce the tax that they are required to pay which exploits the legal definition of taxable income based on categories and legal categories.

is less than 17 per cent of GDP. Effective exchange of information is viewed as a key aspect in achieving this objective.

c) Because the financial system facilitates the movement of IFFs, AML regimes have the potential to be effective tools to identify and mitigate the flow of illicit funds into the financial system.

d) An estimated USD 1 trillion is paid annually in bribes, and by reducing the predicate offence of corruption, IFFs can be mitigated. By adopting the OECD Anti-Bribery Convention and criminalising the payment of bribes, countries can address the supply side of corruption.

e) It is important that assets siphoned off to foreign jurisdictions are repatriated to their country of origin, thereby providing additional resources and a sense of justice to societies bearing the brunt of IFFs.

The Economic Commission for Africa articulates further underlying issues to IFFs:

> "Money laundering, drug trafficking, racketeering, counterfeiting, dealing in contraband goods and terrorist financing account for 35 per cent of illicit financial flows globally (ECA, 2014). Money laundering was estimated at USD 1.6 trillion, the illicit drug trade at USD 320 billion and counterfeiting at USD 250 billion. Also, commercial transactions by multi-nationals, tax evasion, laundered commercial transactions, aggressive tax avoidance through harmful tax holidays, duty waivers and mis-invoicing account for 60 per cent of global illicit financial flows. The remaining five per cent of these flows is driven by corruption (theft, bribery and other forms); although the figure could be much higher. This is because corruption is cross-cutting and relates to other IFFs components such as organized crime, drug trafficking, money laundering, tax evasion, trade mis-invoicing, lobbying and transfer pricing by private sector businesses, which are often overlooked."[24]

The World Bank describes IFFs as a powerful concept to bring together previously disconnected issues and expresses the view that it is more constructive to focus on how best to address the flows, instead of debating as to where the line should be drawn between legal and illicit flows.[25] The World Bank further points out that in some instances, actions to address illicit flows will revolve around preventing criminal activity. In other cases, it may involve increasing officials' capacity to identify and sanction serious and substantial tax evasion.[26]

[24] UNECA (2015) 2.
[25] World Bank (2016).
[26] World Bank (2016).

Whilst it is a logical and systematic approach to draw a distinction between the legality/illegality of the source of IFFs to take remedial action, it may not always be possible to do so. A corrupt act may only be uncovered when a "legal" transaction is audited. For example, a transfer pricing arrangement is scrutinised through an assessment of all relevant information (such as structure of the company, copies of contracts or agreements related to the potentially affected transactions entered into by the person with each connected person, description of funding structures, etc.) and it is found that the transaction is permissible. However, the contract is found to have been concluded through abuse of office by a politician. The enquiry then turns into a multiple stakeholder investigation into corruption, contravention of anti-money laundering legislation and tax laws. It also asks questions in relation to government policies relevant to the industry. The ultimate effect is that the entire value chain becomes open to scrutiny.

Fiscal policy is an important determinant in how wealth is generated or destroyed in an economy. It is also the means for promoting foreign direct investment in a country, on the one hand, and addressing capital outflows on the other. However, excessive reliance on large taxpayers such as MNEs, may create difficulties in establishing a valid social contract with the poor. This is so because government dependence on a larger taxpayer base potentially increases incentives to promote broader prosperity and to put in place administrations that can collect and administer taxes effectively. In this sense, governments can be perceived to be more responsive to their citizens and, in that way, government can build state capacity.

The state building role of taxation is underscored by various authors and institutions.[27] Brautigam, Fjeldstad and Moore argue that taxation may in fact play the *central* role in building and sustaining powers of states in two main areas, namely: (a) the rise of the social contract based on bargaining around tax and (b) the institution building stimulus provided by the revenue imperative.[28] Progress in the first area may foster representative democracy, and progress in the second may strengthen state capacity. Both areas have the potential to improve state legitimacy and accountability between the state and its citizens.[29]

Tax policy and as a result tax laws, typically provide for mechanisms to discourage and address tax avoidance and tax evasion. There are however, statutory limitations to the tools at the disposal of revenue authorities to collect revenue that is due and payable. The revenue authority may then

[27] Brautigam, Fjeldstad & Moore (2007) 1; 34; 114. The authors identify state building as the process of increasing the administrative, fiscal and institutional capacity of governments to "interact constructively with their societies" and to pursue public goals more effectively; Bird (2015: 23) states that it is necessary for any state to function, and the most reliable way to get it to do so is with an effective tax administration. The OECD (2014a: 59). highlights that "tax collection is central to the exercise of state power, making the need to address governance issues in tax collection of wider importance."
[28] Brautigam *et al* (2007) 1.
[29] Brautigam *et al* (2007) 1.

be required to rely on coordination mechanisms with other agencies to increase its reach. For instance, financial intelligence units (FIUs) are statutorily enabled under anti-money laundering legislation to take action that may not be allowed under tax laws. In instances where corrupt officials are protected, enablers such as sanctions on “politically exposed persons” may be invoked locally or by foreign FIUs to seize proceeds of crimes and to take steps toward prosecution of such persons.

It is commonly recognized that corporate groups are notoriously difficult to tax due to their legal, economic and functional nature.[30] This raises very complex issues when approached through the lens of contemporary corporate income tax systems which are largely based on the corporate law paradigm of the corporation as a self-sufficient governing entity. The economic activity of multi-national corporations is driven to achieve competitive advantage through the capacity of their operating subsidiaries to innovate. Innovation is anchored in the efficient use of resources (including key assets and responsibilities throughout the corporate group) located in the jurisdictions where subsidiaries are located. As the structures become more decentralized and more networked, several of the group’s operating companies can become highly dependent on each other’s resources to achieve their own objectives.[31] From a tax perspective, it becomes necessary to consider that the functional structures of corporate groups do not necessarily follow their legal structure, and that one therefore needs to understand the value chain of the group.

The complexities of value chains in different industry sectors and the diverse government agencies responsible for facilitating trade and for protecting society[32] require an integrated government response which takes into account globalization, national regulations and international obligations. The sheer scale of the monitoring obligations of any country to address illicit financial flows is illustrated through the diamond value chain and a recent tax dispute between *Omega Diamonds* and the Belgian Tax Authority.[33]

The *New York Times* sketches the scene underlying the dispute quite dramatically as:

> “a flurry of legal cases, investigations and leaked bank documents have drawn attention to the opaque movement of diamond-backed money. The dealings between gem traders and bankers are coming under new scrutiny as European governments extend

[30] Correia (2013) 1; Devereux & Vella (2014) 1; Johansson *et al* (2016) 18,19.
[31] Correia (2013) 1, 79, 81.
[32] According to the WCO, the efficiency and effectiveness of customs border compliance is a determining factor in ensuring goods, people and means of transport comply with laws and regulations, the attainment of safe and secure communities, the economic competitiveness of nations, the growth of international trade and the development of the global marketplace.
[33] Open Source Investigations (not dated).

crackdowns on tax evasion and money laundering at a time of persistent economic trouble."[34]

The investigations were triggered by a whistle-blower who provided a list of 3,000 secret Swiss accounts at HSBC. Of these accounts, 70 per cent were reported as held by diamond dealers and, of the 369 offshore companies included on the list, 193 were connected to diamond dealers. In 2013 Omega Diamonds was accused of participating in a scheme to avoid taxes from 2003 to 2008 by transacting deals for Congolese diamonds through dozens of offshore companies and banks in Dubai and Geneva, before allegedly transferring the money back to Belgium. The matter also made a turn in the South African Supreme Court of Appeal after the Belgian examining magistrate requested South Africa to assist in obtaining shipping documentation, Kimberley Process (KP) certificates[35] and packing lists from the local shipper.[36] The request from the Belgium authorities was opposed by *Tulip Diamonds Fze* (a foreign Dubai-based entity) on the grounds that, by providing the requested documents, the South African authorities would be violating its right to confidentiality.

The request from the Belgian authorities recorded how Omega was implicated in alleged criminal activities. In the request, it was stated that Omega, based in Belgium, imported diamonds originating from Angola and the Congo through an associated company in Dubai. Omega ordered the shipment of diamonds in accordance with the legally required Kimberley Certificates, from Angola and the Congo, for delivery to Tulip Diamonds, located in Dubai. The diamonds were packed in small parcels, and when the parcels arrived in Dubai, the small parcels were kept but repacked into bigger parcels. The newly packed parcels contained diamonds from both Angola and the Congo, but there was no physical mixing of the stones. A new Kimberley Certificate was issued for the repacked shipment of diamonds, indicating that the shipment originated from the United Arab Emirates and was marked "diamonds of mixed origin." The new shipment was issued with a new invoice made out by Tulip Diamonds and was addressed to Omega. The new invoice

[34] Carvajal (2013).

[35] The Kimberley Process is a joint government, international diamond industry and civil society initiative to stem the flow of conflict diamonds (KPCS – not dated). It is a certification system that aims at preventing diamonds originating from an area of conflict, from entering the legitimate diamond supply chain. The Kimberley Process aims to ensure that only rough diamonds accompanied by a government-issued certificate can be imported and exported, providing an assurance that the diamonds are from conflict free sources. Under this United Nations mandated system, only countries that are part of the Kimberley Process (74 countries are members) can import or export rough diamonds. Any imports or exports of rough diamonds between these countries without a Kimberley Process certificate is illegal (KPCS not dated). In addition to the Kimberley Process, the voluntary *System of Warranties* was developed by the World Diamond Council (WDC) to extend the Kimberley Process conflict free assurance to polished diamonds and to "provide a means by which consumers can be assured their diamonds are from conflict free sources. Its principal element is a declaration on the invoice accompanying every transaction (apart from the transaction directly to the consumer) of polished diamonds that declares the diamonds are 'not involved in funding conflict and are in compliance with United Nations resolutions'." (WDC 2014:1).

[36] *Tulip Diamonds Fze v Minister of Justice and Constitutional Development* (810/2011) [2012] ZASCA 111 (7 September 2012).

reflected an increase of between 20 and 31 per cent in the diamonds' value. In so doing it was said that "the value of the diamonds was artificially increased, generating profits which were kept secret from the Belgian tax authorities."[37]

This case, which involves Angola, South Africa, the Congo, the UAE, Switzerland and Belgium, highlights several issues relevant to understanding illicit financial flows (IFFs). First, diamonds are a highly portable commodity and can be used as collateral for loans, employed to evade tax and to conduct money laundering. Questions can be asked around the extraction of the commodity, for example whether it was done legally – meaning the miner held title to a claim, whether the Kimberley Process (KP) certification process was followed and whether the correct value was declared to the tax and customs authorities. Second, if the legality is not in dispute, questions around tax avoidance can be asked relating to transfer pricing practices or taxpayer behaviour which seeks to conceal the beneficial ownership of the commodity. Additional questions can be asked in relation to the contract between the mining company and the host country, in as far as benefits accrue to the host country from the extraction and sale of diamonds.

The conclusion of the case is that a settlement was reached between the parties for EUR 160 million in penalties in the previous year, and the accused claimed that under the *non bis in idem* principle they cannot be tried twice for the same offence.[38] The court held that the principle could not be relied on, as the settlement was yet to be confirmed in law. The court held further that there were no legal grounds to prosecute, as the statutory sections on which the customs and excise authority relied, were unenforceable because they conflicted with European Union (EU) legislation.[39]

The customs and excise authority claimed that it had a due diligence obligation by virtue of its mandate to protect the integrity of the Antwerp diamond market, and that it therefore applied stricter control mechanisms to the diamond industry. It is for this reason that the court found that the application and regulation of the act was in violation of EU law and trade policies.[40] The case is illustrative of the inherent conflict between trade facilitation and law enforcement, for example, the Financial Action Task Force (FATF) would no doubt have supported the stance of the Belgian Customs and Excise authority, as it found the following deficiencies in the country's anti-money laundering framework:

[37] *Tulip Diamonds Fze v Minister of Justice and Constitutional Development* (810/2011) [2012] ZASCA 111 (7 September 2012) [9].

[38] De Standaard (2015).

[39] Reportedly, this excludes at least €205 million worth of diamond transactions between the Antwerp-based firm and fictional companies in the United Arab Emirates. If customs do not appeal against this acquittal, the suspects could only be fined €160 million and not be punished for this €205 million. See Johansson S (2015).

[40] "In dit licht is het duidelijk dat de toepassing van de reglementering in huidig dossier in strijd is met het Unierecht en de handelspolitieke bevoegdheden overschrijdt die werden toegekend aan de lidstaten."

a) The implementation of anti-money laundering and counter terrorist financing (AML/CFT) measures by diamond dealers does not seem adequate to guarantee control of the sector's high risks. Supervision of these players remains extremely limited, notably due to a lack of available resources. Despite the proven risk of money being laundered into this sector, suspicious transaction reports (STRs) are totally lacking. The number of investigations and prosecutions seems insufficient to date, given the identified level of risk, even though two significant cases are currently under investigation.[41]

b) There are significant risks associated with the diamond industry due to Antwerp's position as a main centre of global diamond trade and the high volumes traded through the city.[42]

c) Due to the high level of risk pertaining to Belgium, specifically, under-prosecution of offences such as cross-border movement of cash, precious metals or diamonds occurs.[43]

Illustrative of the case is that each phase of the diamond value chain has its own characteristics, different geographical dimensions are present, the participants differ and the vulnerabilities and risks differ in accordance with each phase of the value chain.

Globally there are 29 diamond bourses affiliated with the World Federation of Diamond Bourses (WFDB).[44] In many countries in Africa, where diamond mining is not controlled by large multi-nationals, localised markets exist close to diamond mining locations, where street vendors are able to buy diamonds from artisanal miners. With limited regulation, the latter is not only hard to control, but also "hard to tax". There is also ample opportunity for conflict diamonds[45] to enter the formal or regulated industry, as a result of weak administration and corruption. Once cut and polished, tracing of a diamond becomes increasingly difficult, thus exposing the polishing stage to vulnerabilities.[46]

From a revenue leakage perspective, the FATF highlights the fact that exported diamonds carry the risk of having a low value assigned to them as a way to minimize income tax or export duties,

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[41] FATF Mutual Evaluation Belgium (2015) 6.

[42] FATF Mutual Evaluation Belgium (2015) 28. The FATF report claims that "It is estimated that around 84% of the global production of uncut diamonds are traded in Antwerp, as well as 50% of polished diamonds. In 2012, the city's diamond trade represented a total of USD 51.9 billion, i.e., the equivalent of USD 200 million in diamonds passing through Antwerp every day. Diamonds represent approximately 5% of Belgian exports and approximately 15% of all Belgian exports outside the EU, but according to FPS Economy, the sector represents only 0.5% of the GDP, if the value added in Belgium is taken into account. Diamond dealers account for 1 700 businesses, of which 19% are individual enterprises and approximately 65% are small and medium-sized businesses".

[43] FATF Mutual Evaluation Belgium (2015) 13.

[44] Founded in 1947 as "a body to unite diamond exchanges under one roof, and to provide a common set of trading practices for bourses trading in rough and polished diamonds, as well as coloured stones" (WFDB: not dated).

[45] Conflict diamonds, also called "blood diamonds": diamonds-for-weapons trade in Africa near the end of the 20th century, as defined by the United Nations (UN), refer to diamonds that are mined in areas controlled by forces opposed to the legitimate, internationally recognized government of a country, and that are sold to fund military action against that government (Encyclopedia Britannica).

[46] FATF (2013d) 62.

whereafter the commodity is traded in another country or re-exported with a much higher declared value.[47] The final sale of diamonds will generate a value that is much more than the diamonds' originally stated value, despite the fact that no real value was added in the trade path, except for the traders' mark up.[48]

Within this context, it is clear that addressing negative consequences of each component of the value chain requires not just cooperation between one or two government agencies, but cooperation between all affected stakeholders. This is inclusive of tax administrations, customs (where administered separately from tax), mineral and energy affairs and other role players such as law enforcement and business.

1.2 Research objectives

As illustrated in the preceding pages, the concept of IFFs has a broad range of implications across a variety of government agencies. There is also broad consensus that the concept of IFFs is ill defined. The key research questions posed are firstly, what constitutes IFFs and where does it occur, secondly, which policy handles are available to address IFFs and thirdly, what actions can be taken to reduce IFFs? In answering these questions, this study is guided by the following primary research objectives, namely to:

- Determine from existing literature what constitutes IFFs and what are its main underlying drivers;
- Determine how IFFs manifest in the diamond industry value chain;
- Determine the policy measures available to sub-Saharan African countries in identifying and countering IFFs in the diamond value chain;
- Develop guidelines which can assist governments in formulating a holistic approach to address IFFs as a common objective across different, yet related, mandates of government agencies.

A secondary objective is to analyse global financial flows and to identify factors which impact on trade and investment flows.

[47] (2013) 54.
[48] FATF (2103) 54.

1.3 Research methodology

I follow an inter-disciplinary qualitative research approach in order to address a complex contemporary problem by drawing from a range of disciplines. According to Starkey and Madan,[49]inter-disciplinary research has the potential to "produce outcomes that are more than the simple sum of the parts." Because of the interconnectedness and complexity of tax problems within the broader concept of IFF, an inter-disciplinary approach can be justified. The inter-disciplinary approach entails a qualitative document analysis[50] of inter alia, selected policy positions, academic literature and media reports. According to Flick, "data analysis is the central step in qualitative research. Whatever the data are, it is their analysis that, in a decisive way, forms the outcomes of the research."[51]

In this thesis, I attempt to formulate a solution to address IFF's by specifying layers of holistic treatment required in the diamond industry value chain. I choose the diamond industry because it can be viewed as a microcosm that is illustrative of the pervasiveness of IFFs. The starting base is to ascertain whether IFFs is indeed a complex problem and whether it meets the criteria for a "wicked problem" and to thereafter determine whether a horizontal management approach will be suitable in addressing the particular subsets of problems associated with IFFs. This suggested approach and its application is detailed in Chapter 2.

1.4 Assumptions and limitations

The nature of the topic of IFFs has a broad range of sub issues. Some of these are very complex (e.g. transfer pricing, mispricing, mining taxation and anti-money laundering) and it is not within the scope of this thesis to delve into all the details involved with these subjects. The intention is only to frame these issues to the extent of illustrating how they may or may not relate to IFFs. This approach also entails that this thesis does not contain primary data collected through qualitative methods such as interviews. Such an approach would have entailed delving into the details of each component of IFFs and would have made the scope and length of the thesis difficult to manage. As Bowden indicates, document analysis is not always advantageous

[49] (2001) S18; S19. Lamb *et a*l (2004: 282) indicate that inter-disciplinary research concentrates on the relationship/s between two or more disciplines.
[50] Flick defines qualitative data analysis as "the classification and interpretation of linguistic (or visual) material to make statements about implicit and explicit dimensions and structures of meaning-making in the material and what is represented in it. Meaning-making can refer to subjective or social meanings. Qualitative data analysis also is applied to discover and describe issues in the field or structures and processes in routines and practices. Often, qualitative data analysis combines approaches of a rough analysis of the material (overviews, condensation, summaries) with approaches of a detailed analysis (elaboration of categories, hermeneutic interpretations or identified structures). The final aim is often to arrive at generalizable statements by comparing various materials or various texts or several cases.
[51] (2013) 2.

because of inherent limitations in documents such as insufficient detail.[52] Detailed areas of study, that may entail qualitative approaches such as questionnaires and interviews, are pointed out as areas of future research.

Whilst there is ample indication that various commodities (most notably natural resources and especially oil) contribute to IFFs,[53] this study is restricted to the diamond value chain. Whilst a number of countries in Africa are active in diamond mining, the study is restricted to focus only on a selection of Anglophone diamond mining countries in the Economic Community of West African States (ECOWAS) and the Southern African Development Community (SADC) regions. Lusophone and Francophone African countries are excluded, due to language barriers in interpreting legislation and case law. Other producing countries in the Central African region (such as the Democratic Republic of the Congo and the Central African Republic) are currently experiencing political unrest, and indications are that violence is partly fuelled through the sale of rough diamonds. These countries are not included in this study, but the current situation that these countries face, is very similar to what some of the ECOWAS countries went through at the turn of the century.[54]

Various estimates are provided by civil society[55] and UNECA on the extent of IFFs. However, these estimates are purely indicative of the size of the problem, because accurate data for most sub-Saharan African countries is not available. This lack of country specific data on the study of IFFs is also limited by the fact that country specific data on IFFs does not exist. The use of statistics pertaining to the diamond value chain is limited to those published by the Kimberley Process Certification Scheme[56] (KPCS) and those published in the *U.S. Geological Survey Minerals Yearbook*. Both sources provide some form of standardization of production and sales statistics in as far as diamond mining in Africa is concerned. Statistics are used in this study only as an indicator of the resource endowment of selected countries and the potential revenue collection and/or revenue leakage that may be associated therewith on account of IFFs or other underlying crimes.

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[52] (2009) 31. The advantages of the approach, however, outweigh its limitations and are described by Bowden as efficient, cost effective, lack obtrusiveness and reactivity, stable, exact and provide broad coverage.

[53] Le Billion (2011) 2, 9; GFI (not dated); UNECA (2014) 56-59; World Bank (not dated).

[54] Like Sierra Leone and Liberia, the DRC experienced civil war between 1998 and 2003 which was partly funded though illegal diamond trade (Global Witness 2006:1). In 2017 Global Witness describes the situation in CAR as follows: "CAR's natural resources are at the heart of the dynamics driving the conflict. Timber, gold and diamonds have played a central role in motivating and financing the conflict's main two rival groups, the Seleka and the Anti-balaka. Both groups have profited from the trade in a number of ways, including through exploitation, looting and illegal taxation" (Global Witness: 2017). Gettleman (2013) sketches a similar scenario to that, in the DRC, and shows that despite international initiatives such as the Frank Dodd Act, minerals are still funding conflict in the DRC.

[55] Supra 2.

[56] KPCS is an international governmental certification scheme set up to prevent trade in diamonds that fund conflict.

1.5 Structure of the thesis

This thesis consists of thirteen chapters. The first chapter provides an introduction and background to the present study. It poses the research question(s) in the context of the prevalence of so-called IFFs and sets out primary research objectives by focussing on the diamond value chain, which highlights some of the multi levels of enquiry and secondary research objectives which relate to the topic. Next, the rationale and scope of the study is delimited, whereafter the research approach is explained. The chapter concludes with a short overview of the chapter contents.

Chapter 2 sets out the research methodology by means of which it is proposed that the prominent inter-connected "subsets of problems that cut across multiple policy domains and levels of government"[57] associated with IFFs, can be identified. The definitional problems of IFFs and underlying causes are addressed in Chapter 3, whilst Chapter 4 provides an overview of the main types of financial flows which are prevalent in global trade and investment.

Chapter 5 affords an analysis of different types of mining, diamond mining in Africa and the diamond value chain. This chapter also touches on conflict and illicit diamond trade and the role of the Kimberley Process Certification Scheme in regulating the industry.

Chapter 6 is dedicated to tax policy considerations, as the structure of a tax system reveals the preferences of the government for redistribution and equity. Taxes have an impact on economic decisions and governments may try to use tax policy to encourage certain types of economic behavior. The chapter concludes with tax policy recommendations pertinent to the diamond industry. Chapter 7 deals with aspects of corporate structures which are used by multi-nationals to facilitate the most tax efficient cross border investment. It touches on transfer pricing practices related to the diamond industry and the challenges that these practices pose. The concept of BEPS is introduced, as is its relevance for multi-national enterprises (MNEs) and tax authorities. The focus of Chapter 8 is on the inter-relationship between corruption, tax crimes and money laundering in the diamond sector, whilst Chapter 9 introduces risk management as a "control mechanism" for ensuring that the overall scale of risk resulting from IFFs in the diamond value chain stays within acceptable limits.

Chapter 10 highlights mechanisms for enabling domestic cooperation, and these include joint investigations, the use of task teams and "the whole of government approach". Limitations on the scope of domestic cooperation are also discussed. Chapter 11 focuses on the impact of

[57] Weber & Khademian (2008) 336. The authors use the phrase to describe the space that wicked problems can occupy.

globalization on international cooperation and the range of legal instruments available for international cooperation in combatting IFFs.

Remedies available to governments may impact on taxpayer rights, and Chapter 12 provides an analysis of the impact of transparency rules and public disclosure on taxpayer rights in a globalised world. Based on the findings and conclusions stated in earlier chapters, Chapter 13 states the overall conclusions and proffers policy recommendations, and areas for future research.

CHAPTER 2:
METHODOLOGY

In 1972 Horst Rittel, an urban planner at the University of California, observed that "there is a whole realm of social planning problems that cannot be successfully addressed with traditional linear and analytical approaches."[58] He defined these issues as "wicked"[59] problems and contrasted them with tame[60] problems.[61] Rittel and Webber summarize the problem as follows:

> "A great many barriers keep us from perfecting such a planning/governing system: theory is inadequate for decent forecasting; our intelligence is insufficient to our tasks; plurality of objectives held by pluralities of politics makes it impossible to pursue unitary aims; and so on. The difficulties attached to rationality are tenacious, and we have so far been unable to get untangled from their web."[62]

In this study, I apply the social sciences theory of "wicked problems" to the concept "IFFs", to ascertain whether IFFs meet the criteria of wicked problems as set by Rittel and Webber, and whether the concept "IFFs" qualifies as a wicked problem. This requires that, at a minimum, the prominent "inter-connected subsets of problems that cut across multiple policy domains and levels of government" [63] are identified before a solution can be formulated.[64] As explained in Chapter 1, I use the diamond industry value chain to illustrate how inter-connected subsets of problems and policy overlaps manifest. In framing a solution, I explore whether action strategies or collaborative approaches, such as knowledge networks or other forms of horizontal government initiatives, such as the "whole of government approach", are feasible solutions to address IFFs.

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58 Rittel (1972) 390.

59 Meaning malignant or vicious or tricky or aggressive.

60 Examples of tame problems are, according to Rittel and Webber (1973:160), "mostly scientific such as problems of mathematics e.g. solving an equation; the task of an organic chemist in analysing the structure of some unknown compound; or that of a chess player attempting to accomplish check mate in five moves – for each example the mission is clear and in turn, it is clear whether the problem was solved. In contrast, wicked problems do not have these clarifying traits because they include nearly all public policy issues. Examples provided include concerns on the location of a freeway or the adjustment of tax rates."

61 Rittel (1972) 390.

62 Rittel & Webber (1973) 160.

63 Weber & Khademian (2008) 336. According to the authors, these subsets of inter-connected problems define the wicked problem space. The other two key components of wicked problems identified are their unstructured nature and their "relentlessness."

64 Weber & Khademian (2008) 336.

2.1 Wicked problems

By recognizing the "dynamic complexity of many public problems" which "defy the confines of established stove piped systems of problem definition, administration and resolution", the term "wicked problems" was coined.[65] Rittel and Webber identify *defining problems* and *locating them* as two of the most intractable problems.[66] These two propositions are explained as developing knowledge of what differentiates an observed condition from a desired condition (the definitional problem), and to thereafter find where the problem really lies in the complex causal networks (the location problem).[67] In Chapter 3, the definitional aspects of IFFs are analysed in order to identify whether *definition*, in the case of IFFs, is an intractable problem. The chapters following Chapter 3 are an analysis aimed at identifying where the problem/s underlying IFFs is/are *located*.

Literature on wicked problems defines its characteristics as follows:[68]

a) There is "no definitive formulation of a wicked problem" - it is, in essence, a problem that is "unstructured" which means that it is difficult to identify and model the causes and effects thereof.[69] Further complexity is added where there is little consensus on the problem or solution. For Rittel and Webber, it means that the problem is not understood until a solution is developed;[70]
b) It has a "no stopping rule"; since there is no definitive problem, there is no definitive "solution." Problem solving stops when resources are exhausted and when a "good enough" outcome is reached;[71]
c) Solutions to wicked problems are not "true" or "false", but "better" or "worse", and because they are judged in a social context in which different stakeholders have differing goals and values, they are difficult to measure objectively.[72]
d) There is no immediate solution and no ultimate test of a solution to a wicked problem, as every wicked problem is essentially unique. According to Rittel and Webber "unique" means that "despite long lists of similarities between current problems and previous ones, there might always be an additional distinguishing property that is overriding in importance."[73]

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65 Rittel & Weber (1973) 159.
66 (1973) 159.
67 Rittel & Webber (1973) 159.
68 Head & Alford (2008) 4; Rittel & Webber (1973) 161-167; Menkhaus (2009) 86; APS (2007) 4-5.
69 Weber & Khademian (2008) 336.
70 (1973) 159.
71 Weber & Khademian (2008) 336.
72 Weber & Khademian (2008) 336.
73 (1973) 164.

e) Every solution to a wicked problem is a “one-shot operation”. There is no opportunity to learn by trial and error. As Rittel observes: “You cannot build a highway to see how it works and then easily correct it after unsatisfactory performance.”[74]
f) Every attempt to solve a wicked problem counts significantly. Jeff Conklin notes aptly: “You cannot learn about the problem without trying solutions, but every attempted solution is expensive and has lasting unintended consequences, which spin off new wicked problems.”[75] Put differently, the policymaker “has no right to be wrong” because of “the high costs of failure.”[76]
g) Every wicked problem is a symptom of another problem. Rittel described problems “as discrepancies between the state of affairs as it is and as it ought to be, and that the process of resolving the problem starts with the search for a causal explanation of the discrepancy.”[77] “Removal of that cause poses another problem of which the original problem is a symptom. In turn the latter could be considered the symptom of still another higher-level problem.”[78] In this context, IFFs can be considered as a result or a symptom of immoral profit shifting or corruption, or bad policy or whichever causal relationship one happens to like best.

It is pointed out by Rittel and Webber that one is not able to prove that all solutions have been identified and weighed because there is no criteria to enable such a process.[79]

2.2 Dealing with wicked problems

Rittel and Webber state that “it makes no sense to talk about optimal solutions to social problems, unless severe qualifications are imposed on such problems first and, even worse, there are no solutions in the sense of definitive and objective answers.”[80] They continue to state that “the higher the level of problem formulation, the broader and more generalised the problem becomes and the more difficult it becomes to do something about it”. They conclude by stating that when a problem is addressed on too low a level or an incremental basis, then success in resolving the problem may make things worse in that it may become more difficult to deal with the higher-level problems.[81]

[74] Rittel &Webber (1973) 163.
[75] Conklin (2005) 8.
[76] Conklin (2005) 8.
[77] (1973) 165.
[78] (1973) 165.
[79] (1973) 164.
[80] Rittel &Webber (1973) 155.
[81] Rittel & Webber (1973) 165.

Examples of wicked problems can be found in various diverse policy domains, such as climate change, foreign policy, terrorism, health care and water management.[82] According to Termeer, wicked problems pose serious challenges to those working in government:

> "Ambitious policy makers may even become frustrated by wicked problems, because they keep trying to solve problems which are perhaps unsolvable. They never know whether they are doing well, as wicked problems have no stopping rule and because additional efforts might increase the chances of finding a better solution."[83]

The main strategies identified in literature in dealing with wicked problems are post-normal science approaches,[84] horizontal management, various forms of collaboration across functions, knowledge networks[85] and incrementalism. Incrementalism advances a "policy of small steps in the hope of contributing systematically to overall improvement."[86] The Australian Public Service Commission (APSC) notes that "if policy and performance measures are limited to the sub-problem rather than the wicked problem, the problem may appear to be solved in the short term."[87] To illustrate, if the sub-problem to IFFs is deemed to be only profit shifting by multi-nationals, then a short-term solution may lie in aspects such as adjustment in transfer pricing regulations, automatic exchange of taxpayer information and capacity building in tax administrations. However, as illustrated in the following chapter, IFFs are attributed to a variety of factors, of which profit shifting is but one.

Horizontal management refers to greater cooperation and collaboration across departmental boundaries, which can include the management and coordination of a set of activities between two or more organizational units, which do not have hierarchical control over each other, and where the aim is to generate outcomes that cannot be achieved by the units working in isolation.[88] According to Halligan, Buick and O'Flynn, jointly managed secretariats or informal networks can be used as structures and processes to attain coordination between units.[89]

Different terminology is used to refer to horizontal management in government: in the UK reference is made to "joined-up government", in Canada, "horizontal government/ management" and in New Zealand, "integrated government". In Australia, the "whole of government" approach

[82] Batie (2008) 1176; Termeer *et al* (2012) 2-3.
[83] Termeer *et al* (2012) 2.
[84] See point 2.3 on limitations.
[85] Weber & Khademian (2008).
[86] (1973) 165.
[87] (2007) 12.
[88] Halligan, Buick & O'Flynn (2012) 75.
[89] Halligan, Buick & O'Flynn (2012) 75.

emerged as both a horizontal management approach as well as a strategic enabler.[90] As a strategic enabler, it emphasises cooperation between all levels of government in anticipation of future challenges. As a horizontal management approach, it emphasises increased coherence across government departments and objectives shared across organizational boundaries. This can reflect in delivery of programmes, policies and services which can involve all levels of government in conjunction with non-government entities.[91]

Public administrations are traditionally not set up to deal productively with wicked problems, for example, departments become cultural fortresses whenever there is a tendency to recruit administrative employees at entry level and retain them in the same organisation, and where specialisation in areas of professional expertise is fostered. Such cultural fortresses are categorized by an organisational fragmentation between functions (referred to as a silo approach) to both functional work and problem solving.[92] In summary, bureaucracies have a tendency to be averse to risk and less tolerant of messy processes such as those associated with wicked problems.[93]

In addressing wicked problems, the Australian Public Service Commission (APSC) follows a whole of government approach. The APSC finds that for wicked problems to be handled properly, holistic thinking should have precedence over linear thinking. [94] It states that:

> "the wickedness of an issue lies in the interactions between causal factors, conflicting policy objectives and disagreement over the appropriate solution. Linear thinking is inadequate to encompass such interactivity and uncertainty. The shortcomings of a linear approach are also due to the social complexity of wicked problems. The fact is that a true understanding of the problem generally requires the perspective of multiple organisations and stakeholders, and that any package of measures identified as a possible solution usually requires the involvement, commitment and coordination of multiple organisations and stakeholders to be delivered effectively."[95]

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[90] In 2004 the Australian Public Service Commission (APSC) articulated the need for a whole of government approach due to a variety of reasons such as "ensuring security, building a strong economy, coping with demographic change and crafting social policy," where these deliverables require "the active participation of a range of central and line agencies." According to the APSC, the whole of government approach "goes beneath the surface of the 'coordination' that the APS strives to achieve. It examines the many different and sometimes competing imperatives that contribute to successful whole of government work and seeks to learn from our successes and failures" (APSC Management Advisory Committee Report (2004: v).
[91] Halligan, Buick and O'Flynn (2012) 76, 79.
[92] Head & Alford (2008) 9.
[93] APSC (2007) 13.
[94] APSC (2007) 13.
[95] (2007) 11.

The term “whole of government approach” can be described as a resurgent form of coordination between government departments. According to Christensen and Laegreid, it can be defined in various analytical ways. Empirically it can mean different things in different countries, or even different things within the same country.[96] The scope of a whole of government approach can range from increased inter-governmental vertical coordination between ministries and agencies, to increased horizontal coordination between different policy areas in central government.”[97] It can also include coordination of service delivery programmes with the aim of enhancing performance, effectiveness, and efficiency. [98]

According to Colgan, Kennedy and Doherty,[99] whole of government can be described as an overarching term for a group of responses to the problem of increased fragmentation of the public sector, or services provided by the public sector. The adoption of whole of government approaches is therefore driven by a need to increase coordination, resource sharing and coordination, in addition to wanting to increase overall efficiencies and effectiveness of the public sector.

According to Colgan, Kennedy and Doherty, there are four core issues at stake when considering a whole of government approach to address policy matters.[100] The first is being outcome focused, which means that government agencies seek to achieve outcomes that cannot be achieved by working in silos, but through optimizing the resources at the country’s disposal.[101] Secondly, citizen centred outcomes are dependent on how well boundary spanning considerations between different government agencies are managed.[102] Thirdly, the whole of government approaches to policy are seen as enabling governments to address complex policy challenges through the usage of knowledge and skills within different agencies. Fourthly, the whole of government approach can help to tackle issues from a systemic perspective, as and when they emerge, thereby strengthening prevention strategies.[103]

The reasons for a whole of government approach are derived from both internal and external factors. For instance, single purpose organisations may have produced self-centred authorities, too much fragmentation, and a general lack of attention to cooperation and coordination requirements.[104] Structural devolution may have removed levers of control or influence from

[96] (2006) 6.
[97] Christensen & Laegreid (2006) 6.
[98] Christensen & Laegreid (2006) 6.
[99] (2014) 9.
[100] (2014) 3.
[101] Colgan, Kennedy & Doherty (2014) 3.
[102] Colgan, Kennedy & Doherty (2014) 3.
[103] Colgan, Kennedy & Doherty (2014) 3.
[104] Christensen & Laegreid (2006) 7.

political and administrative leadership that raises questions of accountability.[105] Globalization and increased threats of terrorism are examples of external pressures that drive the need for a whole of government approach.[106] In this context the whole of government approach can be seen as an efficiency measure to address budgetary and resource pressures.

The APSC defines the whole of government approach as:

> "Whole of government denotes public service agencies working across portfolio boundaries to achieve a shared goal and an integrated government response to particular issues. Approaches can be formal and informal. They can focus on policy development, programme management and service delivery."[107]

The concept was implemented in 2005 to address financial crimes (including tax evasion and money laundering) under Project Wickenby[108] which successfully ran for ten years resulting in tax assessments of AUD 2.285 billion and 46 convictions for serious offences.[109]

In 2012 Termeer *et al* proposed an "integrative approach" for dealing with wicked problems. Such an approach consists of action strategies, observation of the wickedness of problems and enablers in the governance system.[110] Action strategies essentially are the "how to" steps necessary to address the problem.[111] By identifying and analysing the known components of IFFs, (a) a better understanding of the dimensions of IFFs can be developed, (b) action strategies can be identified to address some of the under-lying and inter-related causes of IFFs; and (c) the applicability of horizontal management practices in drawing policy setting and action strategies closer together, can be determined. The latter is informed by the APSC's suggestion that public administrations can increase their adaptability by "blurring the traditional distinction between policy development and programme implementation when dealing with complex matters."[112] The reason put forth is that on the ground, operational intelligence is required to inform policy development and evolution needs because it takes in the views of stakeholders and it serves as a feedback mechanism as to what works and what does not.[113] Another way of increasing

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105 Christensen & Laegreid (2006) 7.
106 Christensen & Laegreid (2006) 7.
107 Management Advisory Committee Report (2004) 1.
108 Discussed in further detail under 10.3.1.1.
109 ATO (not dated).
110 Termeer (2012: 2) identifies four governance capabilities that are essential to an integrative approach, namely "reflexivity (the capability to deal with multiple frames); resilience (the capability to adjust actions to uncertain changes); responsiveness (capability to respond to changing agendas and expectations) and revitalization (ability to unblock stagnations)." These capabilities form the basis for achieving small wins in wicked problems in the Termeer integrative approach.
111 Termeer *et al* (2012) 1-5.
112 APSC (2007) 14.
113 APSC (2007) 14.

adaptability is by focussing on shared experiences and learnings from dealing with wicked problems amongst and within public service administrations. Ancillary hereto, is that broad acceptance and understanding is needed that quick fixes are not an option, and that levels of uncertainty around the solutions to wicked problems should be tolerated. [114]

Viewing IFFs with the perspective of an Aristotelian world view of seeing the whole as more important than the sum of its parts, implies that even if the separate components are working well, but are doing so in isolation of each other, the "whole" cannot be achieved. This is reflected in the following statement by Von Bertalanffy:

> "The properties and modes of action of higher levels are not explicable by the summation of the properties and modes of action of their components *taken in isolation.* If, however, we know the ensemble of the components and the relations existing between them, then the higher levels are derivable from the components."[115]

Thus, to understand an organised whole, one must understand the respective parts and the relationships between these parts.[116]

Performance management in government institutions is illustrative of the problem that even if some of the components are working well, the performance objectives may not consider the larger organisational or government strategy, thus the whole cannot be achieved. Whilst performance management is focused on encouraging organisations and individuals to meet their own performance targets, a tendency towards some fragmentation of organizational forms has arisen.[117] In contrast, the whole of government approach aims to promote collaboration and cooperation between organisations.[118] It is important to note that whole of government initiatives will encounter difficulties in becoming a major tool to address IFFs or any of its components, if cross-cutting targets do not get equal status to that of organisation-specific targets.[119] From a management perspective, differentiated silos within administrations exist for reasons of enabling vertical and horizontal organizational boundaries. These are brought about by the division of labour and specialization associated with modern organisations.[120] The whole of government approach does not concern itself with clarification of lines of accountability, so the challenge is to create a balance between horizontal and vertical accountability and responsiveness.[121] In this

[114] APSC (2007) 14 – 15.
[115] (1972) 407.
[116] (1972) 407, 411.
[117] Christensen & Laegreid (2006) 20.
[118] Christensen & Laegreid (2006) 20.
[119] Christensen & Laegreid (2006) 20.
[120] Christensen & Laegreid (2006) 21.
[121] Christensen & Laegreid (2006) 21.

regard the four governance competencies identified by Termeer *et al*[122] may provide a suitable governance structure to observe and enable specific activities within a whole of government approach.

Whole of government approaches have been applied to wicked problems such as health and poverty, to strategic challenges in the form of climate change and global terror, and to deliver services to a population or a community of interests.[123] IFFs have the hallmarks of wicked problems and pose a strategic challenge to sub-Saharan Africa. The next chapter explores the definitional complexities of IFFs and the context wherein IFFs take place, whereafter some components of IFFs are discussed, specifically in relation to their nature, where they are located and the challenges they pose to governments.

2.3 Limitations

There are a variety of approaches in the economics fields that can possibly be helpful to address wicked problems. Batie states that addressing wicked problems in a policy context, requires "both use-driven science that recognizes and addresses uncertainties", as well as "meaningful engagement of stakeholders in decision making."[124] In addressing these "uncertainties", there is a growing body of literature of various approaches to post normal science[125] and examples of such approaches are ecological economics,[126] complexity economics[127] and sustainability science.[128]

Sustainability science is defined "by the problems it addresses rather than the disciplines involved."[129] One of the objectives of this approach is to have an informed facilitation of a societal transition toward sustainable development.[130] It includes natural, social and engineering sciences research knowledge, in combination with insights from the humanities.[131] A requirement for

[122] (2012) 1-5.
[123] Colgan, Kennedy & Doherty (2014) 3.
[124] Batie (2008) 1181.
[125] Post-Normal Science (PNS) is "a new conception of the management of complex science-related issues. It focuses on aspects of problem solving that tend to be neglected in traditional accounts of scientific practice such as uncertainty, value loading and a plurality of legitimate perspectives. PNS considers these elements as integral to science. By their inclusion in the framing of complex issues, PNS is, according to Funtowiczi and Ravetzii, able to provide a coherent framework for an extended participation in decision-making, based on the new tasks of quality assurance. As a theory, PNS links epistemology and governance, because its origins lie in the relations between those two domains" (Funtowiczi & Ravetzii 2003:1; 3).
[126] "A pluralistic but scientific approach to the study of environmental problems and policy solutions" (Batie 2008:1181).
[127] This amounts to a "… highly mathematical and statistical approach that focuses on complex adaptive systems in pursuit of real world relevancy" (Batie 2008:1181).
[128] Clark (2007) 1737.
[129] Clark (2007) 1737.
[130] Clark (2007) 1737.
[131] According to Kates *et al* (2001:641) "in each phase of sustainability science research, novel schemes and techniques have to be used, extended or invented. These include observational methods that blend remote sensing with fieldwork in conceptually rigorous ways, integrated place-based models that are based on semi-qualitative representations of

sustainability science is that stakeholders are engaged because it is the experience and feedback from the stakeholders which will allow for stating or framing the problem and determining what the goals should be for implementing changes.[132] Sustainability science is defined as an "evolving integrated and multi-disciplinary science which aims to analyse and predict behaviour at multiple scales of complex self-organising systems."[133]

Batie[134] asks the question as to whether applied economics can play a role in addressing wicked problems, because wicked problems, by their nature, are inclusive of issues of high consequence to society. She concludes that the role of applied economics will, however, depend on the nature of the subject matter boundary placed on the discipline.

Whether these approaches could be useful to address IFFs is not explored in this study, but they are identified as potential areas of future research.

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entire classes of dynamic behaviour, and inverse approaches that start from outcomes to be avoided and work backwards to identify relatively safe corridors for a sustainability transition. New methodological approaches for decisions under a wide range of uncertainties in natural and socioeconomic systems are becoming available and need to be more widely exploited, as does the systematic use of networks for the utilization of expertise and the promotion of social learning."

[132] Kates *et al* (2001) 641.

[133] Batie (2008) 1182.

[134] Batie (2008) 1185.

CHAPTER 3:
DEFINING ILLICIT FINANCIAL FLOWS (IFFs)

3.1 Introduction

The OECD states that financial crimes can only be effectively addressed through a "whole of government" approach which requires a pooling of resources and skills of different authorities. Country experiences show that a whole of government approach can be very effective in addressing financial crimes, for example in Australia such an approach is associated with a recovery of AUD 2.2 billion in tax liabilities raised, increased tax compliance and improved compliance behaviour.[135] Form an anti-corruption perspective, Hobbs and Williams find that there is evidence that suggests that the "multi-agency approach can detect, investigate and prosecute acts of corruption."[136] With the current emphasis on the phenomenon of "illicit financial flows" (IFFs) which is partly to blame for, amongst others, low tax collections and consequent poor infrastructure and economic developments in Africa, the definitional aspects of whether IFFs constitute only financial crimes or something wider, need to be explored.

The concept of IFFs is emerging as an umbrella term for bringing together seemingly disconnected issues.[137] The concept is poorly defined in the current literature, but there are various identifiable components underlying the term IFF, such as capital flight, corruption, money laundering, tax avoidance, tax evasion, tax havens and abusive transfer pricing practices.[138] I identify the key areas of concern through a literature review and then make recommendations on prioritization of short to medium term risk areas and long-term policy imperatives.

In July 2016, the then Minister of Finance of South Africa, Pravin Gordhan, stated that:

> "tax crimes, money laundering and illicit flows are part of a complex phenomenon which is undermining good governance, ethical politics, government and civil society programmes intended to promote inclusive growth, reduce inequality and improve the standard of living of the poor and lower middle classes on this continent and elsewhere in the world."[139]

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135 See 10.3.1.1 hereunder.
136 (2017) 179.
137 The World Bank (not dated).
138 World Bank (not dated).
139 Gordhan (2016).

This statement underscores the need for governments to identify and address the prevalent components of IFFs.

Literature identifies various reasons for IFFs.[140] As already stated in Chapter 1, these can include tax evasion, smuggling of illegal goods, trafficking in people, transfer pricing and false declaration or trade mispricing, customs fraud, the failure of anti-money laundering controls, corruption and terrorist financing – or a combination of these.[141] Further delineation of reasons for IFFs can include conflict, weak domestic resource mobilisation, poor governance and weak institutions, uncontrolled exploitation of natural resources, crime, as well as inequality and exploitative elites.[142]

IFFs result in a depletion of state coffers[143] and can lead to financial market instability through sub-optimal investment decisions. They can also contribute to growing income inequality within and between countries.[144] IFFs also undermine tax morality and recovering funds can be arduous for states, especially so where legislation is outdated, when staff are poorly trained and where bank secrecy in foreign jurisdictions and the use of opaque corporate vehicles make the tracing of assets nearly impossible.

In 2012 the World Bank in conjunction with the Norwegian Government produced a comprehensive study about illicit flows entitled *Draining Development? Controlling Flows of Illicit Funds from Developing Countries*.[145] The publication unpacks various aspects associated with illicit flows covering illegal markets, the extent to which corporations facilitate illicit flows, the political economy of IFFs and policy interventions with the latter focusing on tax havens, anti-money laundering (AML) controls and corruption.

3.2 Defining IFFs

According to Rittel and Webber, "the formulation of the wicked problem is the solution" as "the process of formulating the problem and of conceiving a solution" (or various iterations thereof) is identical, since "every specification is a specification of the direction in which a treatment is considered."[146]

140 Reuter ed (2012) x.
141 The World Bank (not dated); Reuter ed (2012) x; UNECA (2014).
142 OECD (2016a) 146.
143 Reuter ed (2012) x.
144 Reuter ed (2012) x.
145 Reuter (ed) (2012).
146 Rittel & Webber (1973) 161.

IFFs is described by various authors as an "ill-defined term" with disputable boundaries, primarily for the reason that, as some commentators point out, "illicit" does not equate to "illegal".[147] Reuter suggests that the defining characteristics of "illicit" are:

> "That (1) the acts involved are themselves illegal (corruption or tax evasion) in a regime that has some democratic legitimacy, or (2) the funds are the indirect fruits of illegal acts… thus illicit funds are not merely the consequence of bad public policy and do not include all international illegal flows from illegitimate regimes." [148]

Blankenburg and Khan[149] define an "illicit capital flow" as "a flow that has negative impact on an economy, if all direct and indirect benefits in the context of the specific political economy of the society are taken into account." According to the authors, their definition allows one to make sense of the perception that "not all illegal flows are necessarily illicit, while some legal flows may be illicit" and the "use of the notion of illicitness suggests that damaging developmental outcomes may not always correspond to violations of the law"[150] and that it is therefore necessary to be very specific in defining economic, social and political damage.[151] An illicit financial flow (IFF), according to their minimal definition, is one that results in overall negative effects on economic growth, inclusive of both direct and indirect effects, in the context of the specific political dispensation of a country.[152]

The OECD defines IFFs as "flows generated by methods, practices and crimes aiming to transfer financial capital out of a country in contravention of national or international laws."[153] The OECD definition therefore only includes illegal activities.

According to Kar and Spanjers, IFFs are different from capital flight (which includes both licit and illicit capital). [154] Licit capital flight is recorded and tracked, significantly lowering the probability that it has a corrupt or criminal source. In contrast, IFFs are by nature unrecorded, and cannot be used as public funds or private investment capital in their country of origin.[155]

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147 Reuter (2012); Blankenburg & Kahn (2012). Supra 3.
148 Reuter (2012) 7.
149 (2012) 23.
150 For example, double tax agreements (DTAs) that would place some form of prohibition in law are not in place, nor are relevant domestic laws.
151 (2012) 24.
152 Blankenburg and Khan (2012) 24.
153 OECD (2014) 16.
154 In the UNECA Report the panel decided to exclude capital flight from its definition of IFFs as it states: "We felt that it was important to distinguish IFFs from capital flight, because capital flight, which is sometimes driven by macroeconomic and governance factors, could be entirely licit. For the purposes of our work, we agreed on a definition of IFFs as money illegally earned, transferred or used. This definition avoids complicated explanations of what qualifies as IFFs and debates about whether investors should be allowed to respond rationally to economic and political risk. Moreover, we believe that our preferred definition addresses the issue of IFFs across the entire breadth of financial transactions."
155 (2014) 1.

Everest-Phillips provides the following definition for IFFs:

> "Illicit indicates that the activity is generally perceived as illegitimate, which, in turn, requires the state to be regarded as legitimate. International capital transfers become illicit if they originate from an illegal source (evasion, corruption, or criminality), or are illegal by bypassing capital controls, but also immoral in undermining the state's willingness and capacity to deliver better lives for its citizens."[156]

The United Nations Economic Commission for Africa (UNECA) defines IFFs as "money illegally earned, transferred or used where such flows of money are in violation of laws in their origin, or during their movement or use, and are therefore considered illicit."[157] With reference to outflows, emphasis is placed on "illegality across any stages" to demonstrate that appearance of a legal activity in one country does not nullify the intent and purpose (e.g. hiding money, even if it is legally earned) resulting in the outflows.[158] The UNECA Report sees the term "illicit" is a fair description of activities that are not in line with established norms and rules, and such activities are inclusive of tax avoidance.[159]

In describing how IFFs take place, the UNECA Report[160] differentiates IFFs into the three components, namely criminal activities, commercial activities and corruption. The commercial component of IFFs is described as those that arise from business-related activities, however, sometimes there is a fine line to differentiate the fair use of, for example, policy incentives and straight out abuse of such incentives that can lead to outflows.[161] The report continues to state that IFFs which originate from commercial activities can have a variety of objectives, such as aggressive tax avoidance, tax and duty evasion or hiding wealth.[162] It is also found that some activities can be in the form of base erosion and profit shifting. There are a variety of ways in which IFFs manifest in Africa and they include trade mispricing, abusive transfer pricing, mis-invoicing of services and intangibles and using unequal contracts.[163] The components described under criminal activity range from drug trafficking, trafficking in people, smuggling of arms and ammunition and various forms of fraud such as outright forgery and stock market manipulation.[164] In as far as the third leg, corruption, is concerned, it is noted that:

156 (2012) 70, 71.
157 (2015) 23.
158 (2015) 23.
159 (2015) 23.
160 UNECA (2014) 24.
161 UNECA (2014) 24.
162 (2014) 24.
163 UNCEA (2014) 24.
164 UNECA (2014) 31.

> "there are both demand and supply sides to bribery, which is why the legislation in some developed countries against the giving of bribes by companies makes an important contribution to stemming corrupt practices in Africa. We agreed that corruption was better understood as the abuse of entrusted power as defined in various anti-corruption instruments, which makes a cross-cutting contribution to IFFs without the officials concerned necessarily exporting their illegally acquired wealth."[165]

According to Everest-Phillips, [166] the frequent confusion between "illicit" and "illegal" "loses the important moral dimension for developing countries and their partners in the international community of the need to tackle poverty and deliver the United Nations' Millennium Development Goals." In this regard, Moore[167] suggests that questions about the dimensions and effects of illicit flows should be secondary to a focus on developing a better understanding of the components and correlates of IFFs, namely: "capital flight, corruption, money laundering, tax avoidance, tax havens, and transfer mispricing."

The definitional challenge posed by IFFs is not unique and is reminiscent of similar definitional problems associated with broadly defined concepts such as "transnational organised crime" which arose, particularly in the 1990s.[168] According to Paoli, the expression "organised crime" has been used as "a catch all phrase" to:

> "express the growing anxieties of national and supranational public institutions and private citizens in view of the expansion of domestic and world illegal markets, the increasing mobility of criminal actors across national borders, and their perceived growing capability to pollute the licit economy and undermine political institutions."[169]

The latter sentiment is echoed in the United Nations Convention against Transnational Organised Crime (UNTOC), as it does not contain a precise definition of "transnational organised crime,"[170] neither does the UNTOC list the kinds of crimes that might constitute transnational organised crime.[171] This lack of definition was, according to the UNODC, intended to make provision for a broader application of the Organised Crime Convention to new or emerging types of crime which

[165] UNECA (2014) 31.
[166] According to the United Nations' Millennium Development Goals (MDGs), USD 529 billion will be needed to cover MDG costs by 2015, which requires that illicit flows are addressed as a matter of high priority. If not, poverty will increase and there will be a decline in access to basic services.
[167] (2012) 458.
[168] Paoli (2002) 51.
[169] (2002) 51.
[170] Under Article 2(a) of the UNTOC 2(a), "organized criminal group" shall mean "a structured group of three or more persons, existing for a period and acting in concert with the aim of committing one or more serious crimes or offences established in accordance with this Convention, to obtain, directly or indirectly, a financial or other material benefit."
[171] UNODC (not dated).

result from changes in local, regional and global conditions.[172] The UNODC explains that the UNTOC only covers crimes which are "transnational" in a broad sense, offences committed in more than one country, as well as offences that take place in one country but are planned in another. The implied definition "transnational organised crime" then encompasses virtually all profit-motivated serious criminal activities which have international implications.[173]

In tackling the definitional aspects of organised crime, Smith proposes substitution of the term organised crime with "illicit" or "illegal enterprise," because "illicit enterprise is the extension of legitimate market activities into areas normally proscribed (those beyond existing limits of law) for the pursuit of profit and in response to a latent illicit demand."[174] Other authors propose that organised crime equates to the provision of illegal goods and services, and that the term should be limited to coordinated vice and racketeering activities.[175]

The dilemma posed by both the concepts "transnational organised crime" and "IFFs," is whether a wide or narrow scope should be assigned. If a too narrow scope is chosen, there is a risk that not all underlying components of IFFs are addressed, and that policy interventions aimed at reducing IFFs may fail. A too wide scope may be dependent on institutional effectiveness of different agencies having to work in unison to achieve common policy objectives. An inability to identify different components and their inter-relationship may lead to limited implementation of interventions and consequent policy failure. Of importance is that, in the establishment of criteria of what constitutes IFFs, there should be sufficient consensus amongst government agencies and between developing and developed countries on the causes of IFFs and the measures required to mitigate them.

3.3 Conclusion

Defining the properties of IFFs is of importance to policy makers, in order to ensure that the appropriate set of tools are used in combination, or in aligned, but separate, ways. If the definition of IFFs were limited to activities which are illegal, then it would be fair to state that IFFs consist of *inter alia*, organised criminal activities, money laundering, tax evasion and corruption. Were such a definition to be used, then it begs the question as to whether IFFs is an appropriate term to use. It would be more sensible then to discard the term IFFs and instead refer to "illegal financial flows" or "the proceeds of crime". The latter is an established term to describe financial flows resulting from illegal activity.

[172] UNODC (not dated).
[173] UNODC (not dated).
[174] Smith (1976) in Paoli (2002) 55.
[175] Block & Chambliss (1981) in Paoli (2002) 55.

As pointed out in Chapter 1,[176] the term "illicit" means "not allowed by the law" and/or "not approved of by the normal rules of society."[177] It therefore includes both an illegal aspect and an immoral aspect (which may be legal but morally frowned upon), or as Reuter puts it: it "includes a variety of legally ambiguous transfers.[178] In reviewing available literature, organisations have followed an approach of (a) either limiting the scope of illicit to mean illegal, or (b) to use the term inclusive of illegal and immoral. The term IFFs in its wider meaning attaches political consequence to different types of conduct across a very wide spectrum (both illegal and legal). By doing this, it pulls together various overlapping issues under one umbrella, which from a government policy perspective, enables government to identify shared outcomes across different agencies, opportunities for cooperation and opportunities for resource mobilization. Put differently, in the words of the ASPC:

> "a true understanding of the problem generally requires the perspective of multiple organisations and stakeholders, and that any package of measures identified as a possible solution usually requires the involvement, commitment and coordination of multiple organisations and stakeholders to be delivered effectively."[179]

IFFs can be described as a wicked problem, as it displays the characteristics thereof, for example, that there is no definitive formulation of a wicked problem. This means that the problem is not understood until a solution is developed. Since there is no "definitive problem", there is no "definitive solution" and "solutions" are difficult to measure objectively, since they are judged in a social context in which different stakeholders have differing goals and values – consider for instance how different countries view corruption. "Uniqueness" of the problem means that "despite long lists of similarities between current problems and previous ones, there might always be an additional distinguishing property"[180] (e.g. does the definition include illegal acts only, or also those that are morally frowned upon) which is overriding in importance.

Looking at IFFs as the outcome of different activities (for example, IFFs are a consequence of either institutional, governance or policy failures or a combination thereof), it may be useful to assign a wide definition to IFFs. The latter resonates well with the definition that Blankenburg and Khan assign to illicit capital flows, namely that economic damage to a society, within a given political or economic context, may result from illicit capital flows.[181] The authors further elaborate

[176] Supra 3.
[177] Oxford Dictionary; Cambridge Dictionary.
[178] Reuter (2017) 4.
[179] APSC (2012).
[180] Rittel & Webber (1973) 161-167.
[181] (2012) 23.

that “the use of the notion of illicitness also suggests that damaging developmental outcomes may not always correspond to violations of the law and that therefore, social, economic and political damage needs to be more precisely defined.”[182] Reuter cautions that although this interpretation may be conceptually attractive, it defies operationalisation.[183] I propose that if IFFs is approached as a wicked problem, the operationalisation problem may be overcome in two ways. First, IFF becomes the strategic policy enabler that draws government agencies together in focusing on the same objective. Second, the goals of each agency (in as far as these goals address the underlying causes of IFFs) can be drawn together under a horizontal management approach to align objectives and outcomes sought. Better coordination and cooperation also have the potential to identify the interactions between causal factors and conflicting policy objectives which lead to IFFs.

Combating IFFs is a shared objective which requires concerted action by both the OECD and developing countries. It therefore follows that measures designed to address IFFs should be framed under a common understanding and definition. I propose that the approach taken under the UNTOC, where an implied definition is used that encompasses the activities and consequences underlying “transnational organised crime” can be applied to IFFs, because the underlying components of IFFs, like those associated with transnational organised crime, may change in response to changes in global, regional and local conditions. An implied definition can be framed along the lines suggested by Blankenberg and Khan.[184] Their definition suggests that the defining criteria of what constitutes illicit financial flows is “damage to society.” That damage can be brought about by either a violation of laws, or by actions within the laws that have a detrimental impact on society.[185]

A starting point to further assess the workability of the above approach, is to understand financial flows in general and to determine how these can negatively impact society. The next chapter, for example, illustrates that badly designed or negotiated foreign direct investment (FDI) regimes will lead to capital outflows or ineffective taxation, thus constituting an immoral policy setting which affects the well-being and economic prospects of the people of an affected country.

[182] Blankenburg & Khan (2012) 24.
[183] (2017) 3.
[184] (2012) 24.
[185] (2012) 24.

CHAPTER 4:
ASPECTS OF GLOBAL FINANCIAL FLOWS

4.1 Introduction

A general appreciation of global financial flows is required to understand what IFFs potentially include or exclude. Financial flows result from a variety of transactions which include FDI, loans to governments, portfolio investments, remittances, debt and interest payments, profit repatriation, aid, trade and also illegal activity. This chapter deals with the three sources of financial flows, namely FDI into the formal economy, trade and investment resulting from criminal activity and trade and investment through the informal economy.

Both legal and illegal transactions benefit from globalization, which brought about new opportunities in the form of increased markets and technological innovations, which in turn have enhanced work methods and created job opportunities in newly emerging sectors. In addition, goods and services can be traded all around the globe with continuously decreasing transport and transaction costs.[186] However globalization poses new challenges to countries: in the face of rising geographic mobility of capital and skilled workers, national governments have entered into intensified fiscal competition (the so-called race to the bottom) and, as a consequence, countries' scope of financing redistributive and social policies by means of taxation is reduced.[187]

Besides bringing about increased growth in international trade, globalization also accounts for increased FDI.[188] Trade and investment are complementary and reinforce one another in that investment follows trade and trade follows investment.[189] Developing countries (most notably in Asia) which promoted a high level of domestic and foreign investment in the 1990s, saw rapid improvements in exports, the adoption of new technologies and overall rapid economic growth.[190]

However, globalization also benefits criminal groups trading and investing in illegal goods and services. The UNODC states that "organised crime has diversified, gone global and reached macro-economic proportions where illegal goods are sourced from one continent, trafficked across another, and marketed in a third."[191] According to the UNODC, criminal proceeds are likely

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[186] UNCTAD (2016) 100.
[187] UNCTAD (2016) 93.
[188] In 1970, developing economies accounted for 17% of global GDP, and by 2014 their contribution had doubled to 34% (UNCTAD 2016). Since 1990, trade has assisted in halving the number of people living in extreme poverty (World Bank 2016).
[189] Easson (2004) 9.
[190] UNCTAD (2015) xi.
[191] UNODC (2011) ii.

to have amounted to an estimated 3.6 per cent of global GDP, or around USD 2.1 trillion in 2009.[192] The proceeds of illegal activity are then laundered through the formal economy (via e.g. financial institutions, or the purchase of property or high value commodities), in order to create the appearance of legitimate business transactions.

4.2 Foreign Direct Investment

FDI[193] is perceived as an important component in securing economic benefits. Consequently, countries develop investment policy measures that are mainly geared toward achieving investment liberalization together with further promotion and facilitation of investment. This trend has continued since the 1990s, and by 2014, in excess of 80 per cent of investment policy measures were aimed at improving entry conditions and reducing restrictions.[194]

The OECD benchmark definition of FDI is as follows:

> "Direct investment is a category of cross-border investment made by a resident in one economy (the direct investor), with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise), that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long-term relationship with the direct investment enterprise, to ensure a significant degree of influence by the direct investor in the management of the direct investment enterprise. The 'lasting interest' is evidenced when the direct investor owns at least 10 per cent of the voting power of the direct investment enterprise. Direct investment may also allow the direct investor to gain access to the economy of the direct investment enterprise, which it might otherwise be unable to do."[195]

Liberalization of inward and outward FDI policies does not, by itself, account for growth in FDI – the level thereof is determined by the willingness of companies to invest abroad. In this regard,

[192] UNODC (2011) 5, 34.
[193] The main components of FDI are: "(1) equity that comprises: i) equity in branches; ii) all shares in subsidiaries and associates (except non-participating, preferred shares that are treated as debt securities and included under direct investment, debt instruments); and iii) other contributions of an equity nature. Ownership of equity is reflected in shares, stocks, participations, depositary receipts or similar documents. Reinvestment of earnings comprises the claim of direct investors (in proportion to equity held) on the retained earnings of direct investment enterprises. Reinvestment of earnings represents financial account transactions that contribute to the equity position of a direct investor in a direct investment enterprise; (2) deposits (3) debt securities (includes non-participating preferred shares, bonds, debentures, commercial paper, promissory notes and other non-equity securities); (4) loans (financial assets that are created when a creditor lends funds directly to a debtor through an instrument that is not intended to be traded; (5) trade credit (receivables and payables) between FDI related enterprises; (6) other accounts receivable/payable which include advances and deferred payments in respect of exchange of non-produced assets. Financial derivatives are not included in direct investment" (OECD 2008:62).
[194] UNCTAD (2015) xi.
[195] OECD (2008) 17.

multi-national enterprises (MNEs) have not shied away from investing abroad with some 65 000 MNEs and another 850 000 affiliated companies operating globally and accounting for 11 per cent of the world's GDP.[196] UNCTAD estimates that government budgets in developing countries rely on MNE foreign affiliates for approximately USD 730 billion (annually). This represents an average of 23 per cent of total corporate contributions and 10 per cent of total government revenues. The national budgets of African countries depend on foreign corporate payments for an average of 14 per cent of their funding.[197] For the period 2013 to 2015, FDI into Africa has remained consistent at an average of USD 54 billion,[198] whilst FDI outflows have reduced from USD 16 to USD 11 billion.[199] FDI into Africa was low due to low commodity prices for the period, and the drop in outflows is ascribed to investors from Angola, Nigeria and South Africa that reduced foreign investment due to factors such as a depreciation of national currencies, lower commodity prices and a weakening demand from their main trading partners.[200]

From the perspective of capital exporting countries, investment is usually made with a view to securing a return, so that in the long run, the capital exporting country may enjoy a net benefit in the form of repatriated profits, royalties on intellectual property and similar payments.[201] From the perspective of host countries, FDI can mean "an increased pool of capital available for investment", increased revenue, increased employment, the introduction of new skills and technology and other positive spill overs such as enhancement of a competitive business environment, contribution to international trade integration and improvement of enterprise development.[202] For investors making investments abroad, the main objectives may be to maximise profits, spread risk, benefit from exchange rate differentials, protect an existing market, higher growth prospects, or they may possess technologies that give them a competitive advantage over local enterprises in those countries.[203]

A substantial proportion of FDI is made in the natural resources sector, especially minerals and oil, with the objective of exploiting technological advantage (ownership), to secure supplies, or both. Investment in processing natural resources may also be informed by proximity considerations such as reduced transportation costs and lower labour costs. Easson contends that the evolution of international production has been one of the major elements in the growth of FDI, as manufacturing moves offshore to take advantage of the availability of lower wages and suitably skilled workforces.[204] This is confirmed in the World Investment Report of 2016, wherein

[196] Easson (2004) 12.
[197] UNCTAD (2105) xiii.
[198] This represents a percentage of only 3.8 of world-wide FDI.
[199] UNCTAD (2016).
[200] UNCTAD (2016).
[201] Easson (2004) 13.
[202] Kurtishi-Kastrati (2013) 26; Easson (2004) 14-17; OECD (2008) 22.
[203] Easson (2004) 17.
[204] (2004) 18.

it is stated that countries are reviewing policies to support FDI into the manufacturing sector, in order to reduce the vulnerability of Africa to commodity price developments.[205] Increased revenue from natural resource extraction presents an opportunity to unlock the growth potential of African countries. Impediments in doing so exist in the form of lack of basic infrastructure (transportation, communication, power, water, etc.). It follows that well designed public investments can thus not only fill urgent infrastructure gaps, but also together with an overall improvement in the business climate, act as catalyst for increased private investment. However, capital investment will only deliver high returns when good investment choices are made and assets are created, operated and maintained in an effective way – which logically raises the need for good governance.[206]

Governments can also initiate investment to attract FDI for large infrastructure development projects. The host country decides what form the investment project should take on and foreign firms are invited to tender. Whilst these investment types may be consistent with the overall strategy of the investor, this is not always the case. In some instances, these may be undertaken purely for making a profit, and in extreme cases, the "investment" involves nothing more than asset stripping.[207]

From a policy perspective, it is important for host countries wishing to attract FDI (or not losing existing FDI to a competing country) to be acutely aware of the factors which affect an investor's choice of location. The factors which influence locational decisions can differ widely, according to whether the investment is market or resource orientated and whether it is in the manufacturing, service or natural resources sector. Nevertheless, some factors are important to all types of investment, such as political and economic stability; infrastructure (physical/business/legal); bureaucracy; communications infrastructure; quality/level of labour force; the ability to repatriate profits freely and the availability of adequate dispute resolution mechanisms.[208] Additional factors can include stability and predictability of the business climate, how well commercial law and contract enforcement are entrenched restrictions to trade, as well as the intellectual property (IP) regime.[209]

In terms of the World Bank's *Ease of Doing Business Report*,[210] the perception[211] of the ease of doing business and regulatory constraints in the sample African countries covered in this thesis, are as follows:

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205 UNCTAD (2016a) 42.
206 Lundgren, Thomas & York (2013) 41.
207 Easson (2004) 19.
208 Easson (2004) 19-20.
209 UNCTAD (2015) 177.
210 World Bank (2016).
211 The criteria for measurement as per the *Report (2016:2)* include: "Procedures, time, cost and paid-in minimum capital to start a business; procedures, time and cost to complete all formalities to build a warehouse; procedures, time and cost to get connected to the electrical grid; procedures, time and cost to transfer a property; movable collateral

Table 4.1 World Bank "Ease of Doing Business" Ranking

Ranking (1-189)	Economy	Distance to Frontier (DTF) Score[212]
Southern Africa		
72	Botswana	64.98
101	Namibia	60.17
73	South Africa	64.89
155	Zimbabwe	48.17
West Africa		
114	Ghana	57.69
179	Liberia	40.19
147	Sierra Leone	49.69

Source: World Bank (2016) Doing Business 2016 Measuring Regulatory Quality and Efficiency

This report provides a gauge of "whether an economy has in place the rules and processes that can lead to positive economic outcomes," for example, "rules that encourage firm start-up and growth, and which avoid creating distortions in the marketplace."[213] It also provides an indication of how well the country is positioning itself in establishing and clarifying property rights, minimizing the cost of resolving disputes, increasing the predictability of economic interactions and providing contractual partners with essential protection against possible abuse.[214] From the table above, the average score for doing business in the selected sub-Saharan Africa is 55. Placed into context with the top performing economy in Africa (Mauritius ranked 25th globally with a score of 77), the countries listed, individually and as a collective, need to prioritise key areas for economic and business reform to create an improved investment climate.

Empirical studies on the lack of capital inflows from rich to poor countries show that, during the period from 1970 to 2000, the leading explanation for this trend was low institutional quality.[215] The observation that "capital does not flow from developed countries to developing countries

laws and credit information systems; minority shareholders' rights in related-party transactions and in corporate governance; payments, time and total tax rate for a firm to comply with all tax regulations; time and cost to resolve a commercial dispute; time, cost, outcome and recovery rate for a commercial insolvency and strength of the legal framework for insolvency; quality of building regulation and its implementation; reliability of electricity supply, transparency of tariffs and price of electricity; quality of the land administration system; quality of judicial processes; and the time and cost to export the product of comparative advantage and import auto parts."

[212] The measure is normalized to range from 0 to 100, with 100 representing the frontier.

[213] World Bank (2016) 2.

[214] World Bank (2016) 2.

[215] Alfaro, Kalemli-Ozcan & Volosovych (2008) 8.

despite the fact that developing countries have lower levels of capital per worker",[216] is known as the Lucas Paradox. In a 2008 study, Schularick and Steger find that improvements in institutional quality is a critical condition to ensure increases in capital flows to developing countries.[217] Similarly, an International Monetary Fund (IMF) analysis finds that:

> "the seemingly perverse flows of capital from poor to rich countries today are not necessarily a sign of inefficiencies in global financial markets. Rather, they may indicate financial and other structural impediments which limit a poor country's ability to absorb foreign capital."[218]

According to a study by Dehn, uncertainty about future commodity prices does not affect investment decisions.[219] Investors in developing countries are exposed to multiple sources of uncertainty, ranging from political instability and economic policy changes to exogenous weather shocks, disease and civil strife. In the presence of multiple sources of uncertainty, commodity price uncertainty *per se* is not critical to investors. This only becomes critical when commodity price movements take the form of extreme upwards price changes. Dehn describes the investment response to positive and negative shocks as asymmetric, due to irreversibility of investment that reduces the scope for disinvesting, especially in commodity sectors where replacement investment rates are small. The implication is that adjustment to negative shocks occurs via a reduction in capacity utilisation.

Positive factors which have been identified as primary determinants for FDI are: potential profitability, market size and potential, availability of natural resources, appropriately skilled labour and country image. Easson groups the negative factors into four categories namely: risk factors, cost factors, efficiency factors and other factors. Risk factors include political risk, economic risk, risk pertaining to protection of property, physical risk and corruption.[220] The latter can also be considered under efficiency factors, since corruption is often linked with excessive bureaucracy, which is a factor that interferes with the efficient conduct of business.[221]

The administrative cost of doing business in Africa is often listed as an efficiency factor, and according to the World Bank's "Doing Business" survey, the bulk of African countries feature in

[216] Schularick & Steger (2008) 11. The finding is based on historical data/experience and the rate of returns implication of an extended Lucas model.
[217] Schularick & Steger (2008) 11.
[218] Prasad, Raghuran & Subramanian (2007).
[219] Dehn (2000) 2.
[220] Other investment risk may include "the presence/risk of war, civil unrest or terrorism; inflation and currency fluctuations, high inflation and rapidly depreciating currencies impact on country image." Easson (2004:29).
[221] Easson (2004) 29-30.

the bottom third.[222] Another factor is the extent of restrictions on business freedom. This ranges from restrictions on the percentage of foreign ownership, remittance of profits, and foreign exchange controls, to restrictions on the import of necessary materials and machinery. Other factors are geographical remoteness and cultural factors (e.g. language, work ethic, etc.).[223]

The World Trade Organization (WTO) identifies several FDI-related challenges facing resource-rich countries. Firstly, there may be substantial differences in access to information between a government and a multi-national mining company (e.g. pertinent information to a venture such as commercial market data, geological analysis and information on technologies for exploration and extraction). In this regard transparency in the bidding process can reveal the true market value of the host country's natural resources.

Related to the above is the "hold-up" problem, "whereby a government may have an interest in renegotiating *ex post* the terms of a contract". The WTO finds that this is likely to deter investors, because it introduces a new risk into the equation – either through the renegotiation terms or through outright nationalisation. In addition, such changes may bring about reduced investment returns and the government may lower payments in initial auctioning of licences.[224] In this regard the WTO suggests that tax regimes are established which are able to build on contingencies, such as changes in international commodity prices.[225]

A third challenge lies in the fact that foreign investors in extractive industries tend to operate across jurisdictions and through complex company structures. Weijermars states that opportunities for tax evasion, aggressive tax planning and trade mispricing are created by means of mechanisms that limit public disclosure, for example the use of offshore registered corporate vehicles in the ownership chain.[226] Measures to discuss these challenges include better participation in voluntary reporting structures (e.g. the Extractive Industry Transparency Initiative

[222] World Bank (2015) 6.
[223] Easson (2004) 32-33.
[224] WTO (2016) 161.
[225] WTO (2014) 161.
[226] (2014) 7.

(EITI)[227]), mandatory reporting standards (e.g. the US Dodd Frank Act)[228] and increased multi-lateral cooperation.[229]

According to UNCTAD, tax considerations do not drive locational decisions, but they do drive the modality of investments, as well as the routing of investment flows. When a decision is made to enter a market, it is thus not dependent on tax considerations and a MNE will, after the investment decision is made, structure the investment in the most tax efficient way.[230] Thereafter significant shares of global investment are routed to their final destination through special purpose entities (SPEs), offshore financial centres and tax havens.[231]

The issue of taxation in investment decisions is, according to UNCTAD, generally considered as less important for resource and strategic asset-seeking investments. The same is valid for market-seeking investments. Tax is therefore one of several determinants which drive location choices for efficiency-seeking investments.[232] Resource seeking investments are mostly capital intensive,[233] and have long gestation periods. According to UNCTAD, expected return calculations are quite sensitive to cost factors, and tax can be one of these cost factors. Other important considerations include the long time frames of negotiations on the fiscal mechanisms, in which rents will be distributed between the investor and the state.[234] Due to the long term nature of such investments, and the equally long payback periods, predictability and stability in the fiscal treatment of investments are very important.[235]

The growth of global value chains has made taxation of high relevance in countries' attractiveness, especially with regard to factors such as the level of taxation, the ease with which tax obligations can be met, and the procedural ease in registration and licencing. From a broad fiscal policy perspective, investors attach high value to predictability and stability of the fiscal environment in host countries. Drastic changes in fiscal regime or a perceived risk thereof deter

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227 (EITI) is a global standard that seeks to promote open and accountable management of oil, gas and mineral resources. The standard seeks to address the key governance issues of the oil, gas and mining sectors. It aims to strengthen government and company systems, inform public debate and promote understanding. In each of the implementing countries, the EITI is supported by a coalition of government, companies, and civil society.
228 The purpose of the act is to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." "Other purposes" include measures "against the exploitation and trade of conflict minerals originating in the Democratic Republic of the Congo, which is helping to finance conflict characterized by extreme levels of violence in the eastern Democratic Republic of the Congo, particularly sexual- and gender-based violence, and contributing to an emergency humanitarian situation therein." Also of note is the reporting requirement introduced on minerals originating from the Democratic Republic of the Congo or an adjoining country.
229 WTO (2014) 161.
230 (2015) 177.
231 (2015) 177.
232 (2015) 177.
233 See also Boadway & Keen (2010) 13.
234 UNCTAD (2015) 177.
235 UNCTAD (2015) 177.

investors, whereas a demonstration of the ability of authorities to create collaborative relations with investors, provides better certainty on how their investments will be treated.[236] In summary, though not a primary deciding factor, tax plays an important role in location decisions, in three main ways, namely: the administrative burden, the fiscal burden and in long-term stability and predictability considerations.[237]

FDI occurs in a variety of ways, such as purchasing assets in another country, acquisition of substantial shareholding and loans to a subsidiary or affiliate.[238] Easson defines FDI as:

> "an investment made with the purpose of acquiring a lasting interest in an enterprise operating in an economic environment other than that of the investor, with the investor having an effective voice in the management of the enterprise."[239]

Most common forms of FDI are mergers and acquisitions with an enterprise in another country, joint ventures, new ventures (so-called "greenfield investments") and additional investment or reinvestment in an existing foreign venture.[240] According to the OECD, it is important to identify FDI by type because there are differences in how varying forms of FDI can impact on the host economy.[241] In many developing countries cross border mergers and acquisitions constitute an important element of FDI flows, since they entail some form of privatization where foreign investors acquire control or a significant share of a former state owned enterprise.[242] FDI-related activities which add benefit to the host country include licensing technology, sub-contracting operations and the formation of business alliances.[243]

4.2.1 Taxation of FDI

A standard economic approach to framing the relationship between taxation and state-building is to explain the level of taxation in view of economic development and economic structure: ratios are important and countries with higher incomes have higher ratios, as a percentage of national income; the ratios are supported by factors such as literacy, industrialization, economic openness, debt and so forth. New tax handles in the form of FDI, trade and creation of formal manufacturing hubs have the potential to ease the process of tax collection. In theory this reflects the relationship between taxation and state capacity as simple and purely evolutionary, and as an outcome of

[236] UNCTAD (2015) 177.
[237] UNCTAD (2015) 177.
[238] OECD (2008) 62.
[239] Easson (2004) 4.
[240] Generally, greenfield investments involve the creation of new assets, whereas mergers and acquisitions involve a change in ownership of existing assets.
[241] OECD (2008) 20.
[242] Easson (2004) 8.
[243] Easson (2004) 5.

modernization (the ability to tax is closely associated with administrative capability).[244] However, usually a political dimension is present wherein political will becomes a critical factor in revenue collections. This is further complemented/affected by societal factors, such as the willingness of society to pay taxes.[245] As soon as revenue collection is compromised, these different economic, political and social relationships are constrained and consequently the state building process is affected negatively.

Countries typically claim the right to tax income and capital on the basis of the residence of the taxpayer and/or the source of the income or location of the capital. As a general rule residents are taxed on their total worldwide income and capital, and non-residents are taxed on their income from a source within the country or on capital located in the country.[246] The application of the two principles can result in double taxation, where income flows from one country to another, with one taxing on a source base and the other on a residence base. Double taxation agreements are used to address concerns of foreign investors that they may be subject to taxation for the same income by both the home country and the host country. The most important issue underlying all international tax considerations is the extent to which the revenue allocation between countries is done from taxes collected from international companies.[247] The main instruments to resolve these issues are international tax agreements.[248] Such double taxation is usually avoided or mitigated, either unilaterally or by tax treaty, mainly by the country of residence reducing the tax which would otherwise be payable.[249]

The tax of greatest concern to most foreign direct investors is the host country's corporate income tax (CIT).[250] The host country entity, subsidiary or branch will be subject to a tax on its profits; dividends paid to the foreign parent will be subject to a withholding tax. Whilst importance is attached to the nominal rate of tax, investors are generally more concerned with the effective rate of tax[251] and the governing rules on deduction of interest on loans.[252]

Many FDI structures involve more than two countries, in that the parent company may be in the home country, the subsidiary in the host country and another intermediate entity in a third country.

[244] Brautigam ed (2008) 5.
[245] Brautigam ed (2008) 6.
[246] Easson (2004).
[247] UNCTAD (2009) 23.
[248] UNCTAD (2009) 23.
[249] Easson (2004) 36.
[250] Easson (2004) 38.
[251] The burden is determined by multiplying taxable profits by the relevant rate. The manner in which the profits are computed is therefore quite significant to the investor and the host country. Relevant factors are the accounting method used; inclusion of income and the treatment of capital gains; allowances (deductions and treatment of losses) and depreciation rules. Since most FDI ventures take some time to show profit, rules permitting carry-forward losses are important.
[252] Easson (2004) 39.

The tax objectives of such structuring are to extract income from the original host country at the least possible costs;[253] to avoid or mitigate tax on that income in the home country and to pay little or no tax on the income in the intermediate country.[254] In 2016, UNCTAD identified a trend attributed to corporate reconfigurations, including tax inversions, whereby MNEs transferred their tax domicile to jurisdictions that offer lower corporate tax rates, and that do not levy tax on global earnings.[255] It was also found that the proportion of investment income booked in low tax and often offshore jurisdictions, is high despite the slowdown in offshore financial flows.[256] According to UNCTAD, a key concern for policy makers is "the disconnect between the locations of income generation and productive investment," that results in substantial tax losses.[257]

4.2.2 International Investment Agreements

General host country policies affecting investment decisions include ten broad policy areas, as they relate to investment as well as promotion and facilitation of investment, trade, competition, taxation, ethical business conduct, governance, human resource development, infrastructure, financial sector development and, finally, public governance.[258]

A recent UNCTAD report finds that there is limited attention being paid to investment policy in the international community's discussion on anti-avoidance.[259] Due to the fundamental role which investment can play in creating corporate entities that enable tax avoidance, UNCTAD holds the view that investment policy should form an integral part of any solution to tax avoidance.[260] This statement from UNCTAD raises questions of equity and public policy on what the balance should be between domestic and foreign interests, as far as international investment agreements are concerned. Criticism levelled at the international investment agreement (IIA) regime is that investors' rights are often protected over the public interest of the host country. In other words, the promotion and protection of investment is advanced over the right to properly regulate for public welfare purposes.[261] According to UNCTAD, there is a "*pressing need for systematic reform of the global IIA regime … to* ensure that it works for all stakeholders. The question is not about

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[253] Host country tax is reduced or avoided through treaty shopping in that the investor seeks to take a favourable definition of permanent establishment in a treaty between the host country and the country through which investments are routed. A further consideration may be lower rates of withholding taxes.
[254] Easson (2004) 50.
[255]UNCTAD (2016a).
[256]UNCTAD (2016a).
[257] UNCTAD (2016a).
[258] UNCTAD (2009) 7. Specific issues related to the policy areas include "foreign exchange regulations, taxation, employment, including employment of non-citizens, land issues, competition policy, rule of law and respect for property rights, intellectual property protection, corporate governance and accounting standards, licensing and administration of regulations and investment promotion including incentives" (UNCTAD 2009: 7).
[259] UNCTAD (2015) xiv.
[260] UNCTAD (2015) xiv.
[261] De Mestral & Levesque ed (2013) xii; 24.

whether or not to reform, but about the *what*, *how* and *extent* of such reform".[262] It consequently raises the following main IIA reform challenges:

a) Protecting the right to regulate in the public interest, to ensure that IIAs' limits on the sovereignty of countries do not disproportionally restrict public policy making;
b) Reforming the investment dispute settlement mechanisms to address the "legitimacy crisis of the current system" and to advance and facilitate investment;
c) Ensuring responsible investment to take full advantage of the positive impact of foreign investment and to reduce its potential negative effects; and
d) Enhancing the systemic consistency of the IIA regime to address the gaps, overlaps and inconsistencies of the current system and to create coherence in investment relationships.[263]

From a process perspective, it suggests that IIA reform actions require synchronisation at all levels (national, bilateral, regional and multi-lateral) and that, in each instance, the reform process must contain action steps to achieve specific outcomes. These can include actions such as taking stock of the existing IIA regime and developing a strategic approach to address problem areas identified.[264] It is important that the strategic objective of sustainable and inclusive development guides the review and reform process.[265] Countries engaged in national IIA reviews focus on the international policy dimension wherein an analysis of treaty networks and content profiles is done. In some countries, impact and risk assessments are undertaken to identify specific reform needs in line with national development objectives. African countries that have gone through a review process include Egypt and South Africa.[266] IIA reviews can culminate in the creation of a new IIA model, or they can contribute to the ongoing modernization of a country's negotiating documents and approach to international investment policy making. They can also include an assessment of whether certain IIA relationships should be renegotiated, amended or terminated. South Africa specifically focused on codifying IIA concepts into law.[267]

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[262] UNCTAD (2015) xi.
[263] UNCTAD (2015) xii.
[264] UNCTAD (2015) xii.
[265] UNCTAD (2015) xii.
[266] UNCTAD (2016b) 7.
[267] UNCTAD (2016b) 7. The review resulted in the development of a new South African investment bill that was aimed at codifying "investment protection provisions into domestic law, to terminate BITs and offer partners the possibility of renegotiating their IIAs and, to refrain from entering into BITs in the future, unless there are compelling economic and political reasons for doing so." The Promotion and Protection of Investment Act was passed in 2015, which includes investment protection commitments, whilst preserving the right of South Africa to pursue legitimate public policy objectives.

4.2.2.1 International tax and International Investment Policy Coherence

In current discussions on IFFs in the international community, the fiscal contribution of MNEs takes centre stage, especially in the context of tax avoidance, BEPS and the need for sustained investment to support global economic growth and development, particularly in the light of financing needs for the Sustainable Development Goals (SDGs).[268] According to UNCTAD, the government budgets of African countries depend on foreign corporate payments for (on average) 14 per cent of their funding, and in developing countries, the average contribution of foreign affiliates in royalties, tariffs and social contributions, can be double that of the contribution of corporate income taxes to government revenue[269]

4.2.2.2 Incentives

According to a World Bank policy note, time-series econometric analysis and numerous surveys of international investors over the past decades have shown that investment location is not driven by tax incentives, and that factors such as political stability, infrastructure, and labour costs and availability, were more important.[270] The analysis and surveys confirmed that tax incentives qualify as poor instruments for offsetting negative factors in a country's investment climate.[271] However, for some, tax incentives are a crucial factor in choosing investment locations: mobile firms and firms operating in multiple markets such as insurance companies, banks and technology companies can exploit different tax regimes across different countries. In this regard, Sun points out that it is not a matter of coincidence that transactions routed through the Caribbean and South Pacific (generally seen as tax havens) increased fivefold between 1985 and 1994, while the total world FDI flows tripled.[272] Investment flows to offshore financial hubs and centres declined in 2015 (from a peak of USD 132 billion in 2013), however, there was a sharp rise in the size of quarterly flows through special purpose vehicles. Policy makers should therefore be concerned when a disconnect develops between the place of income generation and the place where productive investment is done. This is an area that can be addressed through IIA review processes.[273]

In attracting FDI, countries have to weigh the practical, domestic, political and legal constraints in choosing how to frame and provide incentives. Foremost is the revenue constraint: tax incentives cost money in revenue foregone and a country should assess whether it can afford to do so,

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268 On September 25th 2015, countries adopted a set of goals to end poverty, protect the planet, and ensure prosperity for all as part of a new sustainable development agenda. Each goal has specific targets to be achieved over the next 15 years (UN).
269 UNCTAD (2015) xiii.
270 World Bank (2003).
271 World Bank (2003).
272 Sun (2002) 17.
273 UNCTAD (2016a).

before granting incentives.[274] A country can, however, reduce the cost of investment incentives by careful targeting, for example, by restricting their availability to only those investors which are the most likely to be influenced by tax considerations.[275] Typically, selective approaches that are used as incentives are tax holidays and tax heavens, especially in emerging economies where authorities have favoured a discretionary approach.[276] While such incentives provide immediate and large advantages to the benefiting companies, they mainly attract short-term investments and mainly reward the establishment of a company rather than company expansions.[277] Sun argues that such incentives may cause considerable erosion of the tax base and of tax revenues.[278] There is also a risk of distortions being created if the targeting policy is not supported by sufficient administrative capacity. Such distortions may cause resentment (especially where foreign investors are given preference over domestic investors) that is often translated into political pressure to extend the benefits of the incentives to other sectors which have previously been excluded.[279]

Competition amongst countries to attract investment has resulted in an almost universal lowering of tax rates on income from capital – essentially what is referred to as the race to the bottom.[280] As a result, the fiscal sovereignty of nations is reduced, since tax competition imposes market induced limitations on tax rates, with countries often finding themselves in a position to grant investment incentives which they may have preferred not to offer.[281] Sovereign countries may further constrain their fiscal sovereignty through bilateral treaties which place limitations on their tax jurisdiction in return for corresponding limits implemented by a treaty partner.[282] Also of significance are the rules of the international organisations[283] a country chooses to join. Joining an organisation may imply that some limitations on national tax autonomy are imposed, particularly constraints on the use of tax incentives for foreign investment.[284] Where countries are concerned that tax competition will involve them in a bidding war, the World Bank advises that a

[274] Easson (2004) 199.
[275] According to Sun (2002), a "non-targeted approach entails for example the lowering of the effective corporate tax rate for all firms while providing limited or no incentives. Extreme approaches entail elimination of taxes for all investors or for specific ones. Countries become tax havens and tend to suppress all direct income taxes, and will rely on indirect consumption and employment taxes." Another method is to have limited incentives in export-orientated activities in export processing zones (EPZ).
[276] Sun (2002) 17.
[277] Sun (2002) 17.
[278] Sun (2002) 17.
[279] Easson (2004) 199.
[280] Ireland's tax policy was generally recognized as a key factor in its success in attracting international investors and supports the contention that there is a growing acknowledgment that tax incentives do affect the decisions of some investors some of the time (Sun 2002).
[281] Easson (2004) 200.
[282] Easson (2004) 200.
[283] Most notably the World Trade Organization (WTO); the OECD, specifically actions to combat harmful tax competition; the EU especially in relation to accession of new members and association agreements; the IMF and the World Bank (elimination of tax concessions).
[284] Easson (2004) 200. UNCTAD (2016b) 7.

review of IIAs must be taken, especially where MNEs are favoured at the expense of local entities and the general welfare of the country.[285]

In 2011, the OECD reported to the G20 that:

> "tax incentives such as corporate income tax exemptions in free trade zones continue to undermine revenue; where governance is poor, they may do little to attract investment, and, in instances when they attract FDI, it may well be at the expense of domestic investment or FDI into some other country."[286]

This is a very real predicament in the diamond industry, and the subjective nature of diamond valuation and the ability to understate profits through under-valuation of diamonds further exacerbate the problem.[287]

4.2.2.3 Tax Treaties and IIAs

Both tax agreements and international investment agreements are regarded as treaties.[288] Four major consequences can be assigned to tax treaties, of which two are likely to increase FDI and the other two tend to reduce FDI. Firstly, tax treaties have the purpose of minimizing double taxation of affiliated companies' income. This is done through standardization of tax jurisdictions and tax definitions.[289] Secondly, by reducing withholding taxes and increasing tax certainty, tax treaties affect how MNEs are taxed.[290] Tax certainty and increased FDI can also be created through tax treaties which reduce the likelihood of a host nation unilaterally changing its tax policies.[291] These two rules of treaties put together, have the potential for increasing the expected value of after-tax returns from FDI.[292] Davies *et al*, however, caution that such FDI-increasing elements of treaties can be partially offset by two FDI diminishing roles of treaties. The first is where there is an increase in enforcement of transfer pricing regulation, and the second element

[285] World Bank (2003) 3.
[286] OECD (2014) 21.
[287] Chapter 7 touches on the tax, customs and money laundering risks related to free trade zones.
[288] Treaties are agreements between sovereign nations. Article 2 of the Vienna Convention on the Law of Treaties, states that a treaty is "an international agreement concluded between countries and governed by international law." Tax treaties are referred to as either "agreements" or "conventions." Most tax treaties are bilateral and confer rights and impose obligations on the two contracting States, as pointed out by Arnold (2015) 2. The general purpose of bilateral investment agreements (BITs) is the "promotion and protection" of investments "from one contracting party in the territory of the other contracting party. Most BITs have been concluded between developed capital exporting countries and developing capital importing countries, but a growing number are being negotiated between developing countries" as per Houde & Yannaka-Small (2004)4.
[289] Davies, Norbäck & Ayça (2008) 2-3.
[290] Davies *et al* (2008) 2-3.
[291] Davies *et al* (2008) 2-3.
[292] Davies *et al* (2008) 2-3.

relates to provisions aimed at addressing treaty shopping that may inhibit the ability to channel profits through low-tax treaty partners in order to reduce taxes.[293]

Tax treaties and IIAs have a number of things in common, such as having the purpose to facilitate FDI, provide legal protection, reduce risks and create security, provide predictability and to allow investors to plan and carry out commercially viable activities under the protection of an international legal regime.[294] As a consequence, both can contribute to sustainability of FDI and the legal regimes which support it.[295] Tax treaties only apply to direct taxation in the form of income, corporate profits and capital taxes, and in general not to indirect taxes. VAT, excise duties and customs duties are a central concern in international agreements for the liberalization of trade in goods and services, and can give rise to investor-state disputes under IIAs.[296] Direct taxation is generally expressly excluded from the scope of such agreements, which are typically modelled on the OECD and the UN model tax treaties.

Nearly all of the world's tax treaties are based on precedents found in an OECD or a UN model tax convention.[297] Both models divide taxing rights on cross-border investment and business activities.[298] The difference between the two is that the OECD model shifts taxing rights to capital exporting treaty partners, while the UN treaty allows capital importing countries to keep more taxing rights.[299] The OECD is perceived to favour the interests of capital exporting countries, whilst the UN model is designed to balance the disparate interests of developed and developing countries. Accordingly, the UN model tends to favour taxation of source over residence, in order that a capital importing country's tax base is not unduly eroded by concessions to investors from capital exporting nations.[300] The African Tax Administration Forum (ATAF) has followed the UN model treaty in its development of the ATAF Model Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income for the African continent.[301] As alluded to in the ATAF model treaty title, tax treaties state their primary purpose in title and it typically reads as "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income."[302]

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293 Davies *et al* (2008) 2-3.
294 Tax treaties identify the persons whose tax obligations are affected by the treaty, generally residents of the contracting States, the taxes covered by the treaty (e.g. income and capital taxes imposed by the contracting States) double taxation and other special provisions.
295 O'Brien & Brooks (2013) 303; 304.
296 O'Brien & Brooks (2013) 305.
297 Daurer & Krever (2012) 1.
298 Daurer & Krever (2012) 1.
299 Daurer & Krever (2012) 1.
300 UN (2011) vi par. 3 ; O'Brien & Brooks (2013) 306.
301 ATAF.
302 O'Brien & Brooks (2013) 306.

In analysing the effect of tax treaties on MNEs, Davies, Norbäck, and Ayça ,[303] find little evidence for an effect of treaties on the levels of total sales, but find that a tax treaty can improve the probability of investment by a MNE in a given country.[304] In addition, the study finds that a treaty can promote the attractiveness of one host country over another, even where it does not bring about the desired levels of investment, when the MNE is assured of tax certainty under the treaty.[305] Combined results of the study propose that although treaties may decrease the perceived risks of entry, they nevertheless give MNEs reasons to restructure trade flows to decrease the profitability of the affiliate relative to the parent.[306]

A 2014 study of OECD countries, Lejour finds that new tax treaties increase bilateral FDI by 21 per cent, with the effects tempering out after ten years. The analysis is based on bilateral treaties which specifically deal with taxes on profits and returned earnings such as dividends, interest income and royalties. [307]

4.2.3 Use of Offshore Financial Centres (OFCs)

A quick internet search shows a variety of entities which provide services to establish OFCs and the potential benefits that can be derived therefrom. These include tax minimisation, confidentiality, lesser administrative burden, asset protection, lower capital and start-up costs to businesses that entertain offshore company formation.[308] African countries (such as Mauritius), which create favourable OFCs, have seen increased financial flows.[309] OFCs which channel FDI flows are typically seeking negotiations with host African nations to sign investor protection and promotion agreements. These can provide security of tenure (e.g. minimize the risk of nationalization) by forcing fair compensation and arbitration, as well as double taxation avoidance agreements, which reduce the tax bill that a company may face. [310]

MNEs create corporate structures through investments that span multiple jurisdictions, and this is generally done in a way that is tax-efficient.[311] In this regard, an investment perspective on tax

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303 The analysis makes use affiliate level data from Swedish MNEs to analyse the impact of tax treaties on the overall affiliate sales and the composition of those sales.
304 Davies *et al* (2008) 1.
305 Davies *et al* (2008) 4.
306 Davies *et al* (2008) 5; 29.
307 Lejour (2014) 20-21.
308http://www.infinitysolutions.com/blog/six-benefits-of-setting-up-an-offshore-company/; http://www.unitrustcapital.com/offshore-company/offshore-incorporation-company-benefits.html; http://www.offshorecompany.com/company/benefits/.
309 Over the period 2003 – 2013 Mauritius accounted for 40 per cent of all FDI flows into India thanks to a favourable tax deal with New Delhi. At the time it had already signed 19 tax deals with African countries and it was negotiating another three. It was also in the process of finalizing six investor protection agreements in Africa, in addition to the existing 19 signed. Financial Times (2013).
310 Financial Times (2013).
311 UNCTAD (2015) xiii.

avoidance highlights the role of offshore investment hubs (tax havens and special purpose entities in other countries) as major role players in international investment.[312] According to UNCTAD, an estimated 30 per cent of cross-border corporate investment stocks have been moved through offshore hubs, before reaching their destination as productive assets.[313] UNCTAD ascribes this to the outsized role which offshore hubs are playing in tax planning for international companies.[314] The main tax planning tools used by MNEs include rate differentials in jurisdictions, legislative mismatches and complex and multi-layered corporate structures. In relation to the latter, two categories of tax avoidance practices stand out. The first is the intangibles-based transfer pricing schemes and the second, financing schemes.[315] These schemes typically make use of investment structures which involve offshore investment hubs.[316]

Tax avoidance by MNEs is an international issue for both developed and developing countries, because they are equally exposed investments from offshore hubs.[317] The difference, however, lies in the impact that profit shifting out of developing countries can have on future development. The impact is larger because developing countries, more often than not, do not have the technical skills to deal with complex tax avoidance schemes and can therefore not address profit shifting meaningfully.[318] UNCTAD also states that tax avoidance results in a significant leakage of development financing resources.[319] The point is demonstrated by the UNCTAD findings that on average, every 10 percentage points of offshore investment are associated with a one percentage point lower rate of return across developing countries.[320] What the UNCTAD World Investment Report shows is that the massive worldwide financing needs for sustainable development exist, and that FDI has a crucial role to play to bridge the investment gap.[321] Strengthening and aligning of the global investment policy environment (which includes IIAs and international tax regimes) is required, which means that the two inter-related regimes made up of over 3,000 inter-related bilateral agreements require a joint reform agenda. The report further argues that a common framework for global investment cooperation benefiting all is possible, under conditions of improved governance, more inclusiveness and better coherence to manage the interaction between international investment policies and tax.[322]

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[312] UNCTAD (2015) xiii.
[313] (2015) xiii.
[314] (2015) xiii.
[315] UNCTAD (2015) xiii.
[316] UNCTAD (2015) xiii.
[317] UNCTAD (2015) xiii.
[318] UNCTAD (2015) xiii.
[319] (2015) xiii. "An estimated USD100 billion of annual tax revenue losses for developing countries are related to inward investment stocks directly linked to offshore hubs. There is a clear relationship between the share of offshore-hub investment in host countries' inward FDI stock and the reported (taxable) rate of return on FDI. The more investment is routed through offshore hubs; the less taxable profits accrue" (UNCTAD 2015).
[320] UNCTAD (2015) xiii.
[321] UNCTAD (2015) xiv.
[322] UNCTAD (2015) xiv.

High costs associated with international financial instability highlight the case for governments to manage capital inflows and outflows – not only the amount of foreign capital movement, but also the composition and usage of such amounts. National efforts should be complemented by a global approach aimed at improved monitoring and regulation of financial markets and institutions. A proposal for discouraging speculative flows in the form of a transactions tax[323] may also be useful to address IFFs. The benefits of such a tax are (a) its potential to discourage an activity that has proven to be detrimental to economic stability and development; (b) it represents a progressive tax on wealthy financial actors; (c) it sets similar rules for the game for all participating countries; and (d) it allows for a centralized and efficient system for collecting taxes.[324]

4.3 Financial flows associated with organised crime

Criminal enterprises are viewed by the United Nations Office on Drugs and Crime (UNODC) as representative of a multi-billion dollar set of networks which prey on every level of society on a global scale. The impact is felt in market distortion and corrupt governments. Ironically, the benefits of globalization, expansions in trade and improvements in information technology have also increased the reach of criminal enterprises, in that they have undermined competitiveness of MNEs and the security of nations.[325] In 2009, organized criminal groups'[326] global turnover through profit from the sale of illegal goods and services was estimated at approximately USD 870 billion per annum.[327] According to the UNODC, such "illicit funds are worth more than six times the amount of official development assistance, and are comparable to 1.5 per cent of global GDP, or 7 per cent of the world's exports of merchandise."[328] In 2010, the UNODC estimated illicit flows tied to crime syndicates at approximately USD 125 billion per year, with an estimated 85 per cent of that attributable to the trade in narcotics. A 2011 study by Global Financial Integrity (GFI) estimated the value of worldwide illicit traffic in goods, guns, people and natural resources far higher at USD 650 billion annually.[329] The indirect costs are believed to be far higher, coming in the form of political instability, violence and injury, human health, environmental clean-up, and an unfair playing field that favours illicit enterprise.[330] The economic costs are less well understood, according to the World Economic Forum (WEF), since organised crime extracts a hidden tax on millions of transactions around the world each day, from cybercrime's impact on

[323] The taxation of international transactions was proposed by James Tobin in 1972 (Tobin Tax). It requires a small fee on all international transactions (small enough to be irrelevant to financial operations linked to real investment, but sufficient to undermine the benefits expected from short term speculative operations.
[324] UNCTAD (2015) 132-133.
[325] UNODC.
[326] The defining characteristics of organised crime groups are the seriousness of offences committed and the financial and material benefit obtained by the perpetrator(s).
[327] UNODC.
[328] UNODC (2012).
[329] WEF (2011) 3.
[330] WEF (2011) 3.

the banking industry, to the trafficking of counterfeit pharmaceutical products and intellectual property. Through tax evasion and money laundering, a vast amount in additional funding is lost to governments struggling to provide basic social services. This is revenue denied to governments, with direct impact on the taxpayer.[331]

Organised crime is aptly described by the Global Initiative against Transnational Organised Crime as "a spoiler to development."[332] There are various components to organised crime, but the biggest profit earner in 2012 was the narcotic trade (estimated at USD 320 billion a year), followed by counterfeiting (estimated at USD 250 billion a year). The UNODC estimates the annualised value of human trafficking at USD 32 billion, while some estimates put the global value of smuggling of migrants at USD 7 billion per annum. Other areas such as trafficking in protected timber[333] generates revenues of USD 3.5 billion per annum in South-East Asia alone. Tiger parts, elephant ivory and rhino horn from Africa and Asia produce an estimated USD 75 million in annual criminal turnover.[334] With the rise in poaching of rhino in Southern Africa (for the period 2013 to 2016, 4448 rhinos were killed in South Africa alone)[335] and considering that rhino horns can earn traffickers up to USD 65 000 per kilogramme (one horn can weigh up to 7kg),[336] organised crime revenues from this commodity alone can generate up to USD 2 billion over a very short period.[337]

With the signing of the United Nations Convention against Transnational Organized Crime (UNTOC) in Palermo, Italy, in December 2000, the international community showed the political will to answer a global challenge with a global response.[338] The rationale being that law enforcement must cross borders if and when crime crosses borders, because a country cannot defend itself in such a scenario with purely national means.[339] This is so because the proceeds of crime are frequently moved across jurisdictions and laundered through the financial sector to conceal the audit trail. In this regard, OFCs are commonly used in low tax jurisdictions which offer banking and corporate secrecy. The challenge that this situation poses is that there is a level of bank secrecy, a level of corporate secrecy and most likely, a layer of lawyer-client privilege which stands between law enforcement and the launderer.[340] Money laundering schemes can involve a third layer of cover, such as the offshore trust, which is generally shielded by secrecy laws. A further level of protection can be included in the form of a flee clause, which allows or compels

[331] WEF (2011) 3.
[332] Global Initiative (2015) 3.
[333] Schneider (2010:12) points out that where access to normal banking channels is difficult, funding of arms deals is done through commodity exchanges as is evidenced in the violent conflicts in Liberia and Sierra Leone. These were financed with diamonds and timber concessions.
[334] UNODC (2012).
[335] Save the Rhino International.
[336] OECD (2015a) 59.
[337] Calculated as 4448 delivering 7kg of horn (4448x7) selling at USD 65000 p/kg (4448x7x65000).
[338] Supra 3.2.
[339] UNODC (2004) iii.
[340] Blum, Levi, Naylor & Williams (not dated) 18.

the trustee to change the domicile of the trust, whenever he feels that the trust is threatened. [341] Ample evidence from existing case law supports this *modus operandi*, and it is clearly illustrated in a series of cases referred to as the King matter.[342] The case shows how a bank that was eager to secure Mr. King as a client, helped him to "restructure his network of trusts and offshore companies," to "present a blind alley to any revenue investigation." The senior trust officer at the bank reportedly wrote to his colleague: "apparently, DK wishes to 'dismantle' the current structure and transfer the assets of Ben Nevis into a new company, as the 'tax authorities are chasing him'." This shows that Mr. King was the real owner of the Ben Nevis Trust, and it suggests that he restructured his holdings for the sole purpose of escaping tax scrutiny. Mr. King's role in managing his assets was to be kept under wraps: "DK's position as an adviser should be very much an 'off the record relationship'." [343]

4.4 Financial flows and the informal economy

According to UNECA, the informal sector remains the major source of employment across the African continent, accounting for approximately 70 per cent of employment in sub-Saharan Africa.[344] The dynamics[345] of the informal sector drive employment creation and value addition and represent approximately 80 per cent of the total labour force, as well as contributing an estimated 55 per cent to sub-Saharan Africa's GDP.[346] The prevalence or size of the informal economy is primarily related to two institutional weaknesses, namely taxation and regulation. With reference to the latter, it can be argued that state intervention creates a formal economy, and by extension, an informal economy is an economy that exists outside the regulatory framework of the state.[347] While the introduction of indirect taxes such as VAT enable informal sector businesses to contribute to government revenues, the potential gains from direct tax of the informal employees and businesses could potentially be much higher. However, regulations on eligibility for formal registration require a certain threshold of revenue, which often acts as a barrier or disincentive which pushes businesses into the informal economy.[348]

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[341] Blum *et al* (not dated) 18.
[342] *Commissioner for the South African Revenue Service v Metlika Trading Limited and Others* (20827/2002) [2010] ZAGPPHC 170 (5 August 2010) and *Commissioner of South African Revenue Service v King and Others* (4745/02).
[343] Dawes & Donnelly (2008).
[344] UNECA (2015) 2.
[345] The UNCECA Report (2015)2-3 states that, "on the supply side, the low quality of numeracy and literacy attained in educational systems, and inadequate skills development, are among the main factors leading to informality on the continent. The lack of technical and vocational training, limited investments in infrastructure, technology and innovation, as well as poor alignment of educational curricula to labour market demand, constitute other major hindrances for job seekers to enter the formal market. At the same time, large cities with little or no industrial bases exacerbate informal employment as a coping mechanism, particularly by young people. On the demand side, an employment focused growth trajectory that shifts production processes to labour intensive sectors through backward and forward linkages to the local economy is a critical component."
[346] UNECA (2015) 2.
[347] Schoofs (2015)3.
[348] UNECA (2015) 3.

Informal economies encompass a broad range of economic activities, ranging from taxis and street vendors at one level, whilst on a more systemic level, there are trading networks which operate across borders, artisanal mining activities which exist alongside large-scale mining operations, wholesale markets for counterfeit commodities, enterprises which form part of global supply chains, and community-based systems for saving and credit provision.[349]

Definitions of the informal economy come in varying forms – sometimes it is referred to as the underground economy and/or the black or shadow economy. Schoofs points out that applying the labels 'legal' and 'illegal' can be problematic, because in instances where the state's regulatory capacity is limited, the dividing lines between state and non-state, private and public, as well as legal and illegal become increasingly blurred. According to Schoofs, cross-border trade forms the quintessential example of the gap which can exist between state-sanctioned legality and popular perceptions of legitimacy. Where countries see cross-border flows of people and commodities that need to be policed and regulated, traders see legitimate opportunities for economic survival, which conform to well-established trading patterns that have existed since long before the post-colonial states came into being.[350]

Slemrod and Weber cite the most apt definition of informality as inclusive of:

> "all market-based legal production of goods and services which are deliberately concealed from public authorities to avoid payment of taxes or social security contributions, having to meet labour market standards, or complying with certain administrative procedures."[351]

The authors then illustrate the overlap between evasion and the informal economy, using two examples: (a) an overstatement of income-tax-deductible charitable contributions is tax evasion, but is not part of the informal economy, however, (b) a small business which fails to register to circumvent regulatory standards, is part of the informal economy, but may not constitute tax evasion if no tax liability is triggered by the business activity.[352] Both actions are motivated "by the desire to reduce the burden of some aspect of government regulation" and the "difference lies therein that the informal economy refers explicitly to production, while tax evasion need not."[353] According to Alm, Martinez-Vazques & Wallace,[354] "the perpetrators in the informal economy range from the poor, skilled trades people and professionals to high net worth investors who

[349] Schoofs (2015*)2.*
[350] Schoofs (2015) 9.
[351] (not dated) 3.
[352] Slemrod & Weber (not dated) 3.
[353] Slemrod & Weber (not dated) 3.
[354](2004) 93.

locate part of their wealth offshore - in the case of the latter, this behaviour increases the percentage of non-compliant investment that escapes tax collection." An illustration of this point is:

> "where illicit cash is received from an activity in the informal economy (e.g. theft) whereafter it is deposited (via an intermediary such as a lawyer) into a bank account opened in a tax haven. A loan is made by the offshore bank through its correspondent to finance the acquisition of real estate in the country where the purchase is made. The loan is guaranteed by deposits abroad, which means that the perpetrator(s) use illegal funds under the guise of a loan, and they may even be able to deduct the interest on the loan from any taxable income."[355]

Informality essentially hampers tax collections, but its consequences do not end with that: businesses which operate in the informal economy do so on a small scale, which eliminates the risk of penalties to a degree, but it also means that productivity gains are sacrificed and access to productive resources (e.g. credit and technology) is limited. Thus, informality has costs to the economy and society which go beyond the loss of tax revenue.[356]

A few good practices have arisen in the diamond industry to improve conditions in the informal sector and to increase the productivity of businesses. For example, in Botswana the downstream phase of diamond production created 21 businesses in cutting and polishing stones which employ 3,000 new workers.[357] However, a lack of competitiveness with global players has seen a general contraction in the local industry, and concerns of tax compliance of cutters and polishers have also arisen.[358]

4.5 Conclusion

In this chapter, three major sources of financial flows were identified, namely flows resulting from foreign direct investment, illicit trade, and flows through activities in the informal sector. Of concern is the lack of participation by sub-Saharan African countries in trade and investment, for instance, Africa's share in FDI which is only 3.8 per cent of global FDI.[359] Whilst it is shown that globalisation brought about increased growth in international trade and FDI to many regions, Africa is not benefiting in a similar manner. Various country-specific push and pull factors determine the levels of these (and other) financial flows. The lack of investment can be ascribed to (a) the presence

[355] Schlenther (2014) 27.
[356] Carbacho *et al* (2013) 65.
[357] UNECA (2015) 3.
[358] Chapter 5 below.
[359] Supra 34.

of risk factors such as policy and political uncertainty; (b) a lack of integrated global value chains[360] and (c) difficulties in doing business.

International Investment Agreements (IIAs) can play an important role in a country's ongoing modernization of its negotiating documents and approach to international investment policy making. It can also include an assessment of whether certain IIA relationships should be renegotiated, amended or terminated. Badly negotiated IIAs can lead to capital outflows and can create opportunities for tax avoidance. Sub-Saharan African countries should therefore ensure that new IIAs preserve the right to regulate while maintaining protection of investors.

Improved monitoring and regulation of financial markets and institutions can further contribute toward discouraging transactions supporting illegal activities. In the same vein, improved regulation can also address speculative flows in the form of a transactions tax.

[360] Global value chains (GVCs) are the interconnected production process that goods and services undergo from conception and design through production, marketing, and distribution. The primary measures of a country's participation in GVC trade are backward integration, which occurs when a country sources foreign inputs for its export production; and forward integration, which occurs when a country provides inputs for a foreign country's export production. Combining backward and forward integration gives a measure of a country's total GVC participation (WEF 2015).

CHAPTER 5:
OVERVIEW OF THE DIAMOND INDUSTRY AND ITS REGULATION

5.1 Introduction

The African continent accounts for most of the world's diamond resources and the exact level of Africa's reserves and resources is still an unknown, as there are large unexplored sections of the continent which potentially hold diamonds.[361] Diamond mining is an important economic activity in several African countries and can contribute a large percentage to national GDP and to total exports. Its contribution to tax depends on how the sector is organised.[362] This in turn is dependent on the nature of diamond deposits. Countries such as Botswana and South Africa have large kimberlite deposits, while Angola, the Central African Republic, Namibia and some West African countries (Liberia, Guinea and Sierra Leone) have alluvial diamond deposits.[363]

This chapter provides an overview of the diamond value chain, a description of the conventional and unconventional diamond industry, as well as a description of domestic and international regulation. Key issues are cross referenced with country experiences contained in Annexure A of this study. For example, conventional mining in southern Africa is mostly focused on kimberlite deposits, as reflected in the Botswana[364] and South Africa[365] experience, whilst those in Western Africa are mostly focused on alluvial deposits.[366] In addition, differences in mining approaches are informed by historic events, for example, two of the west African countries, Liberia and Sierra Leone[367], emerged from civil war recently and their mining industry is largely artisanal and informal sector based. The country experiences contained in Annexure A also provide a snapshot of diamond mining and resource taxation in a few prominent countries in the SADC[368] and ECOWAS[369] regions.

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361 Bain (2013); IMF Working Paper (2003) 3.
362 IMF Working Paper (2003) 3.
363 IMF Working Paper (2003) 3.
364 Annexure A1.
365 Annexure A6.
366 IMF (2013) 3. With kimberlite deposits, "diamonds are concentrated in a small area which allows for large-scale corporate diamond production. In these countries, fiscal revenue is mainly derived from corporate income taxes. In the instance of alluvial diamond deposits, corporate diamond production is difficult and in many cases unprofitable, as the diamonds are spread over a large surface area. In the case of the latter, production is usually carried out by small-scale independent artisanal miners whose income is hard to measure" – this sector is often referred to as the "hard to tax". Tax regimes respond by levying export levies which tend to be generally low (estimated at levels below five per cent of the estimated value of diamond production).
367 See Annexures A3 and A5 on background and taxation practices.
368 The Southern African Development Community is a regional group of 15 countries, namely Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.
369 The Economic Community of West African States (ECOWAS) is a regional group of 15 West African countries: Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, The Gambia, Ghana, Guinea, Guinea Bissau, Liberia, Mali, Niger, Nigeria, Sierra Leone, Senegal and Togo.

5.2 Understanding the diamond industry

The conventional diamond[370] business is described as one in which the end product (polished diamonds) is sold internationally and where rough and polished supply companies serve the same group of competitors. The unconventional diamond business includes international transfer pricing mechanisms or methods to gain access to export subsidies to create value. This unconventional segment views the diamonds as a commodity and as an instrument to create, store and dispose of income. Considerable stocks are moving around the globe with increasing frequency.[371]

Before a diamond reaches the end user/consumer, it goes through an upstream, middle market and a downstream stage. In the upstream stage, rough diamonds are mined, sorted and sold by the producer.[372] At that point of sale, the diamonds reach the middle-market stage, where they are cut, polished and manufactured into jewellery. The diamonds then move to the downstream stage, where they are sold to the end customer.[373]

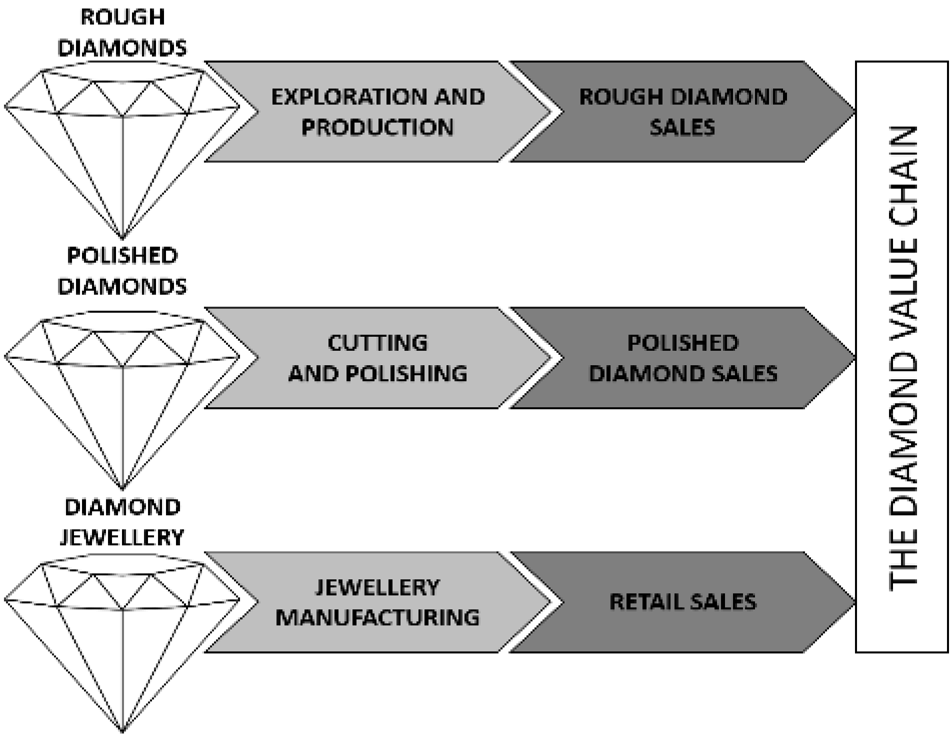
[370] According to the United States Geological Survey (USGS), diamonds “may well be the world's most versatile engineering material, as well as its most famous gemstone. The superiority of diamonds in so many diverse industrial applications is attributable to a unique combination of properties that cannot be matched by any other material. For example, a diamond is the strongest and hardest known material and has the highest thermal conductivity of any material at room temperature. Diamonds that do not meet gem-quality standards for colour, clarity, size, or shape are used principally as an abrasive, and are termed ‘industrial diamonds.’ Even though they are more expensive than competing abrasive materials, diamonds have proven to be more cost effective in numerous industrial processes, because they cut faster and lasts longer than any rival material. Synthetic industrial is superior to its natural diamond counterpart, because it can be produced in unlimited quantities, and, in many cases, its properties can be tailored for specific applications. Consequently, manufactured diamonds accounts for more than 90 per cent of the industrial diamonds used in the United States.”

[371] Even-Zohar (2007) 66.

[372] Bain (2013).

[373] Bain (2013).

Figure 5.1 The Diamond Value Chain



Source: Bain 2013

According to Bain,[374] there is a fivefold increase in the value of diamonds as they move through the value chain from the mine to the final market. The greatest value is added at the jewellery manufacturing and retail stages.[375] For example, in 2013, rough-diamond production generated world-wide revenues of approximately USD 14.8 billion. These revenues grew to USD 47.2 billion when the diamonds were manufactured into jewellery, and grew again to USD 72.1 billion when the jewellery was sold at retail level.[376]

Due to profit margins of between 16 to 20 per cent, the most attractive point in the value chain, is rough diamond production.[377] Comparable margins are only achieved in the retail segment of the market, where large chain retail sellers can achieve margins of 11 to 14 per cent.[378] The other points along the value chain, such as cutting and polishing, are far less profitable, with profit margins of between 1 and 8 per cent.[379] Sorting is the first value-add in the process after diamonds are mined. The overall objective of sorting is to determine the precise value of mined stones and

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374 (2013).

375 The diamond jewellery market typically follows overall trends in luxury goods, and the global luxury goods market has been growing steadily at approximately 12 per cent year on year (Bain 2013).

376 Bain (2013).

377 Bain (2013).

378 Bain (2013). According to the World Bank, approximately 60 per cent of value is added through the cutting and polishing process, with a further 200 per cent (or more) added by jewellery manufacturing and retailing (Guj *et al*. 2017: 135).

379 Bain (2013).

to package those stones for sale.[380] Bain points out that an approximate value of a stone is gauged at the sorting stage, because rough diamonds vary widely in price and quality.[381] Sorting is done in four steps at two separate locations. First, "picking and entry-level" sorting takes place at the mining operation site, whereafter "second-level sorting" is done at sorting centres. Here the diamonds are valued and gem quality diamonds are identified for a second round of grading. In this round the stones are sorted and graded according to four grading criteria, namely: weight, shape, clarity and colour.[382]

There are six major diamond hubs of which three are the traditional hubs of Antwerp, New York and Tel Aviv, and the other three are the newly emergent hubs of Mumbai, Dubai and Hong Kong.[383] The role of rough diamond trade centres is twofold, in that they serve as a link between polishing centres and mining countries and they ensure a flow of rough diamonds.[384] The traditional cutting centres, for example Belgium, have refocused their businesses to concentrate on high value diamonds and specialized services (e.g. locally developed research and technology development. In the emerging hubs, such as China, the domestic market absorbs much of the cut and polished diamonds – most polished stones are processed through local jewellers for export.[385] Competition between countries such as China and India on exports of cut diamonds, is driven by the ability to either seize market share through high quality-control standards (in the case of China), or by having a low cost basis (in the case of India).[386]

In Africa, countries have attempted to boost their cutting and polishing segment. In Botswana[387] employment in the industry has grown from 300 to 3 000 cutters.[388] Botswana's potential to grow into a major cutting and polishing centre is, however, limited due to higher labour costs and comparative experience with traditional hubs in cutting stones. There are for instance 800 000

380 Bain (2013).
381 (2013).
382 Bain (2013). Grading is, according to Bain, "ideally carried out by independent gemmological laboratories, which assign only a grade (not a monetary value) to each stone examined. Grading is not an exact science, given that of the four key grading criteria, only weight (carat) is a purely objective measurement. Colour, clarity and cut are all, to one degree or another, a matter of subjective judgment. Due to subjective considerations, the same diamond can receive markedly different grades from different laboratories, with resulting differences in price. Several different diamond-industry entities, including the Antwerp World Diamond Centre, IDEX, Polished Prices and Rapaport, publish price lists, but these lists provide only a guide to prices. The final price of a diamond is subject to negotiation between the buyer and seller, and the diamond is almost always sold at something other than list price. Discounts and premiums are influenced by the quality and cut of a stone, credit considerations, the location and type of market where the stone is exchanged and the saleability of the diamond in question."
383 Bain (2013).
384 FATF (2013d) 32.
385 Bain (2013). According to Bain, "The Chinese cutters' high quality-control standards have enabled them to capture a share of the lucrative market in high-grade stones from their Indian competitors, but overall, India's lower cost basis has prevented China from more aggressively increasing its share of diamond exports."
386 Bain (2013).
387 See country experience as contained in Annexure A1.
388 This growth is largely due to De Beers' decision to move its Diamond Trading Company's aggregation, quality-assurance and sight-preparation operations from London to Gaborone (Bain 2013).

cutters in India, and only 3 750 in Botswana. The cost of cutting ranges from USD 60 to USD 120 per carat in Botswana, whereas the range in India is between USD 10 and USD 50 per carat. In working the smaller diamonds, Botswana is six times more expensive than India and, for the larger more expensive stones, Botswana is almost three times as expensive as India. The reasons for these cost differences are: low productivity, low cost of ancillary services, and the difference in the number of working days in a year (232 in Botswana as opposed to more than 280 days in India). Thus, Botswana is limited to cutting stones of one carat rough and above. Namibia and South Africa, two other Southern African diamond-producing countries trying to beneficiate diamonds, are more expensive locations than Botswana and have seen a contraction in diamond-cutting. Employment in the sector in South Africa has shrunk from 1 800 workers in 2008 to 1 000 in 2013 and from 1 500 in 2008 to 970 in 2013 in Namibia. In addition, the costs of cutting in Namibia (USD 60 to USD 140 per carat) and South Africa (USD 130 to USD 150 per carat) are higher, and tend to be rising faster, than in Botswana.[389] The emerging hubs of China and India continue to drive growth in diamond jewellery production. In 2010, global diamond production was approximately 127 million carats and was projected to increase to 137 million carats by 2013, 140 million carats by 2015, and 143 million carats by 2017.[390]

Table 5.1 Diamond Production Statistics

5.1.1 Diamond Production (Value in USD) by Country 2006-2016

COUNTRY	YEAR										
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Russian Fed.	2574	2625	2509	2341	2382	2675	2874	3114	3733	4240	3579
Botswana	3208	2960	3273	1436	2586	3902	2979	3626	3647	2986	2846
Canada	1410	1657	2255	1475	2305	2551	2007	1907	2003	1676	1397
South Africa	1362	1417	1236	886	1194	1389	1027	1185	1224	1390	1249
Angola	1133	1272	1210	804	976	1163	1110	1164	1317	1182	1079
Namibia	901	715	918	409	744	873	900	1360	1156	1214	915
Lesotho	84	164	223	134	198	359	301	242	343	283	365
DRC	432	365	432	226	174	180	183	139	137	133	247
Australia	560	365	326	313	252	221	269	381	304	308	216
Sierra Leone	125	142	99	78	106	124	163	184	222	154	159
Zimbabwe	34	31	44	20	340	476	644	538	239	175	105
Tanzania	26	28	24	25	13	11	34	46	81	59	87
Others	199	194	184	116	122	143	151	83	91	82	157
TOTAL	**12045**	**11935**	**12732**	**8262**	**11393**	**14065**	**12645**	**13971**	**14496**	**13882**	**12401**

Source: Kimberley Process (2016)

389 Grynberg (2014).
390 Menzie (2013) 5.

5.1.2 Diamond Production (Volume in million carats) by Country 2006-2016

COUNTRY	YEAR										
	2006	**2007**	**2006**	**2009**	**2006**	**2011**	**2006**	**2013**	**2006**	**2015**	**2016**
Russian Fed.	38.4	38.3	36.9	34.8	34.9	35.1	34.9	37.9	38.3	41.9	40.3
DRC	29.0	28.5	33.4	21.3	20.2	19.2	21.5	15.7	15.7	16.0	23.2
Botswana	34.3	33.6	32.3	17.7	22.0	22.9	20.6	23.2	24.7	20.8	20.5
Australia	29.9	18.5	14.9	15.6	10.0	7.8	9.2	11.7	9.3	13.6	14.0
Canada	13.3	17.0	14.8	10.9	11.8	10.8	10.5	10.6	12.0	11.7	13.0
Angola	9.2	9.7	8.9	9.2	8.4	8.3	8.3	8.6	8.8	9.0	9.0
South Africa	14.9	15.2	12.9	6.1	8.9	7.0	7.1	8.1	7.4	7.2	8.3
Zimbabwe	1.0	0.7	0.8	1.0	8.4	8.5	12.1	10.4	4.8	3.5	2.1
Namibia	2.4	2.3	2.4	1.2	1.7	1.3	1.6	1.7	1.9	2.1	1.7
Sierra Leone	0.6	0.6	0.4	0.4	0.4	0.4	0.5	0.6	0.6	0.5	0.5
Lesotho	0.1	0.2	0.3	0.1	0.1	0.2	0.5	0.4	0.3	0.3	0.3
Tanzania	0.3	0.3	0.2	0.2	0.1	0.0	0.1	0.2	0.3	0.2	0.2
Others	2.5	3.0	4.7	1.7	1.5	1.2	1.1	0.6	0.7	0.7	0.8
TOTAL	**175.9**	**167.9**	**162.9**	**120.2**	**128.3**	**122.8**	**128.0**	**129.8**	**124.8**	**127.4**	**134.1**

Source: Kimberley Process (2016)

The tables above show that five of the selected countries (Botswana, Namibia, Sierra Leone, South Africa and Zimbabwe) have featured consistently under the top ten performing diamond mining countries in the world from both a volume and value perspective. This is important because the profits from the industry should also reflect in the average receipts from minerals in per cent of government revenue. Kimberley Process statistics show that almost 80 per cent of diamond mining activity is concentrated in Botswana, Canada, the Democratic Republic of Congo, the Russian Federation, and Zimbabwe, and that China has moved ahead of India as a major cutting and polishing centre.[391] In 2012, Belgium, Israel, Switzerland and the United Arab Emirates were the primary trade hubs for rough stones and the United States had the largest consumer market for polished diamonds.[392]

The diamond mining industry is highly consolidated with the top five companies accounting for roughly 80 per cent of production revenues. In 2012, the mining company ALROSA led industry production in volume (34.4 million carats), while De Beers remained the leader in value terms (USD 5.5 billion). It should be kept in mind that for a long period, the bulk of the world's diamonds were marketed and sold through the De Beers–controlled Central Selling Organization (which

[391] FATF (2013d) 131.
[392] FATF (2013d) 131.

ceased to exist).[393] Diamonds sales were conducted under long term contracts to a selected group of customers. As the market was liberalized, new sales channels emerged outside the Central Selling Organization.[394] In this regard auctions have increased in significance, representing 30 per cent of rough diamond sales, however, long-term contracts are still an important mechanism for big producers' sales, accounting for approximately 65 per cent of rough-diamond sales.[395] The remaining 5 per cent is sold under short-term contracts. These are typically once off agreements to sell diamonds which do not fall inside the typical range or diamonds which have not been purchased through auctions or under long-term contracts.[396]

The value chain in the unconventional segment operates differently from the conventional part in that in the former, the diamonds remain stored or in circulation, whilst selling to the end consumer is the main objective in the conventional market. In a 2006 Canadian Parliamentary Review of the proceeds of crime, it is highlighted that:

> "as more traditional channels for money laundering and terrorist activity financing become less attractive to those who wish to undertake these activities, other avenues for these activities – such as precious metals, stones and jewellery, which can be high in value and easy to conceal – may become more desirable."[397]

According to Even-Zohar, [398] the unconventional segment has an ever growing impact on diamond prices and the competitiveness of the conventional market segment, as the unconventional player is ready to pay prices (even if the rough diamond price is too expensive) which the conventional diamond manufacturers cannot afford.

5.3 Conflict and illicit diamonds

In the 1990s through to the 2000s, rebel armies in several African countries[399] financed their insurgencies through illegal exploitation of natural resources, which included tropical hardwood, ivory and diamonds.[400] It was, however, the latter, which drew the ire of the international

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[393] Bain (2013).
[394] Bain (2013).
[395] Bain (2013).
[396] Bain (2013).
[397] Standing Senate Committee on Banking, Trade and Commerce (2006) 10.
[398] (2007) 66.
[399] Refer to Annexure A3 and A5 on the background of the conflict.
[400] The KP process has its roots in the Security Council Resolution 1237 (7 May 1999), which established an independent Panel of Experts to investigate violations of Security Council sanctions against the Uniao Nacional Para a Independencia Total de Angola (UNITA). The sanctions prohibited the sale or delivery of arms and military equipment to UNITA; the provision of petroleum products to UNITA; the buying of diamonds mined in areas controlled by UNITA;

community, due to the protracted and brutal wars in Liberia, Sierra Leone and Angola, which were funded with the proceeds of illegal diamond mining.[401] With Belgian customs recording the importation of billions of USD worth of diamonds from Liberia in the 1990s, and other countries with no diamond mining activities (e.g. The Gambia), it became clear that the warlords were able to sell ill-gotten diamonds into the legitimate trade channels.[402] Similar activities occurred in the Republic of Congo where production of 5.2 million carats a year were claimed, whilst geological surveys concluded that only 55 000 carats per year were possible from the alluvial mines. It was evident that most came from its politically turbulent neighbour, the Democratic Republic of Congo (DRC).[403]

In response to instability in various African regions, the diamond industry created the High Diamond Council to monitor sensitive countries whose imports might contain diamonds from Sierra Leone and Angola, where civil wars were in full swing. Customs gave more attention to parcels from those countries, however, the use of fictitious labels on the parcels, mixing stones with those of clean countries and labelling the entire batch as originating from the non-conflict country, were common.[404] Colour and quality would have been obvious to the trained eye; however, government officials such as customs officers would be none the wiser in as far as origin is concerned.

The mobilisation of civil society through various NGOs saw the diamond industry (most notably De Beers which was still in a monopolist position) move to engagement and the South African government convened a meeting in 2000 in Kimberley, South Africa, in an attempt to deal decisively with the problem. A nine-point plan – now referred to as the Kimberley Process - was drawn up and aimed at keeping "conflict diamonds" out of the legitimate trade. Conflict diamonds refer to "rough diamonds used by rebel movements to finance their military activities and attempts to overthrow legitimate governments."[405] Angola and, more recently, Sierra Leone, are examples of states where this has been the case. Although conflict diamonds constituted less than one per cent of world production, they had a huge impact on the entire diamond industry and led to the imposition of an international certification scheme for rough diamonds.[406] Conflict diamonds often pass through the same routes as illicit diamonds and inevitably find their way into the legal market

required the seizing of bank accounts and other financial assets of UNITA; mandated the closing of UNITA representation offices abroad and imposed travel restrictions on senior UNITA officials.

[401] The war in Sierra Leone lasted from 1991 to 2002 with the rebel forces (Revolutionary United Front) waging a war on the civilian population and committing brutalities such as the chopping off of limbs (to discourage the populace from voting). The terror campaign saw to the abandonment of the diamond fields which were quickly exploited by the rebels to fund their campaigns. The events were later portrayed in the Hollywood film "Blood Diamonds" which brought the diamond trade and the horrors of the conflict directly to movie goers across the world.

[402] Smillie (2013) 1005-1006.

[403] Zoellner (2006) 179.

[404] Zoellner (2006) 177.

[405] Even-Zohar (2007) 145.

[406] Even-Zohar (2007) 145; 156.

once polished. Illicit diamonds are diamonds stolen from mines and/or diamonds legitimately mined, but smuggled to avoid taxes and/or legitimately mined but smuggled to sell at a higher price. It is estimated that between 20 per cent and 30 per cent of African production may fall into this category.[407]

5.4 Domestic Regulation

The building blocks of a legal framework for extractives are laws, contracts and regulations.[408] Often the laws are sector-specific, treating hydrocarbons and mining separately, but intermeshing with other domestic laws which, for example, deal with tax, investment, environmental issues, as well as any bilateral and multi-lateral treaties to which the country is party. It is important for all parties (both government and investors) that the legal instruments function as a coherent framework, with links where appropriate to other parts of the country's legal system and its enforcement agencies. At the same time the framework should consider all levels of government (local, provincial and national). Typically, mining is a shared responsibility of several key institutions which can include executive and legislative bodies, sector ministries, regulatory agencies, national resource companies, finance ministries, tax authorities, central banks, environment and economic planning ministries.[409] Effective sector management is therefore dependent on close coordination between these institutions.

According to Cameron and Stanley, a mining law or code should, at the most basic level, be simple and clear to understand.[410] The challenge for many sub- Saharan countries is that existing laws may date from colonial times.[411] In reviewing their mining laws, countries in Africa seek to strike a balance between beneficiation of local communities and promotion of an investor friendly regime. Investors typically look favourably at mining laws which include processes that are transparent and clear, which recognize their freedom to transfer rights, which provide security of tenure, as well as the freedom to buy and sell goods at prevailing market prices. Another important consideration is whether tax and investment provision allow for reasonable freedom to dispose of foreign exchange earnings (e.g. the use of profit taxes and the terms and conditions attached thereto).[412]

Some best practice principles for mining reform that attract FDI include aspects such as the ease of access to areas on a first-come, first-served basis, the degree to which mining titles are

[407] Even-Zohar (2007) 156.
[408] Cameron & Stanley (2017) 66.
[409] Cameron & Stanley (2017) 117.
[410] (2017) 72.
[411] See Annexure A on individual country experiences.
[412] Cameron & Stanley (2017) 72.

transferrable, whether an open mining cadastre and title registry exists, whether there is access to simple financial maintenance requirements, and whether royalty obligations are reasonable and clear.[413]

In view of the above, it is important for resource rich countries to assign mineral rights in a manner that is competitive and transparent. Where the quality of resources is high, investment could be encouraged in the form of auctions. Auctions are competitive, formal and a transparent form of assignment, thus they can mitigate potential corruption and encourage competition through a fair and open process – of course subject to the existence of clear rules for the auction process and the state of rule of law in general. Auctions allocate and price scarce resources in setting of uncertainty and address issues such as terms and conditions for licences, royalties and tax obligations.[414]

For ownership to have legal significance there needs to be a system proving such ownership. A mining register typically serves as official record of transactions and property rights. From a public policy perspective, the register serves as basis for knowing who holds what property, it informs service provision, it aids in the regulation and usage of land and it assists in tax collection. For property owners, a registration system enables transacting, provides security of title by encouraging the notification of interests and helps with the prevention of fraud. A register should also play a part in sustainable development and public participation in resource management.[415]

Mineral rights are more opaque than land titles, because it is often not evident who owns the mineral rights and when those rights change ownership. The effectiveness of a mineral title system could be gleaned from the measure of control that government has in resource exploitation, and whether it provides a complete and transparent public record of which rights are held over which resources and areas.

Mineral rights registers are commonly used when minerals are publicly owned – where these are subject to private ownership, “registration” is usually addressed through property registration systems (mineral pass with land ownership), or through contractual arrangements which can include sale, mortgage, arrangement for shared production and profits, as well as options for future purchase.[416] As different jurisdictions may have different requirements on official notification on such dealings, the effect in some jurisdictions may give legal effect, whilst in others it may not: e.g. legislation may require mandatory recording of every document which affects the

413 Cameron & Stanley (2017) 72.
414 Crampton (2010) 289-291.
415 Southalan (2012) 206-207.
416 Southalan (2012):207-208.

title in any way; mandatory recording of some detail with limitations on which dealings can be registered; bans any arrangement which is registerable from having legal effect until it is registered; requires that all arrangements pertaining to mineral rights are in writing; may allow for optional registration or in some jurisdictions, there may not be specific requirements for mineral rights dealings with such being subject to regulation under laws dealing with land.[417]

Whilst large players in industry may be reflected on a register to a degree, this is often not the case with small scale diggers who operate in the informal economy.[418] Such unrecorded activities create problems for many land users who are not formalized through a register. Conversely, informal regulation and recognition of mineral rights create difficulty for formalized mining activity and both are sources of disputes. A recent example is the USAID initiative *Property Rights and Artisanal Diamond Development* (PRADD II) in Côte d'Ivoire, which focuses on increasing the number of alluvial diamonds entering the formal chain of custody and improving the benefits accruing to diamond mining communities.[419] The project assists government in enacting customs and mining regulations and improving systems of diamond production, tracking, and internal controls. The expanded programme consists of four major components, namely, clarification/assignment of land and diamond property rights; strengthening governance, economic development and awareness campaigns.[420]

Attempts at regional and bilateral harmonization of mining regulatory regimes include the African Mining Legislation Atlas, an online platform about legislation in Africa's mining sector, and the ECOWAS Directive on the Harmonization of Guiding Principles and Policies in the Mining Sector, which was adopted in 2009. The objectives of the directive include harmonization measures aimed at ensuring standards of accountability for mining companies and governments, promoting human rights, transparency and social equity and providing protection for local communities and the environment in mining areas within the sub-region.[421]

Cameron & Stanley[422] caution that the directive's impact is likely to be limited by the diversity of circumstances which it encounters amongst the 15 member states, but nevertheless, they can provide an example of a bilateral attempt in mining and geology cooperation: the agreement between Angola and the Congo, which promotes the exchange of geological data and the

[417] Southalan (2012) 208.
[418] According to a Mining Minerals and Sustainable Development report, "the majority of people who earn their livings from the minerals sector do not work for large private multi-nationals. Many of them work for medium scale local private companies or state owned enterprises, whilst the majority (worldwide estimate at 15,000,000 people supporting close to 100,000,000 family members) are in artisanal and small scale mining (ASM)."
[419] USAID (not dated).
[420] USAID (not dated).
[421] Article 2.
[422] (2017) 72.

harmonization of tax frameworks in areas such as diamond mining and establishes training and assistance programmes.

Another innovative approach on the continent involves aerial mapping of diamond sites.[423] In Guinea the United States Geological Survey (USGS) is helping the government and the local community with aerial mapping of most likely locations of diamond deposits. That information will enable miners to lease parcels of land which are more likely to generate a return on their investment, assist the Government of Guinea to better monitor and regulate artisanal mining, and allow farmers to grow crops on surrounding land with fewer conflicts. Land conflicts in the region are expected to decrease overall due to this effort.

5.5 International Regulation

5.5.1 The Kimberley Process

Conflicts in Africa are funded through abuse and exploitation of natural resources and consequently, civil society and governments have put in place measures to ensure that funding – through the sale of illegally acquired commodities - to rebel movements is not facilitated through legitimate trade. The Kimberley Process Certificate Scheme (KPCS) is such an initiative. The KPCS is, however, undermined by corruption and weak governance in participating countries, and it was identified as a vehicle for money laundering.

The KPCS is an international governmental certification scheme set up in 2003 to prevent trade in diamonds that finance conflict. The scheme requires governments to certify that shipments of rough diamonds are conflict-free.[424] In essence, the Kimberley Process is "an import-export certification scheme, which requires participating governments to certify the origin of rough diamonds, and put in place effective controls to prevent conflict diamonds from entering the supply chain."[425] The KPSC also bans trade in rough stones with non-participating countries, in order to

[423] Aerial mapping is necessary since both government and miners do not know where diamonds are most likely to be found. Alluvial diamonds are carried by rivers and deposited across valleys and plains; without geologic surveys, the only way to find them is by beginning to dig and look for tell-tale signs of their presence. The imagery is also useful in asserting property rights/boundaries.
[424] Kimberley Process (not dated).
[425] A Certificate is to meet the following minimum requirements: Each Certificate should bear the title "Kimberley Process Certificate" and the following statement: "The rough diamonds in this shipment have been handled in accordance with the provisions of the Kimberley Process Certification Scheme for rough diamonds"; Country of origin for shipment of parcels of unmixed (i.e. from the same) origin; certificates may be issued in any language, provided that an English translation is incorporated; unique numbering with the Alpha 2 country code, according to ISO 3166-1; tamper and forgery resistant; date of issuance; date of expiry, issuing authority; identification of exporter and importer; carat weight/mass; value in USD; number of parcels in shipment; relevant Harmonized Commodity Description and Coding System; validation of Certificate by the Exporting Authority. B. Optional Certificate Elements: characteristics of a Certificate (for example as to form, additional data or security elements); quality characteristics of the rough diamonds in the shipment; a recommended import confirmation part should have the following elements: country of destination,

decrease the illicit trade in conflict diamonds.[426] A database was set up with the aim of tallying shipment (export) country data with import data of the country of destination.[427]

By requiring participating countries to pass domestic legislation to implement the scheme, whereby they can only trade rough stones with other members, a strong incentive is created for other producing and trading countries to join the scheme.[428] As of 2013, the KP membership consists of 54 participants, representing 81 countries, with the European Union and its 28 Member States counting as a single participant, represented by the European Commission.[429]

The KCPS brought a degree of transparency to the industry and an audit trail for points of production, export and import – thereby reducing the potential of laundering the proceeds of illegally mined diamonds.[430]

5.5.2 KPCS: Current State of Play

The current state of play is that politics trumps revision or improvements to the process. This is illustrated by actions taken by member countries since 2008, where the KPCS was shown to be susceptible to being undermined by "spoilers" in the form of weak governments, smugglers and corrupt officials. Weaknesses in the process are exacerbated by the unwillingness or inability of states to enforce export and import controls, and instances of falsification of certification documents. The KPCS transparency system is described by some as rudimentary in principle, and poorly implemented in practice, making it hard to determine whether states fulfil the obligations assumed under the initiative.[431] Examples of failure in accountability and transparency are situations of non-compliance in Cote d'Ivoire, Venezuela and Zimbabwe. Although the Cote d'Ivoire is not an official KP participant, diamonds are smuggled into some neighbouring countries that are participants. Their inability to control the flow of smuggling has allowed these diamonds to be laundered into legitimate trade by way of the production or manufacturing process. The situation in Zimbabwe became a polarizing case amongst KP Participants in 2008, when it became clear that Zimbabwe was losing its ability to meet the minimum KP standards as "concerns existed of government involvement in human rights abuses, smuggling, and lax

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identification of importer, carat/weight and value in USD, relevant Harmonized Commodity Description and Coding System, date of receipt by Importing Authority, authentication by Importing Authority. C. Optional Procedures: Rough diamonds may be shipped in transparent security bags. The unique Certificate number may be replicated on the container (Kimberley Process: not dated)

[426] FATF (2013d) 131.

[427] Smillie (2013) 1010-1013. According to 2015 statistics the total value of diamonds traded through the KPCS is USD 13,881,626,082.

[428] Kimberley Process (not dated).

[429] Kimberley Process (not dated).

[430] Le Billon (2013) 16.

[431] Wolfe & Baddeley (2012) 14.

controls that compromised the entire chain of production."[432] Amongst other concerns, a large rush of illicit miners into the Marange area allegedly led to hundreds of deaths at the hands of the Zimbabwe armed forces, in an effort to suppress the illegal mining. After months of internal debate, the KP Secretariat sent in a review team to investigate, which found ample evidence of non-compliance with the KPCS minimum requirements and a large complement of human rights abuses. Ironically, India, Russia, China and Namibia denounced these concerns because they did not see KP as having a role in human rights violations, bringing into question the motivations for establishing the KP in the first place. It is also reported that Namibia (the Chair at the time) and South Africa practically absolved Zimbabwe of any wrongdoing before the review team even prepared their report.[433] After follow-up monitoring and negotiations, a plenary meeting in 2011 cleared Zimbabwe to resume exports from the troubled Marange diamond field, under continued KP supervision. This decision continues to remain controversial, however, especially amongst NGOs.[434] The displeasure of being removed from their former official oversight status in the area lead those associated with KP's tripartite structure to express a lack of confidence in the current system. Global Witness, an NGO and founding organisation of the KP, has left the process altogether.[435] They have continually stressed KP's "insufficient system of checks and balances in preventing substantial volumes of illicit diamonds from entering the global diamond supply chain", as a major risk. [436]

The FATF[437] points out that the data provided by the KP does not capture world-wide production, because the figures exclude trade within the EU (e.g. between Belgium and the United Kingdom for which no certificates are required), or internal trades on localised markets. In addition, production is not recorded for a few suspended or sanctioned countries, whilst in some instances, there is not correct reporting of values. In addition, the FATF highlights that smuggling is an established practice and smuggled diamonds do, in some or other way, end up in the diamond value chain. The KP figures should therefore be viewed as indicative only.[438]

The KPCS can be summarised as an initiative born from public sentiment indicting the diamond industry for ignoring the horror and brutality associated with diamond mining in conflict countries. Except for the US's Dodd-Frank Wall Street Reform and Consumer Protection Act, few countries have been able to implement legislation dealing with conflict minerals and the proceeds thereof. One of the countries that has successfully implemented the necessary legislation and that is committed to the KPCS, is Namibia. However, as Munier argues, De Beers plays a dominant role

432 Mail & Guardian (2010); Conjwa (2009).
433 Wolfe & Baddeley (2012) 15-16.
434 Mail & Guardian (2012).
435 Global Witness.
436 Wolfe & Baddeley (2012) 15-16.
437 (2013) 31.
438 FATF (2013d) 31.

in the diamond industry in Namibia and, although the government complies at a high level with KPCS and makes it more difficult for conflict diamonds to reach the global market, the process mostly benefits De Beers and the political elite.[439]Thus, according to Munier, the KPCS is used as a means to maintain monopolistic policies by De Beers in that its influence on the domestic decision making processes results in its preferences being reflected in government policy.[440]

It is important to note that diamonds remain a commodity like many other natural resources (e.g. timber, ivory, rhino horn, etc.) which are used to fund armed conflict, organised crime and terrorism. As Le Billon[441] points out, "the diamond trade (both legal and illegal) is part of a broader context of illicit financial flows and corruption" to which "a lack of governance, weak tax administration, badly designed fiscal policy and tax base erosion and profits shifting (BEPS) can be added."[442]

It can be argued that "the KPCS is currently a process seeking a proper regulatory fit"[443] and it is proposed that a fit can indeed be found within the existing frameworks of anti-money laundering and tax and customs regulation, or within the whole of government approach.

Grant[444] notes that:

> "diamonds are a unique case in many ways, but not so unique that the *KP 'recipe'* cannot inform other initiatives. The crucial first step for success in similar efforts is to include government, industry and civil society in all phases of national and international negotiations, in order to devise the natural resource governance framework. The second step is to incorporate all three stakeholder groups into the subsequent (and much longer) implementation phase of the governance scheme."

In taking this view forward, the KPCS provides a basis for developing specific process verification steps for high-risk and high-value commodities. Awareness and understanding of the processes involved in the diamond value chain allow for the development of a risk-based approach in identifying high-risk individuals, entities and countries. Inclusion of the KPCS in a whole of government approach premised on Anti-Money Laundering and Tax and Customs Regulatory Frameworks and principles could potentially enhance existing risk management practices (notably within government/s, financial institutions, multi-nationals and the informal sector). It

[439] (2016) 543.
[440] (2016) 552.
[441] (2013) 16.
[442] Schlenther (2016) 3.
[443] Schlenther (2016) 3.
[444] (2012) 176.

could ensure that *all* high-risk commodities are rigorously verified in as far as extraction and all further downstream activities are concerned. It requires a collective effort that relies on the participation of all, without which it would be yet another morally sound, but failed initiative.

5.5.3 Financial Sector Regulation

International regulation of financial institutions is primarily driven by the IMF, the FATF and the OECD. The link between financial market integrity and financial stability is underscored in the *Basel Core Principles for Effective Supervision* and in the *Code of Good Practices on Transparency in Monetary and Financial Policies,* specifically the codes and principles that speak directly to preventing, detecting and reporting of abuses in the financial system, such as financial crimes and money laundering.[445] Whilst the FATF seeks to identify financial centres which are prone to money laundering, the OECD seeks to identify preferential regimes or tax provisions that can result in harmful tax competition.[446]

The FATF points out that the diamond trade is primarily funded by financial institutions such as banks, and that numerous countries have banks specialising in the diamond trade, which have designated divisions or branches that diamond dealers must use for conducting business.[447] According to an FATF assessment,[448] the major risks for financial institutions in relation to the diamond trade are:

- Financial sector institutions (e.g. banks and credit providers) do not apply know your customer (KYC) or due diligence procedures to diamond dealers.[449]
- The primary means of payment used by diamond dealers are electronic funds transfers and wire transfers;
- The use of cash is still a common means of payment in the diamond trade in countries where cash is commonly used, such as in mining centres, on the African continent and in trade centres such as Hong Kong.

The FATF notes that whilst the use of cash is reducing for large-scale business-to-business transactions, its use still poses a risk for ML/TF in the trade of diamonds. The risks are also present where cash is used as a frequent payment means, for example, at a retail level, and in countries that do not have AML/CFT legislation that requires the reporting of cash transactions

[445] Boorman & Ingves (2001) 8.
[446] Schlenther (2013) 20.
[447] (2013d) 133.
[448] (2013d).
[449] (2013d) 133.

above a specific threshold.[450] Further vulnerabilities that arise are instances where diamond trade credit is extended at concessionary terms, thereby making it more attractive comparative to rates of credits in other sectors. In addition, where bearer negotiable instruments are used extensively (e.g. promissory notes), an unofficial and unmonitored banking system is created which runs parallel to official banking channels. This provides a financing mechanism (with no audit trail) for traders that can facilitate the transfer of high value assets and make it possible to avoid customer due diligence procedures.[451] The FATF assessment concludes that some ML/TF risk may also be present in one of the most common international trade methods, namely consignment agreements.[452] These risks are linked to the potential variation in the valuation of diamonds and the possibility of consignee fraud.[453]

In 2010, the US Congress developed a response to the Congo war where armed groups financed the conflict through exploitation of regional trade in a variety of minerals.[454] Minerals targeted include those that are extracted from technology scarce mining sites in the remote eastern Congo, and those that are sold at regional trading houses, smelted locally or in other countries, and that are ultimately used in the manufacture of different products. Armed groups profited by extorting, and in some cases directly managing, the minimally regulated mining operations. Section 1502 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, mandates the Securities and Exchange Commission to issue regulations that require companies that use "conflict minerals" to investigate and reveal the source of such minerals. In *National Association of Manufacturers et al*,[455] the Court of Appeal upheld these principles by affirming the requirements of the disclosure regime[456]:

> "A described person must disclose annually, whether conflict minerals . . . did originate in the [Congo] or an adjoining country… and if those minerals did originate in the Congo or an adjoining country (collectively,' "covered countries") then the person must submit [a report] to the Commission."

The report must describe the due diligence steps taken to establish the source and chain of custody of the minerals, including a private sector audit of the report.[457] The court noted that it was not clear that the description at issue (whether a product is "conflict free") is factual and non-ideological, and pointed out that "products and minerals do not fight conflicts" and that "the label

[450] (2013) 133.
[451] FATF (2013d) 72; 133.
[452] (2013) 133.
[453] FATF/Egmont (2013) 133.
[454] *National Association of Manufacturers et al v Securities and Exchange Commission* (2014) No. 13–5252.
[455] Appeal from the United States District Court for the District of Columbia (No. 1:13-cv-00635), 04/2014.
[456] (2014) 20.
[457] (2014) 20.

‘conflict free’ is a metaphor which conveys moral responsibility for the Congo war which requires an issuer to convey to consumers that its products are ethically tainted, even if they only indirectly finance armed groups.[458] The court concluded that Section 13(p)(1) and Rule 13p-1 violated the First Amendment to the extent that the statute and rule require regulated entities to report to the commission and to state on their website that any of their products have not been found to be “DRC conflict free.”[459] The court found that “by compelling an issuer to confess blood on its hands”, the law interferes with the exercising of freedom of speech under the First Amendment.[460]

The case reaffirms the compliance steps required by private companies to ensure that the necessary controls are in place. The predicament caused by the First Amendment ruling can potentially be overcome within the context of customs to business controls, as advanced through the Approved Economic Programmes (AEO)[461] available to customs authorities and businesses. By ensuring that downstream controls are in place (as its AEO obligations), a company would satisfy the requirements of the KPCS, and as it is in partnership with the customs authority, the latter can advise on areas of possible non-compliance (through its own resources and under mutual assistance agreements, the customs authority would be more aware of high risk entities involved in the value chain and it could thereby assist to ensure full compliance by the entity).

5.6 Conclusion

Diamonds can be used to earn or to store value, and can be moved with ease. Characteristics such as their weight to value ratio, high durability, exchangeability for other commodities, ease of concealment, changeability, fluctuating price and the ease with which they can be traded outside the formal banking system, make them vulnerable to ML/TF and tax evasion or avoidance. Further consideration is the use of diamonds as an alternative currency to acquire other legal and illegal goods (e.g. arms and ammunition).[462]

The conventional diamond mining sector is dominated by a few large MNEs that are publicly owned and scrutinized by investors and certifying bodies, and most of their affairs are largely a matter of public record. The same can be said of retailers. However, as indicated in this chapter, diamonds go through many hands on their way from the mine to the retailer, which raises

[458] (2014) 20.
[459] (2014) 20.
[460] (2014) 20.
[461] The AEO concept establishes a partnership between customs and business, with both parties being responsible for identifying and managing risk in the supply chain – this requires an ability of risk identifiers and auditors to understand different risks associated with different supply chains. Mutual recognition is one of the major benefits for businesses applying for AEO status.
[462] FATF/Egmont (2013) 133.

compliance concerns, especially from a tax and AML perspective. There are also concerns regarding pricing due to the many permutations possible in valuing stones.

Regulation supported by a proper legal framework is essential in managing the extractive industry, due to the many stakeholders involved. Assigning mining rights in a transparent manner encourages FDI into the sector, and it is also an important mechanism toward formalizing informal sector mining activity.

The KPSC is a clearly mapped process, so it provides a recipe for a variety of high risk commodities and, as such, could be included within governments' existing risk management processes and control frameworks. Ensuring its inclusion in a whole of government approach, all areas of risk can be addressed. Examples thereof are that corruption issues can be dealt with through the EITI initiative[463] and through AML measures such as dealing with politically exposed persons (PEPs) and beneficial ownership, controls can be managed and monitored through customs control measures, and tax receipts could be increased through a proper policy framework which clearly assigns rights and responsibilities with regard to the commodity.

With continuous enhancements in exchange of information, competent authorities are now better positioned to access information on request, be it either spontaneous and/or automatic. The Multi-lateral Convention on Mutual Administrative Assistance in Tax Matters and Article 26 of the OECD Model Tax Convention provide a further basis for all forms of information exchange. The quality and completeness of information holdings of tax administrations will be key to successful outcomes from sharing of information. In this context, it has been stated that "the 'KPCS recipe' can serve as a perfect starting point for establishing the minimum information requirements for high risk and high value goods" and that, "in addition, specific checks and balances can be applied through the existing risk-based approaches employed by tax and customs authorities, financial intelligence units (FIUs) and the financial sector."[464] In the end, this should be based on a well-coordinated and systematic approach amongst different jurisdictions which have the common purpose of addressing IFFs through exchange of information between law enforcement agencies, civil society and taxpayers.[465]

[463] The Extractive Industries Transparency Initiative (EITI) aims to end corruption through transparency in the payments made by extractive companies to governments.
[464] (2016) 3.
[465] Schlenther (2016) 3.

CHAPTER 6:
TAX POLICY CONSIDERATIONS

6.1 Introduction

This thesis aims to evaluate tax policy measures required to stem IFFs in the diamond value chain. It is already evident from Chapter 3, that the components of IFF are diverse and that tax policy can be effective to combat some forms of criminal activity (e.g. tax and customs fraud) and commercial activity (e.g. transfer pricing abuses and trade mispricing). Chapter 4 highlights the importance of international investment agreements policy as an integral part of any solution to tax avoidance. However, investment policy is often set outside of the tax policy environment and presents itself as a missed opportunity in many countries to influence taxation decisions. Chapter 5 shows that diamond mining differs in scale and extraction method in some countries, and that, depending on the type extraction, the tax policy response may differ. For example, artisanal mining is generally associated with “hard to tax” areas whilst the activity of MNEs requires different tax handles to deal with base erosion and profit shifting. It is also shown that diverse government agencies are involved in the diamond value chain with mandates that do not necessarily support or take into account tax policy. For example customs is mandated to ensure proper control of goods whilst the financial intelligence units are concerned about the use of diamonds in hiding the proceeds of crime and to fund terrorist activity.

In the light of the above, it is already clear that tax policy measures on their own, are not sufficient to stem IFFs. It is, however, important that tax policy is designed to ensure maximum benefit to a country’s citizens and to ensure that taxable gains do not go untaxed. This chapter analyses tax policy measures applied within the selected countries against the criteria of good tax policy for extractives.

The diamond industry represents a highly-traded commodity, a source of FDI and long-term mining activity that generates economic development in a country. The ability to tax the commodity and related activities is primarily dependent on how its political institutions are set up to respond – thus if the political will is there to tax, the administrative means can be found.[466] In relation to the latter, Bird, Martinez-Vazquez and Torgler point out that the primary reason that several developing countries do not tax themselves more, lies therein that it may not be in the interest of those who dominate the political institutions of such countries, to increase taxes.[467] This Chapter deals with the taxation options for the diamond industry while Chapter 8 touches on

[466] Bird, Martinez-Vazquez & Torgler (2008) 56.
[467] (2008) 56.

some of the reasons why tax policy options, on their own, may not be sufficient for countries to "tax themselves more."

How countries go about identifying who to tax, on what basis and to which degree, is an important policy decision which needs to take into account a range of considerations. First and foremost is the principle that taxation is at the centre of the social contract and this contract is further fostered by a well-functioning tax system which influences social relationships, economic interests and government responsibilities.[468] This is important because of the various means of resource mobilisation for economic development, and taxation is closely connected to the question of state formation and capability.[469] A well-functioning tax system therefore takes into account the needs of all stakeholders, which includes both the public and government.[470] The design of tax systems thus says a lot about a state's viability and its ability to provide incentives for growth and increased state revenues.

A dominant theme in political economy literature is the idea that understanding a government's capacity to govern and its accountability to the public, is informed by the type of resources that fund a government.[471] This approach suggests that states can rely on what is defined as "unearned income," which comes from revenues from natural resources, foreign loans or aid, "instead of domestic taxation."[472] It is suggested that where reliance is on the former, there is less accountability to its citizenry, and more predatory, militaristic and corrupt governance patterns are present. Conversely, those states which rely on domestic taxation are more prone to develop accountable state-society relationships with better governance.[473]

6.2 Resource Tax Policy Contextualised

Resource tax policy is defined as the design of the rules contained in either tax or licence agreements, that govern resource taxation.[474] The term tax policy is commonly used to describe tax base and tax rate design.[475] However, in as far as the extractives are concerned, design complexities arise because natural resources are not akin to most other economic activity – here a distinctive feature is the central role of government. Since the rents from extraction of natural resources belong to a country's citizens,[476] government, as their agent, needs to implement a tax

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[468] Majdanska & Owens (2015) 3.
[469] World Bank Group (2008) 4.
[470] Majdanska and Owens (2015) 3.
[471] Fjeldstad & Moore (2008) 8.
[472] Fjeldstad & Moore (2008) 8.
[473] World Bank Group (2008) 5; Fjeldstad & Moore (2008) 8.
[474] Calder (2010) 319.
[475] Calder (2010) 319.
[476] The United Nations General Assembly Resolution F provides for permanent sovereignty of nations over natural resource and declares that the right must be exercised in the interest of their national development and of the well-

regime which captures these rents,[477] over and above the standard taxation of profits, to the benefit of its citizens.[478] A former finance minister of South Africa contextualises this obligation as follows: "…beyond its fiscal role, the tax system has a more substantive role in Africa: it is an important tool for good governance, democracy and the basis for the social fiscal contract between governments and their citizens and corporations."[479]

Tax policy decisions are generally a reflection of the political and social interactions between various groups in society and are therefore not made in a vacuum. Tax policy is also informed by history, country experience and state administration.[480] The best fiscal framework for a country depends on country-specific economic and institutional issues and, from a natural resource perspective, aspects such as the level of resource revenue dependency, resource wealth and reserves, the revenue horizon and the country's developmental needs.[481] A definition of a sustainable tax system is offered by Bird and Zolt as:

> "…one that is sufficiently aligned with prevailing economic and political factors to persist without the need for repeated major reforms. Achieving a sustainable tax system in this sense requires striking the right balance between the equity and efficiency aspects of taxation, in terms of the equilibrium of political forces."[482]

There are four main channels identified in literature through which tax reform may contribute to state building. These include (i) the provision of revenue, (ii) shifting towards more appropriate revenue sources, (iii) creating more effective tax administrations, and (iv) by encouraging constructive state-society engagement around taxes.[483] These channels are, however, influenced by the political economy context in the form of ideas and interests which shape tax policy.[484] Knack describes the political economy context as follows:

being of the people of the state concerned. It also provides that the exploration, development and disposition of such resources, as well as the import of the foreign capital required for these purposes, should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities. The resolution also holds that in cases where authorization is granted, the capital imported and the earnings on that capital shall be governed by the terms thereof, by the national legislation in force, and by international law. The profits derived must be shared in the proportions freely agreed upon, in each case, between the investors and the recipient state, due care being taken to ensure that there is no impairment, for any reason, of that state's sovereignty over its natural wealth and resources.

477 Rents are the revenues in excess of all costs of production, including those of discovery and development, as well as the normal return to capital (Cameron & Stanley 2017:41).

478 Collier (2010) 75.

479 Nene (2015).

480 Bird & Zolt (2003) 4.

481 Lundgren, Thomas & York (2013) 31.

482 Bird & Zolt (2013) 25.

483 Fjeldstadt & Moore (2008) 242.

484 Fjeldstadt & Moore (2008) 242.

> "tax policy issues typically include breadth of the tax base, reliance on trade or other distortionary taxes, level of tariffs and number of rates, and number of exemptions and their transparency, whilst tax administration issues include collection and compliance rates, costs of collection and compliance, availability of effective appeals mechanisms, complexity of tax laws, discretionary implementation and corruption by tax officials."[485]

In relation to "discretionary implementation and corruption", Stürmer finds that despite the commodity boom of 2003 to 2008, which was characterised by strong sales in the sub-Saharan region and high inflows of direct investment into the sector, most countries only profited moderately from tax revenues.[486] His main findings indicate that the reasons for low tax revenues are (a) the presence of corruption when concessions are granted in tax administrations where poor tax collection and poor negotiation on concessions as a result of the underlying phenomena of rent-seeking and patronage are present; and (b) the poor state of investment conditions in most sub-Saharan African countries, which impedes investment in the extractive sector and downstream processing industries.[487] By applying Australia's implicit tax rate to a selection of sub-Saharan African countries' sales revenues for the period 2003 to 2008, Stürmer finds that the potential for tax revenues is much higher and could have been equal to approximately 35 per cent of official development assistance during the period.[488] If the implicit tax rates for Australia for the same period are applied, tax revenues of sub-Saharan African countries could have reached 83 per cent of official development assistance.[489] The impact and pervasiveness of corruption in the supply chain is dealt with in Chapter 8 and the remainder of this section looks at policy tools and their utilization.

Table 6.1: Average Tax to GDP Ratio Percentages (2008-2010)

COUNTRY	DIRECT	CIT	PIT	INDIRECT	TRADE	RESOURCE	TOTAL
Botswana	5.1	1.6	3.2	4	8.6	11.1	**29.1**
Ghana	4.7	1.9	2	5.5	2.3		**13.1**
Namibia	8.4	2.6	5.6	5.5	10.6	2	**27.1**
Sierra Leone	3.5	1.1	2.1	4.2	4		**12.3**
South Africa	13.8	6	7.7	8	0.9	0.7	**24.6**
Zimbabwe	5.4	1.5	2.9	7.4	3		**16.1**

Source: Mansour (2014) [490]

[485] Knack (2008) 6.
[486] Stürmer (2010) 11.
[487] Stürmer (2010) 11.
[488] Stürmer (2010) 11; 19.
[489] Stürmer (2010) 11.
[490] Mansour (2014) 19-25.

Fiscal policy takes centre stage in optimising large endowments of natural resources. This centrality is challenged by high volatility and uncertainty of natural resource revenue. This in turn complicates macro-economic management and medium–term budget planning. It is therefore essential that the fiscal framework should help anchor medium term targets with the recognition that natural resource revenue is exhaustible, long term sustainability is required, inter-generational equity should be considered and effective savings vehicles[491] are needed.[492] The main instruments to obtain fiscal resources/revenues from the non-renewable sector includes both tax and non-tax items. Available tax instruments include corporate income taxes, withholding taxes, progressive profit taxes, windfall profit taxes and export taxes. Non-tax instruments include royalties, fees and income from state equity participation in the resource sector.[493]

A perception exists that African legal and regulatory regimes have been characterised by fragility and that they could therefore not promote a wide range of economic activity for a country. In addition, African countries have seen a tendency of undervaluation of environmental consequences that result from production processes that are marked by externalities that are not mitigated or even captured.[494] Natural resources are typically subject both to taxation under the income tax system and to special resource taxes. Properly designed income taxes attempt to include capital income on a uniform basis, but in most countries the income tax treats resource industries more favourably than most other industries - through favourable treatment of such capital expenses as depletion, exploration and development, and the cost of acquiring resource properties.[495]

The principles of sound tax policy are simplicity, transparency, neutrality, stability, non-retroactivity, a wide base and low rates.[496] These imply that administrative costs should be low and complicated tax measures should be avoided, as they may frustrate voluntary compliance; that the tax system and its workings should be based on sound legislative procedures; that revenue is raised in a tax neutral manner; that temporary tax laws (e.g. tax holidays and amnesties) are avoided; that tax certainty exists, which allows taxpayers to contract with confidence, and that a broad tax base exists which produces relatively stable revenue flows on a consistent basis. According to Bird and Zolt, tax is one of the most visible aspects of the social contract and is therefore not only a means of funding government, but a means of encouraging and facilitating responsive and honest government.[497] A key reason for taxpayer compliance is

[491] For example, a sovereign wealth fund which can be viewed as a complementary tool to fiscal rules. The IMF stresses that it should not be a substitute for fiscal rules. See Lundgren, Thomas & York (2013) 39.
[492] Lundgren, Thomas & York (2013) 30.
[493] Corbacho, Fretes Chibils & Lora ed (2013) 179.
[494] African Executive (no longer available).
[495] Boadway & Flatters (1993).
[496] Bird & Zolt (2003) 5.
[497] Bird & Zolt (2003) 5.

the acceptance by its citizens that the state is legitimate and credible. Without such acceptance, governments will have difficulty in securing sufficient resources to govern or develop the state. In this context, tax reform becomes an essential "exercise in political legitimation" to convince those who are required to pay more that they will receive a worthwhile *quid pro quo*.[498]

According to the International Council on Mining and Minerals (ICMM), designing a tax policy usually requires a prioritisation of government objectives. In this process, government may seek to influence how a company conducts its operations.[499] According to the ICMM, the competing objectives of taxation can be viewed from different perspectives:

> "Firstly, that a neutral fiscal regime is required for the taxing of resource rents and maximizing government revenue, secondly, that taxation can be used as a policy instrument to attract foreign direct investment and thirdly, that there is the proposition that taxation is a key factor in contributing to or undermining state-building and governance. The latter points to political and economic dynamics that are not only particularly challenging to understand, but also to manage. Yet they condition how governments and political elites decide to balance consumption versus investment spending and the value they attach to any revenue generated now against that generated in the future."[500]

Moore identifies eight main groups of obstacles to achieving tax policy objectives. These are (a) constraints arising from economic structure, (b) the use of the tax system for rent-taking, (c) the use of the tax system as a direct instrument of rule, (d) the influence of interest group politics, (e) the configuration of governing institutions, (f) the difficulties of taxing transnational transactions, (g) insufficient use of advanced tax administration practices and (h) the property tax issue.[501]

6.3 Taxation of Extractive Industries

Boadway and Keen point out that evolution of literature on resource taxation, business taxation and commodity taxation, has taken place separately from each other.[502] Resource tax literature has explored issues such as how the design of rent taxes and its impact on taxation of investors is shaped by uncertainty. With regard to the design of the resource taxes, the features of the sector and the scale of activities make it a daunting task. The features, identified in 2010 by Boadway and Keen, are listed and discussed below:

[498] Bird & Zolt (2003) 35.
[499] (2009) 16.
[500] ICCM (2009) 16.
[501] Moore (2013) 13.
[502] (2010) 19.

(a) *High sunk costs and long production periods*: discovery, development, exploitation and eventual closure pose a fundamental problem of "time consistency". The prospective tax base is highly sensitive to the anticipated tax regime when the resource project is in the design phase and, if it is too onerous, the project may be delayed or not started. The game changes again when costs are sunk. Investors have little choice and they would aim to cover their variable costs, since production may be more profitable than stopping operations. At this point the tax base is described as relatively insensitive to tax design.[503]

(b) *The prospect of substantial rents*: economic rent is "an amount by which payment received in return for some action, exceeds the minimum required for it to be undertaken."[504] The advantages of such rents are that they can be taxed up to a hundred per cent without causing any change of behavior and are described as the ideal of non-distorting taxes and – from a national perspective – the most equitable. According to Boadway and Keen, a resource tax system that aims to be efficient should tax full rents by recognizing all phases of resource production.[505]

(c) *Tax revenue*: resource activities can produce significant revenue for governments as well as economic gain in the form of foreign investment, which can provide substantial external benefits to host communities such as employment and development.

Table 6.2: Average Receipts from Minerals in per cent of Government Revenue (2000-2007)

COUNTRY	MINERAL(S)	TOTAL
Botswana	Diamonds	44
Ghana	Gold, diamonds	27.6
Liberia	Iron ore, gold	8
Namibia	Diamonds	8
Sierra Leone	Diamonds bauxite	1
South Africa	Gold, platinum	2
Zimbabwe	Platinum, diamonds	No data

Source: Boadway & Keen (2010); Aryee (2012)

(d) *Uncertainty*: throughout the lifecycle of a resource project, questions of uncertainty arise: how much, how accessible and which technology should be used? There is volatility and

[503] Boadway & Keen (2010) 14-15.
[504] Boadway & Keen (2010) 15-16.
[505] Boadway & Keen (2010) 15-16.

uncertainty of output prices. Together these translate into uncertainty in the aggregate rents which can be generated over the lifetime of the project.

(e) *International considerations*: the extraction of natural resources is typically undertaken by foreign-owned companies or in joint ventures with domestically owned companies. Several implications flow from this in that more than one country will want to tax, and investors need to take into account the combined impact of these taxes.

(f) *Asymmetric information*: policy makers are less informed on the geological and commercial potential than those who undertake projects, which complicates rent extraction, since operators have no interest in sharing their in-depth knowledge with the government; their interest may rather lie in understating the likely stocks or in overstating the difficulty of extraction, outright tax evasion or understatement of profits in the host country through transfer pricing or profit shifting.[506]

(g) *Market power*: host countries may exercise "an appreciable control over the flow of resources into world markets," where the effect of such market power lies in the potential that it can "change the incentives for tax setting in both host and resource importing countries."[507]

(h) *Project basis*: special taxes for the mining sector are levied at the project level and not at the consolidated entity level, (which is common for corporate income tax). In most countries, these special taxes constitute a legitimate deduction in assessing corporate income tax.[508]

(i) *Exhaustibility*: more extraction today means less potential for future extraction and this has economic resource taxation implications, such as how will the marginal cost to benefit reflect today's production and opportunity cost in future extraction foregone?[509] In this regard the Hotelling Rule states that "the price of an exhaustible resource must grow at a rate equal to the rate of interest, both along an efficient extraction path and in a competitive resource industry equilibrium."[510]

[506] (2010) 22; 23.
[507] (2010) 23.
[508] Guj (2012) 4.
[509] Boadway & Keen (2010) 25.
[510] Devarajan & Fisher (1981) 66.

According to Boadway and Keen, the taxation of mineral resources has three dimensions of importance to host countries in the developing world.[511] These include the level of taxation, the structure thereof (e.g. royalties vs. income taxes) and the transparency of the resultant revenue flow. The structure is important to attracting investment and in balancing the resultant partnership between the investor and the government over a period within an environment where markets may fluctuate significantly.[512]

6.3.1 Basis of taxation

The "resource rent principle" provides the theoretical basis for a large portion of the mining taxation literature and is supportive of the argument that "taxation should be based on profitability, not on production or sales."[513] The case for resource rent taxation is based on it being the most accurate of all progressive taxes in capturing resource rent.[514] The ICMM finds that a challenge regarding resource rents is that they are conceptually easier to describe than to identify and collect in practice.[515] The ICCM raise the following points to support their assertion[516]:

- Many costs are not immediate and are incurred at a later stage;
- That the framework may assume that the discount rates for governments are lower than those of companies.
- It may be assumed that governments are less concerned about when exactly revenue is received, but that they seek to maximize revenue in the immediate term. This assumption can become problematic for countries which are dependent on natural resource revenues for a large share of government revenue.
- A government's preference for revenue to be received sooner rather than later, can be easily shifted through political pressures and other factors.

6.3.2 Tax Structure

According to Bird and Zolt, a variety of factors can influence the pattern of taxes in a country, for example, its history, its economic structure, as well as the tax structures of neighbouring countries. Commonly accepted aspects of a good tax system (e.g. fairness, cost of collection and economic effects) may also be assigned different levels of importance.[517] A country's revenue

[511] (2010) 25.
[512] Boadway & Keen (2010) 25.
[513] ICCM (2009) 8.
[514] Land (2008) 1.
[515] (2009) 8.
[516] (2009) 8.
[517] Bird & Zolt (2003) 7.

structure is also dependent on factors such as country location, and its economic structure and tax policy choices are informed by public policy choices such as reaching a certain level of income and wealth distribution.[518] In this regard, how taxes are levied should be done with consideration as to whether the policy changes are, for example, accompanied with lesser/increased disparity in income levels or whether taxes influence before and after tax distribution of income.[519]

In as far as tax structure considerations go, it is important to note that resource limitations and country context will always dictate what can be achieved with a particular choice of tax system.

6.3.3 Efficiency, equity and administrative feasibility

Efficiency, equity and administrative feasibility are the key elements in designing and evaluating tax systems.[520] Tax systems exist mainly to raise revenue to finance government operations and priorities, therefore any tax reforms should be, as a rule, undertaken to achieve long-term rather than short-term objectives.[521] As stated by Bird and Zolt, this implies that:

> "tax systems should not be altered on a temporary basis to meet anticipated current year shortfalls, and that where frequent tax changes are made, the result is increases in enforcement and compliance costs, as well as efficiency costs, especially where businesses (particularly those involved in the extractive sector) make production and location decisions on the basis of a particular tax structure."[522]

Revenue projections are affected by the quality of the administration, economic growth and the tax structure – where these indicators are weak, countries may experience difficulties in achieving their policy objectives, which in turn can cause regular tax reforms aimed predominantly at plugging short-term revenue gaps.[523] Bird and Zolt indicate that where tax policies are implemented in difficult economic or political times, they may fall short in resolving underlying basic problems, such as inadequate revenue elasticity.[524] Countries that have a large dependency on natural resource taxation are therefore more likely to be vulnerable to cyclical swings in commodity prices. It is therefore important that countries look for predictability and consistency in revenue performance through domestic resource mobilization.

[518] Bird & Zolt (2003) 9.
[519] Bird & Zolt (2003) 9.
[520] Bird & Zolt (2003) 10.
[521] Bird & Zolt (2003) 10.
[522] Bird & Zolt (2003) 10.
[523] Bird & Zolt (2003) 14.
[524] (2003) 14.

Foreign investors choose the location of their business in a particular country based on factors such as infrastructure in place, access to markets and the relative costs of production. Taxes are a considered factor in as far as investment and choice of location are concerned, when taxes lower the after-tax return on investments in that location or country. The capital structure of a company (e.g. the extent of debt or equity financing) may be influenced by the corporate income tax rates of a country. An example provided by Bird and Zolt is where retained earnings are encouraged when dividends are subject to tax at the shareholder level, and debt is preferred over equity where interest on debt capital is deductible and dividends paid from equity capital are not.[525]

Good tax policy requires minimizing unnecessary costs of taxation, and, to minimize costs, Bird & Zolt[526] suggest three general rules, namely a broad tax base, as low as possible tax rates and efficiency considerations.[527] These rules can be further broken down to include certainty and simplicity, convenience of payment and economy in tax collection. What is critical from an equity perspective is awareness that equity implications of tax reforms may be different for different groups, and that outcomes of reforms are actually in line with what was intended from a policy perspective. What also needs to be taken into account is that when new tax rules are introduced, the revenue projections of the performance of such rules may be undermined by tax avoidance practices. Where tax laws impact differently on similar taxpayers as a result of tax avoidance, fairness is sacrificed. Tax authorities spend significant resources on combatting avoidance practices and this may not be optimal.[528]

6.3.4 Tax incidence

In the determination of what constitutes fairness in a tax system, a consideration of the economic incidence of taxation is required, in other words, who bears the cost of the corporate income tax. If corporations are seen as engines for development, CIT can be seen as a tax on growing sectors of the economy.[529] Corporations are mere legal constructs and the tax burden therefore falls on individuals.[530] The incidence of a corporate income tax depends on aspects such as the elasticity

[525] Bird & Zolt (2003) 14.
[526] (2003) 14.
[527] From an efficiency perspective, “it is especially important that careful attention be given to taxes on production, because these affect the location of businesses, alter the ways in which production takes place and change the forms in which business is conducted. Developing and transitional countries generally need to impose taxes on production for several reasons, such as limited administrative capacity which makes it easier and less expensive to collect excise and sales taxes at the point of manufacture; and, to the extent that taxes represent the costs of public services provided to businesses, the businesses should bear the cost, via taxation, for those services.” (Bird & Zolt 2003:14).
[528] Brown (2012) 1.
[529] 2003 22.
[530] Bird & Zolt (2003) 20; TJN (2016). The Tax Justice Network points out that the incidence does not fall on workers, but that it largely falls on wealthy capital owners, and as such, TJN views it as a “powerful and precious vehicle for reducing inequality, within and between countries.” Harris finds that “because wage and capital income are highly

in demand (for goods produced by companies), the openness of the economy and the extent to which capital movements take place between the corporate and unincorporated sectors.[531] In most countries, the corporate form remains the preferred vehicle for businesses, because it is able to mobilize large amounts of capital, despite the prevalence of corporate income taxes.

6.3.5 Tax administration

It has been said that in developing countries, "tax policy is often the art of the possible rather than the pursuit of the optimal."[532] Therefore, if bottlenecks to the improvement of tax administrations can be identified, then a strategy can be derived to improve the administration. As many of these "bottlenecks" are found in the tax policy arena, improved relations between the policy maker and the administrator are critical. Guidelines for an improved nexus between tax administration and tax policy include the following:[533]

a) Modern tax structures are complex and the complexity grows with economic development: as economies modernize it is reasonable to expect that the roles within the tax administration and the tax administration itself will become more complex. Such complexity necessitates investing in training, updating procedures and finding ways to improve the competitiveness of tax administrators;
b) Tax policy should not be overused to deal with economic problems;
c) Governments should have long term plans for the improvement of tax administration systems (e.g. a capital budget could protect investment in the tax administration against short sighted politicians, who shy away from significant expenditure in enforcement;
d) Monitoring systems should be set up to track changes in the efficiency of taxpayer identification, assessment, audit and collection;
e) Poor tax administration should not be used as a shield for poor tax policy design, and;
f) Investment in the necessary resources to keep up to date statistics on tax performance as it improves tax administration and assists in the formulation of tax policy is required.

Developing countries are exposed to external events since many are dependent on a few products that earn foreign exchange, commodities they trade in are subject to prices set on world markets and many are highly indebted. Most developing countries are under constant pressure to increase revenues and new taxes or enhancements to the tax system are undertaken to

correlated, higher-income taxpayers will pay a relatively larger share of the tax, regardless of whether the corporate income tax falls on labour or capital" (Harris 2009:2).

[531] Bird & Zolt (2003) 20.

[532] Tanzi & Zee (2001).

[533] Bahl & Martinez-Vazquez in Bird (ed) (1992) 67; 107.

address such. Where the tax administration is not ready to absorb the change, the expected results may not materialize.[534]

6.3.6 Objectives of Taxation

One of the goals of tax administrations is to foster voluntary tax compliance, which in turn requires an effective tax administration. The effectiveness of the administration is likely the key factor of the level of compliance (as opposed to an efficient tax administration which has low tax collection costs but is ineffective in enforcing compliance). The effectiveness of a tax administration can be measured by how it addresses shortfalls such as the number of unregistered taxpayers, the number of registered taxpayers that file and the rate of tax evasion (tax reported vs potential tax payable under laws).[535]

A tax administration which does not have skilled employees, may collect large amounts from easy to tax sectors such as salaried employees, while being unable to enforce taxes on business enterprises and professionals.[536] In such circumstances, the level of collection is thus a somewhat unsophisticated measure of effectiveness, whilst a more accurate measure is the size of the compliance gap.[537] The measure of effectiveness is also echoed in AML guidance which distinguishes between technical compliance (of AML measures) and whether the key objectives of an effective AML/CFT system are being met, such as safeguarding the integrity of the public sector, protecting designated private sector institutions from abuse, increasing transparency of the financial system, and facilitating the detection, investigation and prosecution of corruption and money laundering, and the recovery of stolen assets.[538]

According to Bird, the "best tax administration is not simply the one that collects most revenue – how that revenue is raised is critically important." In other words, what is the effect of the revenue raising effort on equity, on the political fortunes of government and on the level of economic welfare of society.[539]

Governments not only use tax and borrowed funds to provide services to citizens, but also assets which they own, which in turn may represent a large share of the country's total wealth.[540] The manner in which a government mobilizes public revenues has significant implications for other

[534] Bahl & Martinez-Vazquez in Bird (ed) (1992) 101.
[535] Silvani in Bird (ed) (1992) 274-275.
[536] Bird & Casanegra de Jantscher (1992) 1.
[537] Bird & Casanegra de Jantscher (1992) 1.
[538] FATF (2013a).
[539] Bird & Casanegra de Jantscher (1992) 1.
[540] Tanzi (2003) 129.

aspects of the quality of governance, since taxation brings about higher levels of accountability between a government and its citizens.[541] The anti-money laundering framework can, potentially, further delineate that relationship by highlighting agreements which are opaque and where beneficial ownership is not transparent. For a tax administration, this may mean better revenue collection, and for tax policy, greater transparency in the design of, *inter alia*, incentive and/or exemption regimes.

Successful tax policy is dependent upon its effective implementation, and therefore policy design should consider the administrative dimension of taxation. In many instances, the administration of taxes is frustrated by political interests and by countries trying to maintain large bureaucracies premised on a weak fiscal foundation.[542] In addition, there may be practices whereby corporate tax liabilities are negotiated rather than calculated as required by law, and bribery may be a common feature of the administration, in that it is considered a regular part of the compensation of tax officials. Such levels of corruption undermine confidence in the tax system and negatively affect the willingness to pay taxes, thereby reducing a country's capacity to finance government expenditures. A key issue pointed out by Moore is "how does the taxation relationship between state and citizens itself contribute to the quality of governance?"[543] Bird and Zolt describe the policy challenges aptly as follows:[544]

> "The dominant policy ideas in different countries (such as equity, efficiency and growth), like the dominant economic and social interests (such as capital, labor, regional, ethnic group, rich and poor) and the key political institutions (democracy, decentralization, budgetary), and economic institutions (free trade, protectionism, macroeconomic policy and market structure) all interact in the formulation and implementation of tax policy. This changing interplay over time affects the level of taxation, the structure of taxation, and many of its critical details, such as the progressivity of rates. Indeed, taxation is one of the major battlegrounds on which we can observe the working out of these complex forces."

6.4 Tax Policy considerations for the Diamond Sector

The objective of a mining tax policy is to ensure that society benefits from the investment in the sector. Achieving this objective requires consideration and indeed, balancing the interests of governments and those of mining companies. Some of these policy aspects include the overall levels of taxation, how resource rents are treated, timing issues, equity participation and of course,

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[541] Knack (2008).
[542] Moore (2007) 8.
[543] Moore (2007) 8.
[544] (2013) 33.

government's ability to administer the mining tax regime, chosen in such a way that it does not deter future investment.

Tax policy design in respect of natural resources should take into account that the extraction industry is a high cost and high risk industry, and that the revenue generated is often for the benefit of the home country of the operator. Investors in the industry are usually multi-nationals capable of sophisticated tax planning, and the resource itself is also exhaustible. There are some formidable challenges to good tax design in the natural resources sector, especially in as far as the technicalities are concerned. The resource sector challenges range from issues such as whether resource tax regimes should include some element of progressivity, or whether resource importing countries should impose windfall taxes on rents earned on imports.[545]

Developing countries benefit in two ways from mineral resources, namely in foreign exchange and revenue through taxes and other mineral payments.[546] In many sub-Saharan countries, a combination of revenue generating devices are employed, such as corporate income tax, output taxes or equity participation.[547] The latter can be justified for the reason that the investor and the country provide two different types of capital (the country provides the resource and the investor provides expertise and capital). Conrad and Shalizi caution that equity arrangements may in various instances not create expected returns, where the investor will have an additional incentive to use transfer pricing to shift income out of the country via excessive debt, management fees and/or royalties for technical know-how.[548] Returns from equity participation only accrue after a significant time lapse, and a significant portion of the physical investment capital must be recovered and debt repaid, before any significant dividends are declared.[549] This is the problem of "time consistency" which is under-scored by the high sensitivity of the prospective tax base to the anticipated tax regime during the resource project's design stage.[550] According to Boadway and Keen, the fundamental problem simply relates to the ability of government to be able to commit in advance to apply a scheme that would be optimal from the start of implementation.[551]

545 Boadway & Keen (2010) 14.
546 Conrad & Shalizi (1988) 1.
547 Conrad & Shalizi (1988) 6.
548 Conrad & Shalizi (1988) 6-11.
549 Conrad & Shalizi (1988) 11.
550 Boadway & Keen (2010) 15.
551 Boadway and Keen point out that "if the investor is of the view that the anticipated tax regime will be too onerous, he can simply choose not to undertake it. However, once sunk costs have been incurred, investors will seek to cover variable costs and production may be more profitable than ceasing operations, making the tax base relatively insensitive to tax design. The government therefore has an incentive to offer relatively generous treatment at the planning stage (when the base is relatively elastic)."

From a tax design perspective, economic rents[552] are quite attractive. The attraction of economic rents lies therein that they can be subjected to tax of nearly 100 per cent without causing any changes of behaviour.[553]

6.4.1 *Economic costs associated with mineral development*

From a policy perspective, there are various economic costs which need to be considered as part of the mineral development process. Increases in government administration costs are associated with mineral discoveries and the size of these costs depend on the fiscal arrangements and state's choice of organizing the sector's activities. In many African countries this has taken the shape of state owned enterprises (SOEs).[554]

The return to mineral ownership is uncertain, which implies that the economy may bear additional risks as a consequence of the mineral discovery, in exchange for the rewards of mineral ownership.[555] It is for this reason that mineral contracts contain various payments which vary with income, output or value, in order to mitigate risk to society; in other words the risk is reduced to relative changes in mineral production and profitability. Also related to risk bearing, is portfolio diversification which means that government must make decisions on the extent to which diversification of the economic base should be undertaken. Limitations in access to capital markets can also cause diversification to happen over time, as the asset in the ground is extracted and sold.

The discovery of significant enclave resource deposits increases the wealth of the economy by the present value of the flow of net revenue. The phenomenon is referred to as the "Dutch disease" and is defined as:

> "the negative impact on an economy of anything that gives rise to a sharp inflow of foreign currency, such as the discovery of large natural resource reserves. The currency inflows lead to currency appreciation, making the country's other products less price competitive on the export market. It also leads to higher levels of cheap imports and can lead to deindustrialisation, as industries apart from resource exploitation are moved to cheaper locations."[556]

[552] Economic rent is "the amount by which the payment received in return for some action, exceeds the minimum for it to be undertaken" (Broadway & Keen 2010:15).
[553] Boadway & Keen (2010) 15-16.
[554] Conrad & Shalizi (1988) 11.
[555] Conrad & Shalizi (1988) 11.
[556] Financial Times. The phrase originates from an economic crisis in the Netherlands in the 1960s after the discovery of natural gas in the North Sea.

Conrad & Shalizi divide the problem of the Dutch disease into two parts: (1) who gets the benefit and who bears the cost of mineral development; and (2) what should the government do to prepare the economy for the transition to and from a relatively mineral intensive economic base.[557] Whatever adjustments are made, it is important that government expenditure and revenue policy cater for these, as the underlying issue is the cost borne by the poor and non-diversified players in the traditional sectors of the economy, whose welfare may fall if compensation is not made.[558] Long term policy making is critical to ensuring smooth transitions around the use of mineral revenues, and this does not only require tax policies, but also sound policy for government as the resource owner.[559]

6.4.2 Principles of Mineral Taxation

Taxation of the minerals sector may create incentives at all margins, from exploration through to development, extraction and domestic processing.[560] Taxation in turn can have different effects, depending on the stage in which the company is operating, and countries need to take cognisance of these dynamics as they must compete in international markets for both capital and sales of output. Tax policy can therefore have the impact of changing relative profitability of deposits in its jurisdiction.[561]

Available mining taxation instruments are distinguished within two categories, namely profit based taxes and production based taxes.[562] The latter consist of charges assessed against deposits of production, inputs and services, and come in the form of sales and excise taxes, unit-based and *ad valorem* royalties, import duties and registration fees. Profit based taxes are taxes on income, profits or cash flow.[563]

Natural resources are generally taxed through a combination of royalties and income based levies where the latter can include the application of a country's normal corporate income tax, resource

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557 (1988) 14.
558 Conrad & Shalizi (1988) 14-17.
559 Conrad & Shalizi (1988) 17.
560 Exploration commences with examination of wide areas to determine promising geological formations, and then intensive efforts are launched in promising areas through drilling and sampling. Pre-development planning and development entails financial and engineering analysis. Alternative plant size and extraction methods are developed from given geological data. The results are used to determine the potential profitability of development and extraction under a variety of circumstances. At the development stage financing is obtained and construction begins. Once extraction commences, it is constrained by all prior decisions: quantity and quality extracted are determined relative to fixed capacity and the design characteristics of downstream activities (if any are present). Processing can entail different degrees, e.g. close to the ore or closer to final markets depending on transport costs and the type and size of the market served.
561 Conrad Shalizi (1988) 20-22.
562 ICMM (2009) 9.
563 ICMM (2009) 9.

rent taxes once profitability is achieved and production sharing contracts.[564]Royalties become immediately payable upon the start of extraction and are normally specified as a levy on production (either on amount per unit produced or a share of sales) and tend to distort both the operational and the net profit margin.[565] In a sense the extraction path and the decision to invest is affected and high investment/costs are discriminated against. Royalties can be viewed as an additional and distinct type of tax, based on countries' need to seek special compensation for the use of their natural resources.[566] This aspect differentiates a royalty from a tax (based on taxing any economic activity).

Taxes on income tend to be more neutral, but investment decisions may be affected by depreciation rules (e.g. depreciation credits may be limited) regarding the initial investment applicable under the income tax regime. Both royalties and income taxes are regressive in nature: as the commodity price increases, the portion of the tax that is pure rent decreases. Flexibility and stability are also not strong features of either of these instruments.

Dividend taxes on private producers are based on the idea that if substantial rents remain after other taxes have been collected, the authorities can capture a further share of these rents. A general drawback associated with the tax is that it tends to induce over-investment and/or an incentive for entities to over-inflate costs.[567] An alternative is the rent tax: by taking into account the potential cash flows and the risks of the project, a normal rate of return is calculated and profits in excess of that rate are taxed. This makes the rent tax, in theory, a neutral tax; the tax should also be flexible, since positive changes in prices or geology should increase the rate of return and tax revenues. However, this requires proper information holdings on the part of the revenue authority, in order that appropriate rates of return are set up. Since the return should be project based (not company based), the tax authority must set ring fencing provisions to properly measure the project specific returns for entities with different projects. A yardstick measurement across different but similar projects may further assist the tax authority in regulating the rates of return. In instances where "debt" is considered a cost, there is a risk of intra-firm lending being encouraged.[568]

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564 Durst (2016) 7.

565 Large upfront expenditure contains the first cost of exploitation; the second set of costs are incurred in production. Two margins need to be considered – the operational margin which is related to the decision to produce once the investment is made; and the net profit margin which is related to the net return on investment.

566 Glave & Damonte (not dated) 2.

567 Corbacho *et al* (2013) 180.

568 Corbacho *et al* (2013) 180.

6.4.3 Production Based Taxes

6.4.3.1 Per Unit Tax

A tax can change the time of extraction of particular quality and quantity deposits, and it can affect the level of economically recoverable reserves. Per unit output tax can be imposed as an export tax, which has administrative benefits as it relates only to the volume of production. However, economically recoverable reserves are affected by this tax via an increase in the cut-off grade, i.e. the tax may induce the miner to grade the deposit high, since the tax reduces the net of tax revenue for each period.

In the diamond industry, several determinants have been identified which will increase the value in USD per ton. These include:

- changing the bottom cut-off
- control on diamond damage
- increasing plant efficiency
- improving diamond recovery
- improved waste control[569]
- changing the top cut-off
- improved security, and
- better understanding of the resource.[570]

Where these criteria or determinants are applied, it can decrease production costs, improve metallurgical processes and increase profits.[571] By changing the "bottom cut-off size" operational margins can be improved for efficient recovery of all other diamond size fractions. Ringane[572] finds that changes to the bottom cut-off size on the plant can improve the recovery of coarser stones, and lead to more stable production characterised by an easier processing environment with the necessary controls.[573] This type of approach is particularly useful in alluvial processing,

[569] "Maximum extraction of diamonds from the source is attained through use of bulldozers in the pit to break down the deposit. The management of waste plays a vital role in the lack of reconciliation between the estimated gravel grade and the actual grade recovered at the plants. One of the major contributors to grade overestimation or underestimation is dilution. Increased dilution in an alluvial deposit lowers the predicted grade significantly. To combat this, the amount of waste rock that reports to the plant should be reduced through stripping. The impact of increased waste is a decrease in the efficiency of the concentration process (pans). This in turn results in poor diamond recovery, leading to revenue loss (and lower taxable margins)" (Ringane 2013:133).

[570] Ringane (2013) 133.

[571] (2013) 133.

[572] Ringane (2013) 133.

[573] Ringane (2013) 133.

as it is a priority to protect the coarser stones through the processing chain. Conversely, an increase in the cut-off grade can lead to premature mine closure, depending on the quality distribution in the deposit.[574] Exploration and development can also be reduced, as the tax reduces the present value of all future exploration and development leading to an increase in marginal costs.[575]

6.4.3.2 Ad Valorem Output Tax

This tax is a fixed proportion of the mineral output price and can be charged on exports, on industry wide production, or on a mine specific basis (similar to a per unit tax). A value based tax should in theory be simple to apply: value = volume x price. However, establishing price and volume may not be easy due to the volatility in natural resource prices. This, according to Calder, increases the room for error and manipulation, because dependence on realised sale prices presents major risks and the main problem is transfer pricing between related parties.[576] The administrative difficulty of applying the tax is the determination of the arms-length price (ALP) of output. This difficulty is well illustrated in *Golawla Diamonds, Mumbai v Department of Income Tax*,[577] where both the taxpayer and the tax administration got it wrong. In this case the taxpayer was engaged in the business of import of rough diamonds and the manufacture and export of cut and polished diamonds. In determination of an arm's length price, a dispute arose in relation to the assessment amount. Under the statute, it is mandatory for the taxpayer to follow one of the prescribed methods[578] and to demonstrate that international transactions entered into are at arm's length price. Both the taxpayer and the tax administration adopted "enterprises level operating margins" as the transactional net margin method (TNMM) for purposes of comparison. The court held that the method does not allow for enterprise level profit comparisons or adjustments by the assessing officer, and concluded that both parties adopted a method which is not approved in law, and therefore both committed an illegality.[579]

It is common practice within the mining sector to sell output to related parties, and a quality adjusted arm's length price for the output of a specific mine may not be available. Schemes such as net back pricing have been developed to determine the free on board (f.o.b.) value of the material in such a situation.[580] In instances where the total mineral yield is exogenous, the nominal

[574] Conrad & Shalizi (1988) 26.
[575] Conrad & Shalizi (1988) 26.
[576] Calder (2010) 320.
[577] I.T.A. No.2346/Mum/2006 [2] [11] [12].
[578] In this case the Transactions Net Margin Method (TNMM) was followed which requires comparison of net profit margins realised by an enterprise from an international transaction or an aggregate of a class of international transactions.
[579] I.T.A. No.2346/Mum/2006 [3] [8] [9].
[580] Conrad & Shalizi (1988) 26.

(or net-of-inflation) tax payments are a function of the time path of output prices. The miner therefore has an incentive to reallocate extraction to periods with lower discounted prices, in order to reduce the present value of the tax payments. It follows then that if discounted prices fall over a time period, the allocative effect is similar to the per unit tax.[581]

6.4.3.3 Profit Based Taxes

Profits are revenue less costs, and establishing revenues involves both the difficulties of valuing production and valuing other revenues which may be included (e.g. gains on disposal of licence interests, financial income and ancillary income).[582] Profit taxes' main difficulty lies in the administration thereof, because profits must be measured relative to empirical, not theoretical, standards.[583] The administrative difficulty arises in defining the exact nature of each expenditure and the determination of the amortization period.[584] Exploration expenditures can be easy to define in the pre-development stages but, once the mine is developed, there can be continued exploration and, in this context, the determination of exploration costs may be arbitrary.[585] Alternative accounting methods for pre-production exploration costs are available in the form of immediate expensing, or capitalization with amortization for successful exploration and subsequent expensing for unsuccessful exploration. Conrad and Shalazi advise that the overall objectives of tax policy should best inform which method will be used. For example, if cash-flow accounting is used, then immediate expensing is appropriate. If accrual concepts are employed, then one type of capitalization method should be used.[586]

Immediate expensing of development costs (e.g. costs associated with sinking shafts and removal of overburden) is generally allowed. Under standard international conventions, expenses incurred in development are a residual category which can be defined as capital expenses that are not classified under other depreciation categories (such as machinery).[587]In their analysis of profit taxes for sub-Saharan Africa, Conrad and Shilizi[588] point out that:

(a) The neutrality of a pure profit tax is maintained only in a partial equilibrium framework.[589]

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[581] Conrad & Shalizi (1988) 27.
[582] Calder (2010) 321. The difficulties in establishing costs relate to aspects such as categorising costs for different depreciation rates, transfer pricing costs, the treatment of losses, the treatment of finance costs, etc
[583]Conrad & Shalizi (1988) 27.
[584] Amortization is the paying off of debt with a fixed repayment schedule in regular instalments over a period of time.
[585] Conrad & Shalizi (1988) 28.
[586] Conrad & Shalizi (1988) 28.
[587] Conrad & Shalizi (1988) 6.
[588] (1988) 32-33.
[589] Because "if the effective tax rate on mineral investments is higher (lower) than other sectors, then capital may flow between sectors generating welfare cost, even when there are no allocative effects within the industry."

(b) The tax treatment of exploration, development and other intangible expenses is related to overall business tax policy.[590]

(c) The operator's basis for depletion should be limited to bonus payments, exploration, development and other expenses. This is so because government holds title to the resources; and government itself should therefore account for depletion of the resource base, not the producer.

Profit taxes are widely used in both the Anglophone sample of countries representative of the ECOWAS and SADC regions as reflected below:

Table 6.3 Country Comparison Mining Regimes

COUNTRY	ROYALTIES	CIT	EXPORT LEVY	OTHER
Botswana	10% on turnover	22%-55%*	-	
Namibia	10%	55%	2%**	
South Africa	0.5%- 5% refined 0.5%-7% unrefined	28%	5%	
Zimbabwe	15%		25%	Small Scale mining tax regime
Ghana	5%	35%	-	
Liberia	5%	30%		Annual surface rent
Sierra Leone	15% special stones 6.5% precious stones	35%	5%	Small scale mining tax regime

* Variable income tax according to the ratio of profits to gross revenues.

** Proposed: Export Levy Bill

Source: Author

6.4.3.4 Alternative Approaches to Taxing Extractives

Sui, Picciotto, Mintz and Sawyerr argue that a unitary tax and formulatory apportionment can be used as an alternative to separate accounting and the arm's length principle.[591]The benefits of a unitary tax are described as a mechanism to improve general corporate income tax design and to develop better rent/profit extractive industry levies. The use of a unitary tax has the potential to reduce administration and compliance costs associated with both corporate income tax and

[590] If a country adopts cash flow accounting for all sectors, then immediate expensing is appropriate. Also, no depletion allowance of any type is needed. If accrual accounting is the established norm for tax policy then all pre-production expenses should be capitalized and amortized during the life of the project.

[591] (2015) 7. Transfer pricing and the arm's length principle are discussed extensively in Chapter 7 hereunder.

rent related levies, if it is based on a common global corporate group tax base for trans-national companies operating in the extractive industries.

The development of transparency rules under the EITI and other transparency initiatives such as those advanced by the EU, US and G20, may result in extractive industry companies reporting payments ot governments. According to Morgan, it implies "agreement to create universal, coherent and binding international tax law that is not based on separate entity status" where an entire MNE is treated as a single entity. That entity produces one set of master accounts, and thus one ultimate income and profit statement.[592] In such a context, a unitary tax approach that requires country by country reporting on revenue, costs and tax payments, and the apportionment of global revenue based on that information, could help in the development of improved extractive industry policies that are sensitive to the risks and costs incurred by MNEs in mining operations.[593] It is also argued that a unitary tax approach can better align the risk and reward of natural resource extraction for governments and private companies. In addition, it could allow for global offsetting of company profits and provide information for improved design of levies and a reduction in fiscal distortions that affect investment in the extractives. Last, because MNEs invest until the return is sufficient to cover the cost of capital including depreciation, inventory costs and risk, a unitary tax approach can therefore potentially maximise the overall rent shared by the government and MNEs.[594]

In order to achieve better certainty and transparency in the diamond sector, Belgium introduced a carat tax in 2017. The carat tax is described as a clear-cut and predictable fiscal regime that applies to diamond trading companies.[595] The regular corporate tax rate is levied on taxable income which is calculated on the basis of a lump sum margin instead of on the actual margin that is realized. The benefits of the carat tax are described as:

- It will do away with annual burdensome and complex discussions on the valuation of the stocks held by diamond traders;
- The stock is removed from the equation for fiscal purposes, which means that increases and decreases in the value of the inventory are neutral;
- Under the carat tax, diamond traders will be able to monitor their total corporate taxes due throughout the year, as these taxes are based solely on the turnover generated by the sale of diamonds. This can significantly increase simplicity, predictability, stability and clarity.[596]

[592] Morgan (2016) 472.
[593] Sui, Picciotto, Mintz and Sawyerr (2015) 7.
[594] Sui, Picciotto, Mintz and Sawyerr (2015) 7.
[595] AWDC (not dated) 1.
[596] AWDC (not dated) 1;2.

The effects of the of the carat tax are described as promoting ease of doing business; access to banking facilities, improved capital base and as an incentive for companies to perform independent valuation of their stocks, which will increase their transparency and credibility towards the banks.[597]

6.4.4 Tax incentives

Tax incentives can be defined as "any special tax provisions granted to qualified investment projects or companies which provide for favourable deviation from the general tax code."[598] Tax incentives can take several forms, such as tax holidays,[599] preferential tax rates that apply in certain regions, sectors, or for particular types of assets. Incentives can also include targeted allowances[600] for specifically defined investment expenditures.[601]

Whilst many countries seek to improve their economies through incentives (e.g. for investment, to promote exports, regional development or to boost employment, Bird and Wilkie[602] indicate that such incentives are often ineffective, or even redundant. Countries end up with a complicated fiscal system, give up revenue and fail to achieve their stated objectives. The result from incentives is often more distorting or inefficient, in that it diverts scarce resources into less than optimal uses.

In addition, Bird and Wilkie highlight that tax incentives can only improve economic performance if government officials are better able to decide what the best types and means of production should be, than are private investors.[603] Tax incentives can potentially result in uneven and thus unfair tax burdens, where domestic companies may for example be subject to full taxation, while foreign firms may benefit from tax incentives that reduce their effective tax rates.[604]

According to a joint IMF, OECD and World Bank report to the G20, there are many examples where incentives are reported to be redundant, for the reason that the investment would in any event have been undertaken in the absence of incentives. In investment climate surveys, tax incentives generally rank low,[605] and experience suggests that good infrastructure, stable

597 AWDC (not dated) 1.
598 OECD (2015d) 8.
599 Tax holidays are a complete exemption from tax for a limited duration.
600 Generally, in the form of tax credits or tax deductions.
601 OECD (2015d) 8.
602 (2012) 19.
603 (2012) 19.
604 Bird & Wilkie (2012) 19.
605 OECD (2015d) 8.

governance systems and other non-tax factors such as sound macro-economic policy and the rule of law, are factors which better inform business decisions than do tax benefits.[606]

It follows that if a country wants to introduce incentives, these should be limited to a lesser number, they should be well designed and implemented, and should be subject to regular monitoring to determine whether they add any value. In this regard, the OECD found that tax incentives generally have limited impact, particularly where these are aimed at sectors that produce for domestic markets or extractive industries, whilst those geared toward mobile capital and export orientated sectors, have had relative success.[607]

Tax incentives are often the result of tax competition.[608] By attracting investment that, in the normal course of business, would have gone elsewhere, tax incentives can have negative cross-border spill over effects on the welfare of neighbouring countries.[609] The OECD advances the principle that mutually harmful outcomes, that are caused by uncoordinated tax design, can be prevented through a coordinated response which can take the form of banning the use of certain types of tax incentives.[610] Some forms of regional coordination are often limited in scope and scale.[611] For example, the Southern African Development Community (SADC) aims to use the SADC Protocol on Finance and Investment[612] to reduce damaging tax competition that jeopardizes regional revenue mobilisation efforts. The members of the East African Community (EAC) have recently progressed toward better coordination of their tax incentive regime, through the use of a *Code of Conduct* which is aimed at "formalising existing arrangements whereby finance ministers can advise against new tax incentives that put other countries at a disadvantage."[613]

In the West African Economic and Monetary Union (WEAMU),[614] directives which limit the applicable tax rates that countries can use, are issued to tackle the problem of tax competition.[615] This coordination framework has resulted in some convergence of the countries' tax systems, and

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606 (2012) 19; OECD (2015d) 8.
607 (2015d) 8.
608 (2015d) 29.
609 OECD (2015d) 29.
610 (2015d) 29.
611 OECD (2015d) 29.
612 These objectives are set out under Article 2, which "seeks to foster harmonization of the financial and investment policies of the State Parties in order to make them consistent with objectives of SADC, and ensure that any changes to financial and investment policies in one State Party do not necessitate undesirable adjustments in other State Parties."
613 OECD (2015d) 31.
614 Members of the West African Economic and Monetary Union (also known by its French acronym, UEMOA) are Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo. WAEMU/UEMOA member countries are working toward greater regional integration with unified external tariffs.
615 OECD (2015d) 31.

has led to positive revenue effects in WAEMU member states.[616] With reference to the WAEMU's use of incentives, Mansour and Rota-Graziosi find that non-tax laws, primarily investment codes, are used in WAEMU states to circumvent the limitations imposed by regional tax directives and, according to the authors, this behaviour is sometimes permitted by the same directives that are supposed to coordinate or harmonize national tax policies.[617] In addition, the issue of credibility of tax coordination and the role of regional institutions is raised by the existence of special tax regimes.[618] Mansour and Rota-Graziosi find that all WAEMU states provide some sort of special tax regimes (e.g. either contained in mining, investment or trade legislation, or through ministerial or presidential decrees) that depart from the tax treatment under their general tax laws.[619]

6.4.5 Other Mechanisms to Create Incentives

There are a several instruments available to government to create incentives similar to those of tax policy, such as foreign exchange controls and equity participation.

a) Foreign Exchange Controls

Significant incentives in mining can be created through foreign exchange controls, for the reason that the sector is capital intensive and dependent on imported materials. Direct allocation can lead to an increase in the price of imported inputs and can hold back development and extraction of the deposits.

b) Equity Participation

Government can take direct ownership in resource activities, especially at the development stage.[620] Governments can either require free equity or the option to buy equity from the investor at lower than market prices. According to Conrad and Shalizi, such schemes are in effect profits taxes: for example, 30 per cent free equity is equivalent to a 30 per cent net-of-all-other-tax reduction in the return to the company.[621] In this example, tax-like effects may not be present when equity is bought for a value close to the asset's value, but there is a clear shift in the risk structure.[622] In some cases, national ownership becomes complete and the investor becomes an operating entity whose payment may be independent of profits – this has the effect of increasing

[616] OECD (2015d) 31.
[617] (2013) 27.
[618] (2013) 27.
[619] Mansour & Rota-Graziosi (2013) 27.
[620] Boadway & Keen (2010) 40.
[621](1988) 28.
[622]Conrad & Shalizi (1988) 28.

the country's exposure to changes in relative profitability in mining.[623] Conrad and Shalizi note two points in this regard;

- Many major multi-nationals may be more diversified than developing countries. MNEs are not restricted to one resource base or to "one field of endeavour" and the MNE, in all likelihood, probably has less expensive access to world capital markets.[624] Therefore, the risk bearing costs for MNEs are lower than they would be for the country.;
- Opportunity cost is present to the purchase of equity in mineral investments, over and above the capital held as resources in the ground. Such investments, through internal investment or via capital markets, are made at the expense of diversification. In effect, the government is taking a long position in one market which limits its flexibility to respond to increases or decreases in mineral prices and/or in profits generated.

These are some of the reasons as to why a government should weigh the costs of requiring equity participation relative to any perceived benefits.[625]

6.5 Conclusion

A tax regime that is progressive and based on profits is considered best practice for countries endowed with natural resources, because such regimes promise to capture the bulk of resource rents from the sector. At the same time, such a regime has the potential to ensure the required investment which is associated with high-risk, capital-intensive exploration and extraction. Developing countries often find this model challenging to implement and/or to enforce. Instead, underlying political economy drivers and the resulting institutionally weak and fragmented mining revenue administrations often lead to excessive reliance on regressive indirect fiscal regimes, or those based on proxies to profits. High uncertainty, price volatility, and political pressures make fiscal regimes prone to change and instability, which impairs further prospects of attracting investments which are required to develop the sector to the benefit of society.[626]

The mix of fiscal instruments applied should as far as possible, be assessed against the principles of sound tax policy, namely simplicity, transparency, neutrality, stability, non-retroactivity, a wide base and low rates. It follows then that minerals taxation should be simplified, so that it is "easier to calculate the amounts of tax that are due and also to audit the amounts paid."[627] The level of

[623]Conrad & Shalizi (1988) 28.
[624] (1988) 28.
[625] (1988) 40-41.
[626] Minh Le & Viñuela (2012) 1.
[627] Minh Le & Viñuela (2012) 1.

complexity is often a stumbling block for countries with weak administrative capacity in low income natural resource dependent economies.

Simplicity can be attained in various forms, for example by implementing taxes that are easy to administer or by implanting taxes where the administrative burden is shifted to the taxpayer. Administrative capacity is an important factor to take into account when considering a decreased reliance on indirect taxes (such as unit or value based royalties) in favour of income taxes. Royalty tax is an important tax instrument by means of which countries can ensure a stable minimum revenue flow. According to the ICCM, the argument that direct tax instruments based on profitability or some definition income have a greater revenue imperative, is supported by the political economy of taxation. Such instruments are therefore more likely to address problems of low administrative capacity in the long run.[628]

Transparency in the taxation of mining activity and its contribution to government to support socio-economic development is needed, in order to raise awareness of mining sector contributions to the fiscus. Transparency alone does not ensure allocation or distribution of revenue, so it is crucial that the role of mining in revenue generation and the underlying fiscal contracts or terms between government and mining companies are made public.[629]

Whilst tax incentives have been found to be largely redundant, care should be taken in instances where they are in use that principles of good governance of incentives are in place with the necessary transparency. Transparency is necessary to achieve acceptable levels of accountability and to reduce opportunities for rent seeking behaviour and corruption. Tax incentives should therefore be granted according to legislative processes, where after they are consolidated under the tax law. It is important that the fiscal cost of incentives are reviewed yearly, as part of a tax expenditure review.[630] Whilst introducing incentives involves various stakeholders, it is better to consolidate them under the authority of the finance ministry, subject to administration and enforcement by the tax authority. In addition, the process for granting incentives should be based on rules instead of discretion.[631]

Depending on which perspective one takes, tax reform can be seen as (a) “a continuous stream of small technical modifications to law and procedure that are a reflection of specific national circumstances, the interests of diverse lobbyist groups, and the continual efforts of public finance specialists, in order to reconcile the competing objectives of governments’ fiscal activities; or (b)

[628] ICMM (2009) 61.
[629] ICCM (2009) 63.
[630] OECD (2015d) 23.
[631] OECD (2015d) 23-24.

as a global process of tax reform which contributes to state building."[632] In the case of the latter, governments of poor/developing countries have had little choice but to abide by a reform agenda that is not necessarily strongly aligned with their particular circumstances, and where the responses to policy choices are all too often a reflection of the enthusiasm of the more powerful international role players.[633] This is reflected through the preference of many African countries for the UN tax reform practices, as opposed to those of the OECD.

In rating the different tax instruments against the criteria of neutrality, flexibility and stability,[634] the rent tax is by far the most flexible, stable and neutral. It, however, requires advanced administration and increases the compliance burden. The IMF maintains that tailored advice is required, depending on the circumstances of a country, but the main trend in Africa has been to select a regime that combines a royalty and a tax targeted explicitly on rents (together with standard CIT).[635] This is so because there is revenue to be raised when production starts and with increases in rents, and as commodity prices increase or costs reduce, governments' revenues also increase. Of course, such a regime should be characterised by transparency in regulation and contracting, in addition to well-designed international arrangements.[636] Good practice identified by the IMF lies in levying royalties by requiring traders to withhold and pay (rather than attempting to tax miners directly, except perhaps for a small license fee, and by ensuring that consumption taxes are levied and collected in mining areas.[637]

With reference to the country experience of the selected countries,[638] the preferred route is to have profit based taxes and withholding regimes in place to maximize revenue from the industry. Looking at revenues collected from some of these countries, it appears that, although the tax policies are in place, the country does not benefit as it should from the tax regime. South Africa and Sierra Leone constitute cases in point. In the case of the latter, the contribution of the mining sector to the domestic tax base has been limited. While it accounted for 60 per cent of exports in 2010, it only generated eight per cent of government revenue. The variation is ascribed to the generous tax incentives afforded to mining companies, often reinforced by political corruption and possible tax avoidance.[639] In 2011, South Africa produced rough diamonds to the value of USD 1.73 billion (or 12 per cent of global production), yet from 2010 to 2011, diamond producing

[632] Fjeldstad & Moore (2008) 235-237.
[633] Fjeldstad & Moore (2008) 237.
[634] A system is said to be neutral if it does not affect the decisions of a private agent; flexible if it is able to adapt to external conditions and stable if there are no major changes or if the changes are predictable.
[635] (2012) 6.
[636] IMF (2012) 6.
[637] IMF (2012) 13.
[638] As per Annexure A.
[639] Readhead (2016a) 1.

companies paid only USD 11 million in mining royalties.[640] At the core of South Africa's predicament is the valuation of diamonds by the state – in the form of both the government valuator and customs – and the country could benefit from building capacity in this area, or alternatively explore the feasibility of a carat tax.

The extractive sector in most countries consists of a small number of companies (mostly MNEs) that generate high revenues. Whilst this has the potential to make the sector vulnerable to corruption, it nevertheless provides opportunity for substantial increases in tax revenue, if tax administration for this small number of taxpayers is improved. In this regard, political will to reform the tax administration is essential, if tax revenues are to be increased in the extractive sector. The next Chapter deals with corporate structuring by MNEs and risks associated with transfer pricing and trade mispricing. Chapter 8 covers some of the vulnerabilities of the extractive sector to corruption and related crimes.

[640] Sharife (2014).

CHAPTER 7:
CORPORATE STRUCTURING AND PRICING: CONSIDERATIONS FOR THE DIAMOND VALUE CHAIN

7.1 Introduction

Much of the discussion on IFFs relates to trade mispricing and transfer pricing. Various studies indicate that developing countries are losing billions in USD as a result of trade mispricing[641] and through transfer pricing practices by MNEs.[642] A particular concern raised in the UNECA Report was the observation that (at the time) transfer pricing units were only in place in three African countries, and furthermore, that African countries are vulnerable to IFFs as a result of transfer pricing, if they do not have monitoring capacity in place.[643] This is especially worrisome when one looks at the scale of multi-national activity world-wide. The United Nations Conference on Trade and Development (UNCTAD) estimates that multi-nationals' foreign affiliates contribute an estimated USD 730 billion to government budgets in developing countries annually.[644] This, according to UNCTAD, represents, on average, 23 per cent of total corporate contributions and 10 per cent of total government revenues, although the relative size of contributions vary both by country and by region. UNCTAD points out that the relative size is higher in developing countries than in developed countries, which underlines how dependent and exposed developing countries are to corporate contributions.[645] This exposure is also reflected in the fact that African countries are dependent on foreign corporate payments for an average of 14 per cent of their budget funding.[646] In addition, MNE tax avoidance practices cause losses in the form of revenue leakage and through "slippage" that is caused by fiscal incentives which are actively supported by governments to attract investment. Estimates of these losses are as high as USD 140 billion per annum.[647]

According to UNCTAD, where a country finds itself on the development ladder, is a good indicator of its dependence on non-tax revenue streams from companies: the lower on the ladder, the

[641] Cobham, Janský & Prats (2014) 12; Kar & Spanjers (2014) 1 and UNCTAD (2012). UNCTAD defines trade mispricing as "the falsification of the price, quality and quantity values of traded goods for a variety of purposes."
[642] For example, the UNECA report and the studies by GFI estimate that cumulative illicit outflows from the continent over the 30-year period ranged from $1.2 trillion to $1.4 trillion (or between USD 50 and USD 70 billion per annum).
[643] UNECA (2012) 27.
[644] UNCTAD (2015) ix, 179.
[645] UNCTAD (2015) ix.
[646] UNCTAD (2105) xiii.
[647] UNCTAD (2015) 178, 203.

higher the dependence.[648] This dependence is also reflected in the revenue streams from foreign companies, which can be double the revenues generated from corporate taxes.[649]

It is well established that multi-nationals conduct cross border investment through a range of corporate structures, in a manner that is most tax efficient.[650] When looking at tax avoidance practices from an investment perspective, the role of special financing of vehicles and offshore investment hubs, stand out. In this regard UNCTAD estimates that 30 per cent of cross-border corporate investment stocks are directed through offshore hubs, before ending up as productive assets at their destination. Other tax avoidance options utilised are the tax rate differentials between jurisdictions, different legal systems and tax treaties.[651] UNCTAD's simulation indicates that the amount of corporate profits shifted from developing economies is an estimated USD 450 billion and, at a weighted average effective tax rate across developing countries at 20 per cent, annual tax revenue losses of approximately USD 90 billion can occur.[652]

The links between cross-border investment multi-nationals and tax policy have become increasingly significant to both multi-nationals and governments. UNCTAD[653] ascribes the significance thereof to the following:

- The attractiveness of a destination for investment is influenced by tax considerations;
- Fiscal incentives and tax rates are policy tools which are used to promote and attract investment;
- Value add to the economy is experienced, once investors are established, in the form of an increase in the tax base and through both direct and indirect fiscal contributions;
- There are opportunities for arbitrage and tax avoidance due to the way that MNEs are set up and by the nature of their international operations.[654]

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648 UNCTAD (2015) ix. The interest of governments in multi-nationals' tax affairs is not surprising, given that 51 of the 100 largest economies in the world are corporations. The Top 500 multi-national corporations account for nearly 70 per cent of the worldwide trade with this percentage steadily increasing. It is pointed out that "over the past three decades, the number of multi-nationals has risen tenfold, from a modest 7,258 in 1970 to nearly 79,000 by 2006, because multi-nationals are the most successful form of business organization, largely due to inherent advantages in the access to crucial knowledge and processes and in the ability to secure economies of scale" (Leite 2012:236; Fuest & Riedel 2012:112).
649 UNCTAD (2015) IX. For instance, revenue generated through tariffs, levies, PAYE, royalties on natural resources and social contributions.
650 UNCTAD (2015) ix.
651 UNCTAD (2015) ix, 190.
652 (2015) 200.
653 (2015) 176.
654 UNCTAD (2015) 176. "Government authorities have long recognized that transfer prices can be used by MNEs to avoid or evade national regulations. For example, by setting a transfer price above or below the market price for a product and shifting profits to an affiliate taxed at a lower rate, an MNE can reduce its overall tax payments and achieve a higher after-tax global profit relative to two firms that do not have such an affiliation arrangement. Because the goal of the company is to maximize shareholder wealth and because transfer pricing can raise the MNE's after-tax profits on a worldwide basis, transfer pricing is a valued activity for the multi-national" (Eden 2012:207-209).

For developing countries, IFFs can have a serious impact on sustainable development prospects, and tax avoidance is responsible for a significant leakage of development financing resources. In moving the debate on multi-nationals and base erosion and profit shifting (BEPS) forward, UNCTAD provides a different perspective on how to approach international taxation and multi-national tax avoidance schemes, by integrating mainstream approaches of the BEPS project with an investment-based approach. This approach emphasises the enablers of most BEPS schemes, such as corporate structures that are in the channelling of FDI through offshore investment hubs and offshore centres (OFCs). In essence, corporate structures built through FDI can be considered "the engine" and profit shifting "the fuel" of multi-national tax avoidance schemes.[655]

UNCTAD poses three critical questions in moving toward a solution. These are:[656]

a) Can a value determination be made of the MNE foreign affiliates' contributions to government revenues to inform tax policy actions to address tax avoidance?
b) Can a trend be observed in as far as international investment flows drive MNE tax contributions and tax avoidance opportunities?
c) On balance, can the net fiscal contribution of MNE activity be determined and what does this mean for the relationship between tax and investment policy?

Some of these questions are addressed in the form of initiatives such as the Extractive Industry Transparency Initiative (EITI), that aims to provide transparency on the profits generated by a mining company and the revenues received by the state. However, countries can benefit from further understanding of avoidance strategies and how inappropriate investment agreements can fuel such strategies. The manner in which corporates are structured, forms part of that understanding.

7.2 Corporate Structuring

A historical perspective on the structure structuring business operations in a way which reduces tax liabilities was already found in ancient Greece.[657] Sea traders circumvented a 2 per cent tax on imported goods, which was imposed by the city-state of Athens, by using specific locations at which to deposit their foreign goods. [658] In ancient Rome, farmers would abandon their land and flee to the city of Constantinople, which was an early tax haven. In the Middle Ages, Hanseatic traders who set up business in London were exempt from tax and, during this time, some men

[655] UNCTAD (2015) 188.
[656] UNCTAD (2015) 178.
[657] Gorvett (2016).
[658] Gorvett (2016).

had resorted to joining monasteries, thereby resigning themselves to a life of servitude, not out of religious devotion, but out of the desire to avoid paying tax.[659] In the 1700s, the colonies of America used Latin America as a trading base to avoid British taxes.[660]

Corporate structuring can entail securing tax-based advantages. In practice, various steps to minimize the tax burden can be legally taken, such as relocating production, development and/or administration centres. Leite explains that with shifts in assets, functions and risks, shifts in relation to profits will also occur, especially toward countries which have an environment that is geared toward profit maximisation.[661] The shifting of profits, in line with shifts in assets, risks and functions, makes up the essence of tax planning[662] The related financial flows could, in this context, not be considered illicit. However, shifting profits without a business justification is clearly illegal and should, according to Leite, be considered illicit.[663] Gonnet argues that the revised OECD Transfer Pricing Guidelines[664] which focus on risk definition and allocation, may be useful to tax authorities when challenging abusive or extreme arrangements where risk follows neither the functions nor financial capacity.[665]

For tax purposes, the profits of a multi-national have to be allocated to the individual jurisdictions where the company files for income tax. This is done by means of separate accounting, whereby each entity (subsidiary or permanent establishment) of the MNE individually calculates the income it has produced.[666] In principle, transactions between different entities of a multi-national (controlled transactions) should be treated as transactions with third parties (uncontrolled transactions).[667] However, multi-nationals can use controlled transactions to move income across different jurisdictions. Income is typically moved from high tax jurisdictions to low tax jurisdictions through transfer pricing practices. The concept of “income shifting” raises the question of whether a true or objective distribution of profits can be identified.[668] For reasons such as joint use of resources specific to the company (for example, brand name and company specific expertise) and the difficulties in assigning an appropriate price to such resource flows, achieving this can be complicated.[669]

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659 Gorvett (2016).
660 Leite (2012) 245.
661 (2012) 245.
662 Leite (2012) 245.
663 Leite (2012) 245.
664 As mandated by Actions 9 and 10 of the BEPS Action Plan.
665 Gonnet (2016) 35, 38.
666 Fuest & Riedel (2012) 112.
667 Fuest & Riedel (2012) 112.
668 Fuest & Riedel (2012) 112.
669 Fuest & Riedel (2012) 112.

Fuest and Riedel indicate that empirical work in the area of income shifting uses two types of approaches to explore the extent to which companies shift income to exploit tax differences across jurisdictions. The first approach looks at the tools used for profit shifting, for example, transfer pricing, the location of intangible assets and income shifting through debt.[670] With regard to the latter, the question asked is "whether, all else being equal, multi-nationals use more debt in high tax jurisdictions relative to low tax jurisdictions."[671] The second approach focuses on the result of tax-induced profit shifting, by looking at the overall profits of multi-nationals' subsidiaries in different countries.

Both approaches provide estimates on the marginal impact of tax differences on income shifting behaviour, and under certain assumptions, such estimates can be useful for purposes of calculation of the hypothetical profit distribution between countries which would occur if there were no tax differences.[672] According to Leite, the existing literature on the impact of transfer pricing abuses on developing countries does not provide enough evidence of the extent of income shifting and the role of transfer pricing manipulation. In addition, existing literature does not provide enough insights on the possible illicit components of the underlying transactions.[673]As a solution to address IFFs, he suggests expanding the use of the arm's length provisions, and for developing countries to engage in better information sharing practices between tax administrations.[674]

The economic nature of corporate groups is essentially driven by internal organisation of transactions, which allows for reduction of market costs. Companies can adopt different governance structures which blend together hierarchy and contract principles, depending on the transactional considerations which are at stake. The primary objective is therefore to achieve structures that are transaction-cost economizing. Correia further describes the corporate group as a hybrid of market and organization, which replicates within its internal boundaries the structures of both firm and market.[675] Transfer pricing is illustrative of the complexity of finding assurances that tax authorities, often competing with each other, get their fair share of revenue, but also that corporate entities are not double taxed.[676] The legal framework for accommodating this complexity and for providing international consistency, is the arm's length principle.[677] The arm's length principle is "a simulation of the market mechanism and sets the transfer prices as if

[670] A typical tax avoidance scheme is to use special purpose entities to "channel funds through intra-company loans to third-country affiliates" of the multi-national. The underlying rationale of this practice is "to generate an erosion of the tax base in the recipient (high-tax) jurisdiction, with profit shifted to low-tax locations in the form of deductible interest payments." (UNCTAD 2015:190).
[671] Fuest & Riedel (2012) 112.
[672] Fuest & Riedel (2012) 112.
[673] (2012) 235.
[674] Leite (2012) 236.
[675] Correia (2013) 82.
[676] Leite (2012) 235.
[677] Leite (2012) 235.

the transactions had been carried out between unrelated parties, each acting in its own best interest."[678] Procedurally, effective application of the arm's length principle, requires that bilateral tax treaties are in place, together with mutual agreement and competent authority procedures. These procedures should provide a basis for principled negotiations and timely resolutions between the tax authorities on different sides of each transaction.[679]

The arm's length principle is described as a fact-intensive and judgment-based system at the implementation level.[680] A range of acceptable process is reached through benchmarking of comparable transactions and any point inside such a range is consistent with arm's length pricing. Within this context, choosing (whether in response to tax objectives or otherwise) higher or lower prices within the arm's length range of prices, cannot be interpreted as anything other than a legal practice or as tax avoidance.[681] Similarly, moving income from one jurisdiction to another, in a way that is in line with a shift in assets, functions and risks, cannot be interpreted as anything other than a legal way of business restructuring.[682] In the context of a transfer pricing system based on the arm's length principle, income shifting could be considered as illicit, to the extent that it is not in line with a shift in assets, functions, and risks.[683]

With reference to the arm's length principle, the authors of the UNECA Report observed that verification of the correct application of the arm's length principle is not an easy matter for African countries that do not have transfer pricing units, or where they have units, they may not be functioning optimally.[684] Also highlighted in the report is that huge and costly database/s and a high level of expertise are required, due to the difficulties and complexities of ensuring compliance with the arm's length principle. Lastly it concludes that the arm's length principle does not provide remedies with regard to trade in intangibles and services, in as far as establishing that the correct prices are used.[685]In Chapter 6, it is pointed out that alternative approaches to the arm's length principle are available, but that these have not gained traction for various reasons, for example, the approaches are generally developed by global standard-setting organizations.[686]

Action 6 of the BEPS Action Plan[687] is aimed at treaty abuse, specifically in relation to hybrids and permanent establishment. Regarding the latter, the OECD recommends that abuses can be

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678 Leite (2012) 238.
679 Leite (2012) 239.
680 Leite (2012) 239.
681 Leite (2012) 256-257.
682 Leite (2012) 256-257.
683 Leite (2012) 244.
684 (2012) 45.
685 UNECA (2012) 45.
686 Supra 6.4.3.4. See also page 224.
687 OECD (2013) 19.

prevented if the definition of permanent establishment (PE) is updated. In several countries interpretation of treaty rules pertaining to agency-PE allows for contracts for sale of goods, where those belong to a foreign entity, to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise, without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor.[688] According to the OECD, this has led entities "to replace arrangements under which the local subsidiary traditionally acted as a distributor by commissionaire arrangements"[689] with a "resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country."[690] Similarly, it is pointed out that MNEs can take actions such as fragmenting their operations between a multitude of group entities, in order to qualify for the exceptions to PE status for preparatory and ancillary activities.[691]

Ironically, the seminal case which laid down the requirements of a permanent establishment involved Africa, De Beers and diamonds.[692]

7.2.1 Corporate Structuring in the Diamond Industry

The historical dominance of De Beers in the diamond industry shaped current corporate structuring practices. Functioning effectively as a cartel, its primary objective was to maintain high and stable prices for rough diamonds. It managed this objective by means of supply side measures such as production quotas and the maintenance of large buffer stocks. During the early nineteen nineties, De Beers controlled an estimated 70 per cent of all production and 85 per cent of rough diamond distribution through its ownership of mines, structured finance deals and exclusive supply and marketing arrangements.[693]

The Diamond Trading Company (DTC)[694] traditionally made a selection of between 95 to 160 independent rough stone dealers and manufacturers to become sightholders.[695] This "selection" conferred rights and obligations to purchase rough stones from DTC ten times in a year. The DTC

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688 OECD (2013) 19.
689 HMRC (2016) 18: "Under civil law, a commissionaire can enter into sales contracts in its own name, but on behalf of the principal, where the commissionaire does not usually bind the principal. In theory, the customer cannot sue the principal - there is no contractual relationship between the principal and the customer. The use of a commissionaire is an artificial mechanism to avoid PE status. Other mechanisms are splitting activities and use of PE exceptions."
690 OECD (2013) 19.
691 OECD (2013) 19.
692 De Beers Consolidated Mines, Limited v Howe (Surveyor of Taxes) [1905] 2 K.B. 612.
693 King (2008) 68.
694 The DTC is now known as the De Beers Global Sightholder Sales (DBGSS).
695 Sightholders or "Sights" are customers of De Beers to whom De Beers, through its selling arm (DBGSS), sells rough diamonds through term contracts. Approximately 90 per cent of De Beers' rough diamonds are sold to these sightholders. There are approximately 200 sightholders from countries such as Belgium, Israel, China, India and the United States (De Beers: not dated).

sorted rough stones into approximately fourteen thousand categories and combined its production and that of its partners into a series which contained an assortment of stones which varied in size, colour and quantity. While sightholders were permitted to view the series, they were in effect obligated to buy the proffered boxes. The DTC unilaterally determined the value and price of each series and required payment in cash prior to delivery.[696]

In recent years De Beers' role in the upstream market has diminished considerably, due to various factors such as the provisions of US anti-trust laws, the discovery of deposits in Canada, the rapid growth of diversified mining groups such as Rio Tinto and BHP Billiton, country legislation requiring the growth of domestic diamond manufacturing and changes in forward and backward integration.[697] In response, De Beers consolidated its influence via demand side measures such as inducing retail jewellers to enter into exclusive supply arrangements, the creation of the De Beers *Forevermark* brand and the subsidizing of sightholders' parallel efforts to create value brand names and unique propriety designs.[698]

In addition to exclusive supply chain agreements, sales can also happen in the following ways:

a) By tender: bids are solicited from prospective buyers by providing them with preliminary valuations and descriptions of the parcels on offer, whereafter the parcels are sold (generally as a cash transaction) to the highest bidder.
b) Selling to a regular group: this process is similar to the DTC sightholders system, where residual production is sold to a number of designated dealers and manufacturers. In contrast to the DTC single channel marketing model, these transactions are not governed by a formal sales agreement;[699]
c) On a commission basis through agents or dealers.[700]

Product differentiation or branding is quite new to the diamond industry, due to De Beers' historic near monopoly on the supply of rough diamonds. De Beers was successful in binding the various segments of the diamond value chain together, by means of its mine ownership, a supplier of

[696] King (2008) 69.
[697] The jeweller Tiffany & Co, Inc. decided to integrate backwards into production through a stake holding in Diavik Diamond Mines Inc., which reduced its demand for rough diamonds channelled through the DTC sight holder platform. Aber Diamond Corporation, a part owner of Diavik, purchased a prominent US retail jeweller in 2003 thus integrating forward from production to retail sales and bypassing the DTC's single marketing channel. In 2004 De Beers Centenary AG submitted to US jurisdiction and pleaded guilty to charges of price fixing of industrial diamonds
[698] King (2008) 69 – 71.
[699] In early 2016 De Beers announced that the sight holder system would be changed to accommodate volatile market conditions. Given the expected volatility in their markets, they would "restructure global sight holder sales so we can sharpen our focus on customer relationships and on product and service delivery. This will improve our responsiveness and provide all our businesses with the best insulation against those challenges that remain outside of our control." Reported by http://lexis.hosted.inet.co.za/inews/news/story/3d3fa3c9-d23b-4e9f-8ea9-116802df00d4/withrelated/4. (Accessed on 20 January 2016).
[700] King (2008) 71- 72.

choice programme, exclusive rough diamond supply agreements with other producers, and its promotion of exclusive polished diamond supply arrangements between sightholders and retailers.[701] Newer incumbents in the industry have followed this approach to a large degree, as all players in the value chain (miners, wholesalers and retailers) benefit from the development and maintenance of the same brand names and designs.[702]

7.2.2 Pricing

Pricing of extractives generally involves reference to posted prices that are publicly available. A posted price, however, is only the starting point to determine fair market value and it is therefore to consider other factors such as variances in physical composition, the geographic distance between mine and market and the contractual terms under which the commodity is sold. According to Durst, the fair market value of a commodity can be greatly influenced by the length of the contract under which it is sold.[703]

There are no publicly available price benchmarks for rough diamonds in the primary (direct from the producer) or secondary[704] markets and, with approximately fourteen thousand sorting categories for pricing of rough diamonds, there is considerable scope for variation.[705] In this regard, King cites the example of independent assessments of two rough diamond samples mined from the same kimberlite pipe in Canada, which revealed an average range of between USD 77 and USD 58 per carat on the one sample, whilst the other sample values ranged from USD 35 to USD 32.[706] The respective samples reveal a 25 per cent and an 8.5 per cent discrepancy between the upper and lower bound value. In fair market valuations, these discrepancies may not be surprising, given the wide range of variables which influence value, namely weight, crystalline structure, the estimated final weight (of the polished stones which a rough stone can potentially yield) and the perceived demand for each category of stones at particular points in time.[707]

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[701] King (2008) 73, 74.
[702] King (2008) 74.
[703] Durst (2016) 10.
[704] The secondary market for rough diamonds is centred in Antwerp (with trading centres developing and competing in Dubai and India). Antwerp is supplied by mines that have not fully committed their run-of-mine production to specific buyers and by sight holders which are either pure dealers which perform financing, handling and sorting functions, or manufacturers whose allotment exceeds their requirements. In Belgium, diamonds can only be traded legally by members of the Diamond Office, and only Belgian and Luxembourg registered companies can become registered members of the Diamond Office. According to King, "secondary market does not refer to a competitive and transparent auction market where the same rough stones are concurrently offered for sale to a number of buyers; as with primary market transactions, prices in the secondary market are determined by negotiation between individual pairs of dealers, wholesalers and manufacturers" (2008) 76.
[705] King (2008) 75.
[706] King (2008) 75.
[707] King (2008) 75.

According to King, retail and wholesale trades in polished diamonds tend to be negotiated bilaterally. Retail prices are published on a monthly basis in the *Rapaport Diamond Report,* but these are not actual transaction prices, but rather high cash asking prices typically used as a starting point in negotiations.[708] Both rough and polished diamond prices can vary significantly across transactions in similar quality stones. The prices in polished stones of a certain cut vary "with the crown angle, table percentage, florescence in fine colours, clarity and other external factors such as the location of the transaction, the place where the title passes, the method of payment and the credit risk posed by the anticipated transaction."[709] For these reasons, genuine arm's length prices for closely comparable rough and polished diamonds may vary significantly across transactions which take place concurrently.[710]

7.3 Transfer Pricing

The objective of companies is maximizing shareholder wealth, and transfer pricing is a valued activity for MNEs, because it can raise the MNE's after-tax profits on a worldwide basis.[711] In the context of financial and commercial relations and transactions, the price of goods and services is ordinarily determined by market forces, however, when associated enterprises transact with each other, they may not be affected by market forces in a similar manner to unrelated parties.[712] Transfer pricing is therefore an important issue for MNEs in view of ever changing government regulation which requires substantiating documents and penalises failure to keep such.[713] Bird and Wilkie provide the following insight on the challenges of transfer pricing to tax policy: [714]

> "The transfer pricing issue in tax policy is concerned with detecting when such dealings cross justifiable economic limits and in effect become devices to redefine and shift 'profits' to where tax is least. Since there is no international tax system as such, in effect the artificial subdivision of economic units into legally separate accounting units results in a process of fiscal self-help, as economic actors mix and match elements of the different tax systems facing them, until their tax cost of doing business is comparable (or lower) to that of their competitors."

708 King (2008) 75.
709 King (2008) 77.
710 King (2008) 77.
711 Eden (2012) 209.
712 OECD (2017) 34.
713 Eden (2012) 209.
714 Bird & Wilkie (2012) 25.

In the context of the global rough diamond trade, transfer pricing can be linked to both over and under valuation.[715] According to the FATF, it is also possible to use the same scheme for money laundering purposes, because the combination of a lack of transparency in the diamond trade and a lack of transparency in a free trade zone, can contribute to an environment wherein large volume transactions can be conducted without detection.[716] Whilst the Kimberley Process requires that all KP certificates state the value of each package of diamonds in any shipment, transfer pricing remains a real risk at several points in the supply chain. The most relevant from a transfer pricing perspective, are duty free zones.[717]

7.3.1 Transfer Pricing Methodologies

OECD member countries have agreed that the arm's length principle informs the international legal framework:

> "to achieve a fair division of taxing profits and to address international double taxation, transactions between connected parties should be treated for tax purposes by reference to the amount of profit that would have arisen if the same transactions had been executed by unconnected parties." [718]

The arm's length principle is applied to a controlled transaction by hypothetically replacing the actual terms, such as the price, under which a transaction was concluded, with arm's length terms and recalculating the profits accordingly for tax purposes. Under the OECD *Transfer Pricing Guidelines for Multi-nationals and Tax Administrations*, five sanctioned transfer pricing methodologies are provided for, namely the comparable uncontrolled price (CUP) method, the resale price method, the cost plus method, the transactional net margin method (TNMM) method and the transactional profit split method.[719]The main transfer pricing challenges in the mining industry relate to management and procurement services, inter-company debt and marketing

[715] Diamonds are assigned a low value in the country where they are mined by the exporting company; over valuation occurs when a company, operating in a low or no-tax jurisdiction, over valuates diamonds when it sells them to another group company in a higher tax jurisdiction.
[716] FATF (2013d) 61.
[717]MNEs in all industries establish hubs in tax haven jurisdictions that serve as intermediaries in buying services and intangibles from members of the MNE group and reselling them at a tax shielded profit to other members of the group. Durst (2016) 12 indicates that under a hub arrangement the MNE group has a strong incentive to overstate the value of serves and goods because the taxable income of the subsidiary that pays of the goods and services is reduced and the hub company's profit on the buying and re-selling of services within the group are sheltered from taxation. Coincidently, free trade zones are also identified by the FATF (2013)61 as most vulnerable to money laundering in the diamond value chain.
[718] The arm's length principle is endorsed by the OECD and enshrined in Article 9 (the Associated Enterprises Article) of the OECD Model Tax Convention on Income and on Capital (usually referred to as the OECD Model Treaty or Model Convention).
[719] OECD (2017) 101.

arrangements.[720] In assessing transfer pricing risks relating to commodities, the CUP method is generally endorsed for commodities that have a publicly quoted price.[721]

The transfer pricing guidelines are however, viewed by Durst, as insufficient because of the number of uncertainties contained therein. The result is that taxpayers more often than not, resolve the uncertainties in their favour that results in substantial erosion of tax revenue. Morgan finds that the guidelines contain contradictions for example:

> "the principle looks at the transactions between entities that form part of an organisation to assess whether they have price determination characteristics that one would expect based on a market situation. There is an immediate contradiction here. If intra-firm transactions are intended to reduce transaction costs because of the internal nature of the relation, but the test of those transactions are based on a principle that the values ought to reflect distanced market relations, then the very form of the principle is incoherent from the point of view of theory of the firm."[722]

As is shown in the case study below, the diamond industry presents several challenges to the application of the transfer pricing methodologies because of uncertainties as highlighted below.

7.3.2 Transfer Pricing Case Study

The World Bank identified a growing trend of fragmentation of MNE supply chains by means of complex structures of subsidiaries.[723] This results in high volumes of cross-border transactions between related parties and has the effect of shifting taxable income from the country where mining takes place to foreign jurisdictions.

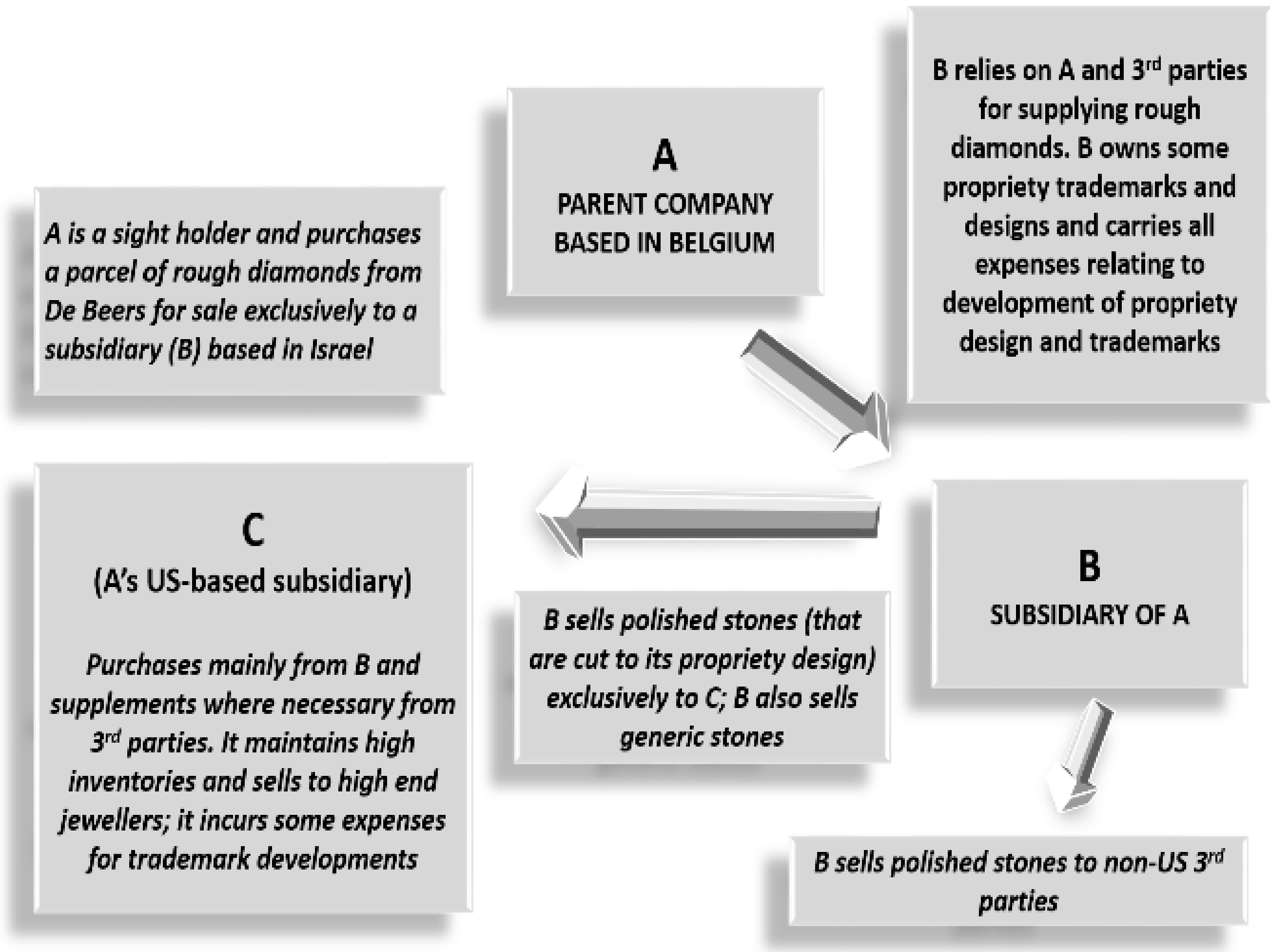
Durst finds that the vulnerability of income based taxes to avoidance by understating the product prices is greatly magnified by tax planning practices adopted by MNEs involved in the extractives. This is so because companies that are part of MNE "virtually never sell a product from a mine directly to unrelated purchasers in transactions in which actual market prices can be observed."[724]What happens is that the commodity is first sold to a captive marketing company established in a tax haven country where the marketing company's profits are not taxed.[725] Thereafter the captive marketing company onward sells the commodity at a tax sheltered profit. The sale can be to either an unrelated trading or refining company or to another subsidiary in the MNE group. Although the commodity is typically not physically delivered to the marketing

[720] Readhead (2017) 3.
[721] Readhead (2017) 7.
[722] Morgan (2016) 466.
[723] Guy *et al* (2017) 18.
[724] Durst (2016) 11.
[725] Durst (2016) 11; Sharife & Bracking (2016) 558.

company, it takes legal ownership of the commodity and is afforded recognition for tax purposes.[726] The critical issue therefore is that the price at which the commodity is sold from the mine to the captive company, is not an arm's length market determined price but a controlled price set by the MNE. The net result is that tax in source country is avoided.

The case study below is illustrative of the complexities of the diamond trade and the transfer pricing issues arising in this environment. The diagram reflects a three-member controlled group that is in the business of buying rough diamonds, cutting and polishing design and reselling at the wholesale level. Relevant transactions are reflected on the diagram and the fact pattern provided follows below:

Figure 7.1: Case Study Transfer Pricing



Source: King (2008)[727]

[726] Durst (2016) 11.
[727] In *Transfer Pricing and Corporate Taxation* 5.1.5.

Company A is a sightholder which purchases pre-sorted parcels of rough diamonds 10 times per year from DBGSS.[728] Each parcel is valued between USD 25 to USD 35 million. The DBGSS expects in advance cash payment. Company A finances its purchases of rough diamonds by means of a combination of equity capital and credit facilities available to it. All of the stones purchased are sold to Company B, and Company B cannot return the stones (Company A therefore bears limited market risk).

Company B is a company which employs 50 people and owns all intangible property of the group. Its businesses is buying rough diamonds from Company A and third parties, cutting and polishing and sales. These functions entail:

- Sorting the rough stones to determine which stones should be sold as rough or polished;
- Making arrangements with third party manufacturers in Israel and other countries for cutting and polishing;
- Sorting polished stones by colour, clarity and carat;
- Maintenance of stocks;
- Performing logistics such as shipment, stocking, import and export of rough and polished diamonds;
- Marketing and sales of stocks of rough and polished stones to Company C and third parties.

Company B retains all rights, titles and interest in the rough diamonds throughout the cutting and polishing processes, and bears all related risks (excluding shipment shortages or damages to the stones caused by the cutters). Cutters are responsible for cutting and polishing according to the specifications provided by Company B; packaging for shipment; maintaining quality standards and maintaining comprehensive all risk insurance. Cutters are paid a fixed fee per carat.
Company C has royalty free rights to use the trademarks owned by Company B and in line with the function of intellectual property in the diamond industry, Company C has built on Company B's trademark and property designs to ensure exclusive marketing arrangements with key US retailers. These arrangements benefit both entities by ensuring demand levels for polished stones.

From the information provided there are three important transfer pricing issues, namely:

- Company A's pricing of rough diamond sales to Company B;
- Company B's pricing of generic polished diamonds on sales to Company C;

[728] Formerly known as the DTC.

- Company B's pricing of propriety polished stones to Company C.

From the information related to the case study above (Company A's sales of rough stones to Company B and Company B's sale of generic stones to Company C), the CUP method cannot be considered a viable approach for the following reasons:

- With reference to Company A's inter-company sales, there are several data limitations, in that Company A does not sell rough diamonds to third parties and market prices for rough stones are not published.
- In addition, no two rough diamonds are identical in nature, and adjustments for noticeable differences would be difficult to make in practice.[729]

In as far as the appropriate transfer pricing methodologies are concerned, King provides some guidance as to which is best suited.[730] With regard to the resale price method, she points out that minor assembly that does not add significant value to the diamonds or limited enhancements such as repacking, labelling and final packaging, are acceptable.[731] She cautions, however, that where physical modification (e.g. conversion of rough into polished diamonds) adds significant value, the resale price method cannot be applied.[732] Although Company B acts as reseller of rough stones in the example, its arm's length resale margin on polished stones should exceed its resale margin on rough stones, because it does not sell rough stones to affiliated companies. King concludes that in the absence of reliable third party resale data on polished stones, the resale price method will not be applicable to Company B.[733]

The cost-plus method (to establish Company B's arm's length prices on sales of generic polished stones to Company C) cannot be applied, because Company B's inventory of rough stones is commingled, and therefore mark-ups on diamonds sourced from both affiliated and independent suppliers cannot be determined.[734]According to King,[735] the same difficulty will be encountered with the profit based method, because the mark-up on the diamonds cannot be determined.

The Comparable Uncontrolled Price (CUP) method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services

[729] King (2008) 79-80.
[730] King (2008) 79.
[731] King (2008) 79.
[732] King (2008) 79.
[733] King (2008) 79.
[734] King (2008) 80.
[735] (2008) 80.

transferred in a comparable uncontrolled transaction in comparable circumstances.[736]In the given scenario there are numerous individually negotiated arm's length prices for similar (albeit not identical) stones, but not a market price for diamonds.[737] Since the transaction prices are not published, the only way to apply the CUP method in this scenario could potentially be with reference to internal comparables of uncontrolled prices and ranges of arm's length prices.[738] According to King, "categories of sales are defined by certain ranges of cut, quality and colour. Within these ranges, quality gradients are considered moderate."[739] Thus, variation percentages (e.g. 5-15 per cent) for stones included in the same internal category, sold to the same third party on the same date, can be determined. Whilst this is inexact, it does serve as an indicator that similar diamonds will sell at a similar price.[740] According to the World Bank, comparable uncontrolled prices for rough coloured stones are hard to obtain and are largely unreliable.[741]

Sharife and Bracking argue that diamonds, in contrast to other minerals, only have "an internally imputed pricing system that has no international or free market measure" against which it can be compared by volume and value.[742] Because of the presence of this system, Sharife and Bracking find that capital holders who control marketization of diamonds, can as a consequence, condition prices for diamonds and taxes.
In the customs domain, the arm's length principle is applied as:

> "a principle of comparison between the value attributable to goods imported by associated enterprises, which may be affected by the special relationship between them, and the value for similar goods imported by independent enterprises."[743]

Whilst there may not be an alignment of customs and transfer pricing valuation methodologies, the customs valuations are useful in "evaluating the arm's length character of a controlled transaction transfer price and *vice versa*."[744] The OECD[745] points out the particular importance of up to date transactional information that could be relevant for transfer pricing purposes, which is held by customs officials. Taxpayers may have competing incentives in setting values for customs and tax purposes.[746] A taxpayer importing goods or services may benefit from lower customs duties, if he sets a low price of the transaction for customs purposes, whilst a higher

736 Supra 7.3.1 (i).
737 King (2008) 80.
738 King (2008) 80.
739 King (2008) 80.
740 King (2008) 80.
741 Guj (2017) 139.
742 (2016) 557.
743 OECD (2015c) 41.
744 OECD (2015c) 41.
745 (2015c) 41.
746 OECD (2015c) 41.

price paid for the same goods or services could, for tax purposes, increase the deductible costs in the importing country. To address these problems, countries can benefit from closer cooperation between tax and customs agencies in evaluating transfer prices in order that the instances of unacceptable valuation practices can be reduced. Countries that have separate customs and tax administrations could consider measures to improve information flow between different administrations such as a modification of exchange of information rules.[747]

To overcome the challenges in accessing tax information from offshore companies, tax administrations need to engage their counter-parts in other jurisdictions to, for example, obtain third party sales agreements from marketing hubs for comparison against the terms and conditions related to the sale/purchase of a mine's future production. The instruments to enable such an exchange include:

- Legislation: can allow for (a) requiring taxpayers to keep and maintain, in addition to a local file, a master file [748] and (b) for assigning the burden of proof in transfer pricing cases to the taxpayer instead of the tax administration;[749]
- Multilateral Agreements: by joining the OECD Convention on Mutual Administrative Assistance and/or the ATAF Multilateral Agreement on Mutual assistance in Tax Matters, automatic exchange of information and assistance in collection of taxes, is possible.[750]
- Cooperative Compliance: government and mining companies need to develop objective valuation mechanisms (e.g. valuation matrix) to define the relationship between transfer prices of rough diamonds and cut and polished diamond sales to allow for progressive adjustments to transfer prices that reflect movements in cut and polished diamond sales and their related margins.[751]
- Joint investigations and audits: by joining initiatives such as Tax Inspectors without Borders (TIWB)[752], countries can build better cooperation on tax matters and contribute to domestic resource mobilisation.

[747] OECD (2015c) 41.
[748] For standard information that relates to all the members of the MNE whilst the local file makes specific reference to material transactions that take place in the local tax jurisdiction.
[749] Readhead (2017) 10.
[750] Readhead (2017) 10.
[751] Guj *et al* (2017) 134. In the case of Argyle mine in Australia, the company supplied their valuations to government but they were hesitant to disclose the realised sales values of their foreign cut and polished pink diamonds. The government diamond valuator, in assessing the values of the rough stones, imputed costs and margins derived from market intelligence to downstream processes. This resulted in huge discrepancies between values assigned by government and by the company. To resolve these discrepancies the minister deemed the values assigned by the government valuator to be the correct base for levying royalties.
[752] A joint OECD and UNDP programme that supports countries with building tax audit capacity.

7.4 Trade Mispricing

The wide definition of the term IFF includes (a) abusive transfer pricing between subsidiaries of the same group for the purpose of tax avoidance; (b) tax evasion; (c) money laundering; (d) bribery and (e) manipulative trade mispricing. Trade mispricing can be defined as the practice wherein "export or import documents carry false prices, which may be important, both as a source of tax evasion and as a channel for movement of illicit funds."[753] In contrast to transfer pricing, trade mispricing involves transactions between "formally unrelated parties."[754] Trade mispricing entails that importers overstate import costs, whilst exporters may understate the export revenue on their invoices (either by manipulation of figures for price and quality or quantity). The balance is paid into a trading partner's account (usually in a foreign jurisdiction).[755] According to a Raymond Barker study, profit shifting and transactions amongst unrelated parties are estimated to account for 60 to 87 per cent of total IFFs which arise from legal commercial activity..[756]

False declarations or trade mis-invoicing is a method for shifting funds illegally across borders. It entails deliberate misreporting of the value of a commercial transaction on an invoice submitted to customs. Global Financial Integrity (GFI) views trade mis-invoicing as a form of trade-based money laundering, and it constitutes the largest component of IFFs as measured by GFI.[757] Trade mis-invoicing allows for the laundering of proceeds of crime; evasion of duties; unlawfully claiming tax incentives and evading capital controls.

According to Nitsch,[758] discrepancies in trade statistics may be the consequence of intended misdeclaration of trade activities or completely hidden transactions (the latter results in underreported trade that is reflected through official statistics). Unreported trade activities, such as smuggling, affect asymmetries in partner country trade statistics, and fictitious trade inflates statistics artificially. Lastly, misreported trade reflects trade which may be recorded, but the invoices may have been faked.[759]

A GFI study involving East African states found that insufficient data and limited processes for questioning under or overvalued invoices are plaguing efforts of each government to curtail trade mis-invoicing and to reduce the reach of the shadow financial system. The customs authorities are not collecting, or do not have the ability to collect, the data which they need to understand the magnitude of illicit flows of capital due to trade mis-invoicing, or the tax revenue and investment

753 Reuter (2012) 11.
754 Reuter (2012) 13.
755 Nitsch (2012) 309.
756 GFI (2017).
757 GFI (2015).
758 (2012) 313.
759 Nitsch (2012) 313, 314.

capital which is lost as a result. There is a gap in tracking trade flows, whether invoices are altered in different jurisdictions and whether declared values compare to world market norms. Access to company ownership and controlling entities' information may be limited or non-existent in many jurisdictions.[760]

A common problem identified is that customs authorities are hampered by not only the lack of data on trade, tax, and corporate transactions in their own country, but also by the lack of data on international trade. The latter is prevalent across most countries in Africa, as reflected in poor record keeping of contravention and seizure data.

Studies aimed at quantifying the extent of trade mispricing, have examined price anomalies in transactional data or analysed asymmetries in matched partner trade statistics.[761] Nitsch points out that that estimates of trade mispricing are "critically dependent on assumptions on how to interpret observed asymmetries in trade statistics," and that "aggregate trade data may mask considerable variation in trade discrepancies at the transaction level." He concludes that the importance of trade mispricing as a method for unrecorded transfer of capital across borders is generally unclear.[762]

The reasons for asymmetries in trade statistics can vary, and a useful categorization can be between legitimate statistical reasons and intended misdeclarations. Nitsch provides a further breakdown:

a) Statistical

Nitsch identifies the most noteworthy source of discrepancy between the imports of one country and the exports of another, as the "conceptual difference in valuation."[763] This conceptual difference is explained by the fact that exporting countries report the value of goods at the initial point of departure (free on board [f.o.b.]), while the importing countries' values refer to the value at the point of final destination, in which cost, insurance and freight (c.i.f.) are included.[764] Another reason is that where the country of final destination is not known at the time of export, the exporter declares the country of last shipment. In contrast, the country of final destination classifies its imports by country of origin. Statistics whereby import and export statistics are distorted due to the transit through intervening countries, is a subject dealt with by Cobham, Janský and Prats,[765]

[760] GFI (2014) 2.
[761] See for instance Kar & Spanjers (2014), GFI; Kar (2015).
[762] (2012) 309.
[763] Nitsch (2012) 312.
[764] Nitsch (2012) 312.
[765] (2014) 350.

and Carbonnier and Zweynert De Cadena.[766] Whilst the former suggests models – relying on difference in trade margin - to estimate illicit financial flows, the latter points out that the assumptions underlying the models may lead to fundamental problems (e.g. assuming price of re-export in relation to the original export of the commodity group remains undistorted) regarding the use of trade margins to estimate IFFs. The authors nevertheless conclude that deeper insights into the actual operations of the traders of the commodity are required, due to the weak reliability of the estimates.[767] Put differently, it means that transaction level data is required to produce best estimates that can inform meaningful counter-measures.[768]

Extensive time lags[769] between the departure and arrival dates of a shipment can be captured in different calendar years.[770] Data capturing in the source and destination countries may value goods at different prices or exchange rates. The recorded trade at the commodity level may also differ, due to the omission of individual transactions in one or more of the partner countries. Certain product groups in a country's trade statistics may also be excluded (typically regarded as national security issues such as military material) and differences in commodity classifications (e.g. regrouping transactions under "other" in Chapter 99 of the Customs Harmonized System) may also result in exclusions.[771]

A last point worth mentioning in relation to statistical reporting is the probability of data captured incorrectly, or not at all, by the relevant administration, which will result in commodities not being accounted for.

b) Fraudulent trade activities

Intended misdeclaration of trade activities can be aimed at completely hiding transactions in under-reported trade or in mispriced invoices.

c) Unreported trade

For unreported trade, activities typically refer to smuggling of commodities which can affect asymmetries in partner country trade statistics, because the transactions have to be recorded by one of the partners.

[766] (2015).
[767] Carbonnier & Zweynert De Cadena (2015) 1, 16.
[768] Cobham, Janský & Prats (2014) 14.
[769] These can be caused by aspects such as temporary storage of the goods in a warehouse, customs delays or delays caused through long distance sea routes.
[770] Nitsch (2012) 313.
[771] Nitsch (2012) 313.

d) Misreported trade

Misreported trade occurs where trade may be captured, but because the invoices are fake, the declared value of a trade transaction deviates from the true value.[772] Explanations for trade mispricing include capital flight (e.g. if exchange restrictions are in place, over invoicing of imports and under invoicing of exports are prevalent ways which explain unrecorded movement of capital out of a country);[773] underreporting of exports (allows companies to obtain foreign exchange that is not disclosed to national authorities which can be utilised by exporters without complying with foreign currency controls and hiding output and exports (authorities may use information on the export activities of companies to infer the production output of such companies).[774]

Considering that trade mispricing can have either a legal or illegal source, it is particularly problematic to determine whether anomalies exist as a result of a deliberate tax fraud or due to statistical errors in reporting. Figures produced by the FATF shed some light on such anomalies which arise in the diamond trade through hubs. More than 80 per cent of global diamond cutting work takes place in India, and most of the diamonds meant for cutting are reaching India through trade hubs in Antwerp, Dubai, Tel Aviv, London, New York and Hong Kong.[775] As such, a company could export a diamond at a low value from a developing country in Africa; the diamond could then enter via a hub such as Dubai, where the importing company assigns a mark-up price and exports it to a related company in another trading hub, cutting centre or polishing centre. No tax is payable in the free trade zones in Dubai, so the company in Dubai makes a substantial non-taxable profit.[776]

In this regard the FATF found that whilst the volumes (carat) imported into and exported from the United Arab Emirates (UAE) are almost identical (60 million carats), the value of the exported rough stones is almost 50 per cent higher than the value of imported rough stones.[777] The same diamonds entering and leaving the UAE are thus sold at a higher price, which can potentially reflect something more than a production value chain mark-up.[778] According to the FATF, a small part of the difference may be explained by a 10 to 15 per cent mark-up in the sorting phase.[779]

[772] Nitsch (2012) 314.
[773] Nitsch (2012) 314.
[774] Nitsch (2012) 314-315.
[775] Russia and India Report (2014*)*.
[776] Amnesty International (2015) 59.
[777] FATF (2013d) 32. The report looks at 2011 and 2012 data. For 2011 the difference was 54 per cent and for 2012 it stood at 39 per cent. For 2013 - 2015 the aggregate price difference from import to export was roughly 33 per cent (for 2015 it is 30 per cent; for 2014 it is 36 per cent and for 2013 it is 35 per cent).
[778] FATF (2013d) 32.
[779] Sorting is the process whereby diamonds are categorised and assigned a value. Diamonds are sorted into parcels in accordance with the valuing criteria of shape, size, clarity and colour - within these categories there are thousands of variants which can affect the price.

There is therefore a 30 to 40 per cent difference which cannot be explained by the normal value chain additions.

The FATF also highlights changes in the export-import to production ratio, which indicates that for the period 2008 to 2013, the ratio between the volumes in USD of rough diamonds exported to rough diamond production has risen by 33 per cent. In this period the rate of export to production in terms of volume (carat) has risen by 27.3 per cent. In the FATF analysis, it is found that the same diamonds are exported and re-exported (at a higher price per carat than the price of carat at the production level) more times in 2013 than was the case in 2008. This analysis shows that diamonds are going through additional hands, and, from an anti-money laundering perspective, it may be an indication that more circular transactions in stones are occurring, which may result from activities related to money laundering or financing of terrorist activity. [780]

7.5 Base Erosion and Profit Shifting (BEPS)

BEPS can be defined as a term encompassing those tax planning strategies which are perceived to be employed by multi-national companies, in order to exploit mismatches or gaps in domestic and/or international tax rules, to artificially shift profits to low tax or no tax jurisdictions, where there is little or no economic activity undertaken.[781] At the heart of BEPS is transfer pricing and transfer price manipulation. The latter is described as a key benefit of multi-nationality, because by over and under invoicing intra company transactions, multi-nationals can take advantage of differences in government regulations between countries.[782]

Global estimates indicate that multi-nationals account for approximately two-thirds of trade flows and half of those are intra-company transactions.[783] This, according to Leite, impacts on international taxation, since some observers have connected weak tax collection in developing countries with the tendency of MNEs to use financial artifices to shift profits around the globe through transfer pricing practices on intra-company trade.[784] The OECD estimates revenue losses from BEPS at between USD 100 and USD 240 billion annually, or four to ten per cent of global corporate income tax (CIT) revenues.[785] Given developing countries' greater reliance on CIT revenues,[786] the impact of BEPS on these countries is particularly damaging.[787]

[780] FATF (2013d) 33.
[781] Deloitte (2016) 3.
[782] Eden (2012) 205.
[783] Leite (2012) 236.
[784] Leite (2012) 236.
[785] OECD (2016b).
[786] According to the OECD this represents, "on average, some 23 per cent of total corporate contributions and 10 per cent of total government revenues."
[787] OECD (2013) 7.

The OECD's Action Plan on Base Erosion and Profit Shifting[788] highlights the impact of globalisation on countries' corporate income tax regimes, and the need for commonly accepted rules that provide certainty and predictability. A key concern is that sovereign countries may not sufficiently take into account the effect of other countries' rules in designing domestic tax rules. This can result in friction between independent sets of rules when these are enforced by sovereign countries. These frictions manifest in the form of potential double taxation for companies operating in multiple jurisdictions, and through the creation of gaps where income is not taxed effectively.[789]

In order to address these shortcomings, countries typically enter into bilateral tax treaties that are based on common standards and which are aimed at prevention of double taxation on profits resulting from cross-border activities.[790] Over time, weaknesses in existing rules created opportunities for BEPS. BEPS relates primarily to occurrences where the interaction between different tax rules leads to double non-taxation, or less than single taxation, as well as arrangements that shift profits from the source countries where the activities take place to achieve no or low taxation for the MNE.[791] The OECD cautions that low taxation is not in itself a cause of concern, but it becomes a concern when it is related to practices that artificially segregate taxable income from the activity that generates it.[792] A multi-lateralism[793] approach was thus endorsed by the G20 leaders to resolve these and other underlying difficulties of the global economy.

In viewing the BEPS' twenty points listed in its action plan, several aspects of what is termed a wicked problem, come to the fore. In fact, a cursory glance at the key BEPS issues which developing countries and international organisations identify[794] as being most critical and of most relevance in moving forward, reveal that each of the six listed[795] meet Rittel's criteria of wicked problems,[796] most notably the criterion of "every wicked problem can be considered to be a

788 (2013) 7.
789 OECD (2013) 9.
790 Several countries are concerned "about how international standards on which bilateral tax treaties are based, allocate taxing rights between source and residence states. The BEPS actions are not directly aimed at changing the existing international standards on the allocation of taxing rights on cross-border income." (OECD 2013: 10).
791 OECD (2013) 10.
792 OECD (2013) 10.
793 BEPS Action 15. Aims to develop a Multi-lateral Instrument to amend bilateral tax treaties.
794 OECD (2014b).
795 The OECD list these as"(1) Base erosion caused by excessive payments to foreign affiliated companies in respect of interest, service charges, management and technical fees and royalties; (2) Profit shifting through supply chain restructuring that contractually reallocates risks, and associated profit, to affiliated companies in low tax jurisdictions; (3) Significant difficulties in obtaining the information needed to assess and address BEPS issues, and to apply their transfer pricing rules; (4) The use of techniques to obtain treaty benefits in situations where such benefits were not intended; (5) Tax loss caused by the techniques used to avoid tax paid when assets situated in developing countries are sold; and (6) Developing countries often face acute pressure to attract investment through offering tax incentives, which may erode the country's tax base with little demonstrable benefit." (The last point is included in the OECD report, not as an integral part of BEPS, but of first order concern to developing countries that impacts on the tax base).
796 Due to reasons such as the difficulty to clearly define the problem; there may be several inter-dependencies and multi-causal aspects; the proposed measures may have unforeseen consequences or effects; the problems may be

symptom of another problem."[797] In the context of the BEPS Action Plan, these are wicked problems which involve causes and effects at multiple scales of time and space, owing to their multi-dimensional and interconnected characteristics. Correcting negative effects can become a wicked problem in itself, for example a too narrow scope in defining BEPS has already shown discrepancies between what the developed and the developing world deems as BEPS to include/exclude.[798] Due to the inherently incomplete understanding of problems, every action can have unpredictable consequences, for example: failure of states to share information will undermine success in the majority, if not all, of the actions. Policy makers are therefore faced with the challenge of balancing tensions between institutional stability and flexibility.[799]

The OECD identifies a variety of high level and sub-level challenges, which require action steps, enablers and responses:

> "Because many BEPS strategies take advantage of the interface between the tax rules of different countries, it may be difficult for any single country, acting alone, to fully address the issue. Furthermore, unilateral and uncoordinated actions by governments responding in isolation could result in the risk of double – and possibly multiple – taxation for business. This would have a negative impact on investment, and thus on growth and employment globally. In this context, the major challenge is not only to identify appropriate responses, but also the mechanisms to implement them in a streamlined manner, in spite of the well-known existing legal constraints, such as the existence of more than 3 000 bilateral tax treaties. It is therefore essential that countries consider innovative approaches to implement comprehensive solutions."[800]

In response to these challenges, the OECD boldly defines the required approach to BEPS as follows:

> "… fundamentally, a holistic approach is necessary to properly address the issue of BEPS. Government actions should be comprehensive and should deal with all the different aspects of the issue. These include, for example, the balance between source and residence taxation, the tax treatment of intragroup financial transactions, the implementation of anti-abuse provisions, including CFC legislation, as well as transfer

unstable and may continue to evolve; there is no clear or correct solution; the problem may be "socially complex with many stakeholders"; the responsibility to address the problem may stretch across many organisations, and lastly, the solutions may require behavioural changes by citizens and stakeholder groups (Rittel and Webber 1973:164).

797 (1973) 164.

798 See below the views of ATAF, the IMF and the South African Finance Minister on scope.

799 Termeer *et al* (2013) 6.

800 OECD (2013).

pricing rules. A comprehensive approach, globally supported, should draw on an in-depth analysis of the interaction of all these pressure points. It is clear that coordination will be key in the implementation of any solution, though countries may not all use the same instruments to address the issue of BEPS."[801]

In addressing the priorities for BEPS for the African continent, the ATAF identified (a) base eroding payments in the form of interest, royalties, management fees, technical fees;[802] (b) treaty abuse;[803] (c) permanent establishment[804]and (d) transfer pricing issues relating to intangibles, risk and capital allocations.[805] From these priorities, the main tax risk areas identified are transfer pricing, treaty issues, interest deductibility and access to information for transfer pricing purposes.[806] However, the ATAF also stipulates additional areas, not included in the BEPS Action Plan, which are to be considered:

- Lack of transfer pricing comparability data;[807]
- The granting of wasteful tax incentives;
- Taxation of natural resources;
- The indirect transfer of assets;
- The informal sector;
- The fraudulent mis-invoicing of trade transactions.[808]

The additional areas identified above correspond with an IMF analysis, which concluded that, due to lower administrative capacity to address BEPS, developing countries are likely to have significantly higher BEPS concerns than developed countries.[809] Furthermore, the South African Finance Minister accepted in 2015 that BEPS is a problem for developing and developed countries alike, but he underscored the following aspects:

> "profit shifting is not the only driver of the erosion of the African tax base. Factors contributing to erosion of the continent's tax-bases are exacerbated when, for instance,

801 (2013) 7-8.
802 BEPS Action 4 and 10.
803 BEPS Action 6.
804 BEPS Action 7.
805 BEPS Action 8 and 9. The 2015 BEPS Final Reports emphasizes the ongoing applicability of the arm's length principle as opposed to "special measures."
806 Monkam (2015).
807 Argentina, Brazil, China, Colombia, India, Mexico, South Africa and Turkey have stated that they have difficulties in obtaining information on the global operations of an MNE group headquartered elsewhere, and would like to require reporting in the country-by-country report of additional transactional data (beyond that available in the master file and local file for transactions of entities operating in their jurisdictions) regarding related party interest payments, royalty payments and related party service fees (BEPS Action 13).
808 Monkam (2015).
809 OECD (2015b) par 35.

> governments sign away their own tax revenues through ill-conceived tax incentives, insufficient tax mix and over-reliance on single source taxation, poorly negotiated contracts and non-transparent concessions (especially in the extractive industry), inadequate taxation of high net worth individuals, the lack of automated systems in tax administration and a disconnect between tax policy and tax administration – which leads to weak policies and legislation and under-resourced tax administrations." [810]

This assessment concluded with the observation that "weaknesses in Africa's tax regimes give away so much of the tax base that some of these new international tax rules may not even matter."[811]

With the OECD Multi-lateral Instrument on BEPS, it is anticipated that provision will be made for the amendment of approximately 2,000 of the 3,000 tax treaties currently in existence, without the need for each treaty to be individually amended.[812] The Multi-lateral Instrument will thus sit alongside existing tax treaties of participating states, modifying those for implementing the BEPS measures, which impact on existing tax treaties, most notably with regard to hybrid mismatches, preventing treaty abuse, preventing PE status avoidance and dispute resolution.

Recognising that not all provisions will be acceptable to every participating state, the Multilateral Instrument includes provisions that a state may opt out of, or choose an alternative option. The default position is that, in such cases, both parties to a particular tax treaty must choose the same option.

Considering the subject matter under review, *BEPS – Considerations for the diamond value chain*, a key question may be: which opportunities for improvement in the diamond value chain can be brought about by the BEPS Action Plan? The KPCS is a key element in regulating the diamond trade, but it lacks credibility. The KPCS's main criticism is that "it has not been able to evolve beyond its initial mandate, in that it has not been able to address broader human rights abuses in diamond mining, illicit financial flows resulting from corruption, tax crimes and smuggling."[813] The FATF also has concerns that "enforcement efforts related to diamonds are directed more at ensuring compliance with the KPCS, rather than preventing the underlying crimes such as smuggling, fraud, tax crimes and money laundering."

[810] Nene (2015).
[811] Nene (2015).
[812] OECD (2016a) 1.
[813] Le Billon (2013)16; Smillie (2013) 1015-1018.

Within this context, Schlenther proposes that the objectives of the BEPS Action Plan, may create some opportunities to improve the KPCS.[814] The BEPS Action Plan highlights that successful action to counter base erosion and profit shifting cannot be achieved without the availability of timely, targeted and comprehensive information, and that prevention implies transparency at different levels. Transparency also relates to transfer pricing and value chain analysis, and a key issue in the administration of transfer pricing rules is the asymmetry of information between taxpayers and revenue administrations, which has the potential to undermine the administration of the arm's length principle.[815] In many countries, revenue administrations have limited capacity in developing a holistic view of a taxpayer's global value chain. In this respect it is important that complete information about the relevant functions performed by other members of the multi-national group in respect of intra-group services and other transactions is made available to the revenue administration. The BEPS Action Plan highlights the need to adapt international standards to prevent BEPS-related activity which results from the interactions between and amongst more than two countries, and the need to fully account for global value chains. The interposition of third countries in the bilateral framework established by treaty partners has led to the development of schemes such as low-taxed branches of a foreign company, conduit companies and the artificial shifting of income through transfer pricing arrangements.

Although the BEPS Action Plan is concerned with tax rules and regulations that aim to prevent abusive practices, the potential exists for its expansion into areas of governance and the broader political economy tax planning. Taxation is described as one of four conditions for good governance, and tax relationships have evolved to become a keystone to good governance. The soundness of this relationship is especially relevant for developing countries that wish to protect the return they get from natural resource extraction.[816]

Should one approach transfer pricing and BEPS as a wicked problem, removal of the underlying cause may resolve the problem. If it is for instance argued that corporate taxation is the reason for harmful transfer pricing and base erosion, then removal of corporate tax will solve the problem. One can also argue that the BEPS measures aimed at making BEPS inspired tax planning structures ineffective, as advocated by the OECD, are not reliant on fundamental consensus on the benefits principle, and therefore the BEPS solution is not correctly informed. The former can be argued under the principles of tax theory, by following the argument that the tax incidence of corporate tax is theoretically borne by individuals (which include shareholders, creditors, employees, suppliers or customers of corporations) and not by an abstraction such as a "company". For instance, Robillard argues that "only people pay taxes. Things and abstractions

[814] (2016) 3.
[815] Schlenther (2016) 3.
[816] Schlenther (2016) 3.

do not pay taxes. A corporation is, in law, a legal person, but that is, in fact, a legal fiction. Therefore, corporations do not really pay the corporate income tax."[817] He continues to state that the proposal to remove the corporate tax addresses the need to (under Action 11) "establish methodologies to collect and analyse data on BEPS and the actions to address it, since most of the countries around the world have already implemented comprehensive processes to address tax avoidance on their territory and tax evasion (which is illegal)."[818]

However, Fuest[819] indicates that even "before starting to think about who bears the tax burden, it is important to take into account that there are different ways in which a corporate income tax can be designed and fitted" and he poses a range of questions in this regard:

> "Firstly, how does the corporate tax interact with the personal income tax? Depending on whether or not corporate taxes are partly or fully credited against personal taxes, the incidence of the tax is likely to differ significantly. Secondly, the corporate income tax can have a narrow or a broad tax base. The design of the tax base will be of key importance for how the tax affects investment. The effect on investment, in turn, will be crucial for the impact of the tax on wages, because investment matters for labour productivity. Thirdly, in an international context, a country may tax the worldwide profits of domestic corporations, providing credits for taxes paid abroad. Alternatively, the tax may effectively be restricted to domestic profits, because foreign source income is tax exempt or the taxation of this income is deferred until repatriation."

In addressing the issue as to whether one type of individual – specifically the shareholder – bears the incidence burden, Fuest points out that because corporate income tax reduces profits, it may be logical to conclude that because the tax reduces dividends, it is therefore borne by shareholders.[820] He states that in the real world, ownership of shares is more complicated due to aspects such as companies being owned by other companies or by health or insurance funds.[821]

817 Robillard (2014) 18-20.
818 Robillard (2014) 22.
819 Fuest (not dated) 12.
820 Fuest (not dated) 4.
821 Fuest (not dated) 4. "If the fund offers a defined benefit plan, a decline in dividends caused by a higher corporate tax may reduce the profits of the institution running the fund. This may be a financial services firm but it may also be a public sector institution. Shares may also be owned by universities or charitable foundations. In this case the burden of the corporate tax would ultimately fall on the donors, the beneficiaries or the employees of these institutions Another complication is that corporate tax changes may affect different groups of capital owners and shareholders very differently. For instance, many tax reforms in recent years have combined a cut in statutory tax rates with a reduction in the present value of depreciation allowances. This type of reform is likely to benefit owners of existing capital or corporations with a large stock of old capital, while it puts a burden on corporations with large investment plans for the future. The reduction or abolition of investment tax credits would have a similar effect."

Avi-Yonah and Xu[822] argue in response to the OECD's view[823] of the measures taken to address BEPS, that these measures are inadequate because the basic problem is that the OECD takes as a given that there is fundamental consensus underlying the international tax regime, also referred to as the benefits principle.[824] According to the authors, the shortcomings of BEPS are directly related to reliance on the benefits principle, because upholding the benefits principle requires cooperation by too many jurisdictions.[825] This is exacerbated by the mobility of MNEs, through the shift from heavy manufacturing to services and intangibles, which results in tax competition whereby countries are pitted against each other in attracting investors.[826]

7.6 Country Specific Tax Policy Considerations

Country specific tax policy measures required to stem IFFs from sub-Saharan Africa. In a study of five African countries,[827] Readhead[828] identifies several major challenges in implementing transfer pricing rules. The first challenge lies in the actual introduction of transfer price regulations into income tax legislation. Whereas inclusion of the concept of the arm's length principle in the income tax law is the first step, regulations, administrative guidance or company-specific advance pricing agreements, to clarify documentation requirements and methods for determining an acceptable transfer price based on the arm's length principle, are required. A second issue of concern is that legislation or agreements which impose taxes on the mining sector do not always refer to generally applicable transfer pricing rules, leaving an ambiguity that could be exploited, or which can lead to unnecessary disputes. Third, assessing transfer pricing in a way that is consistent with the arm's length principle requires data (which may not exist, or may not be available to tax administrations) on comparable independent transactions. Fourth, administratively, revenue authorities are rarely adapted to the efficient implementation of transfer pricing rules. A dedicated transfer pricing unit, the common approach recommended by international organizations, may not be appropriate in developing countries with limited resources,

[822] (2016) 2.
[823] Gurría (2015) "BEPS is depriving countries of precious resources to jump-start growth, tackle the effects of the global economic crisis and create more and better opportunities for all. But beyond this, BEPS has also been eroding the trust of citizens in the fairness of tax systems worldwide. The measures we are presenting today represent the most fundamental changes to international tax rules in almost a century: they will put an end to double non-taxation, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective."
[824] Under the benefits principle, active business income should be primarily taxed at source, while passive investment income should be primarily taxed at residence. The compromise between claims of residence and source was reached in 1923 by four economists and still serves as the basis of the international tax regime. The benefits principle is embedded in more than 3000 bilateral tax treaties and domestic laws of a number of countries. It is also reflected that BEPS to a degree is an attempt to improve source based taxation of active income (Avi-Yonah & Xu 2016:2).
[825] Avi-Yonah & Xu (2016) 2.
[826] Avi-Yonah & Xu (2016) 3.
[827] Ghana, Guinea, Sierra Leone, Tanzania and Zambia.
[828] (2016) 2-3.

a small number of MNEs and internal coordination challenges. Fifth, information and expertise may exist in silos, preventing revenue authorities and the agencies responsible for mining sector regulation from developing a comprehensive picture of transfer pricing risks created by the mining industry and deciding which risks warrant an audit. Related to this challenge is that of accessing taxpayer information from other jurisdictions, which results in the inability to develop a holistic view of a company's global operations for the purpose of investigating transfer pricing risks. Lastly, the political economy of many resource-rich countries undermines the implementation of transfer pricing rules, where the relationship between the mining industry and the political leadership can prevent the systematic implementation of transfer pricing rules.[829]

Table 7.6: Country Specific Tax Policy Challenges

COUNTRY	POLICY CONSIDERATIONS
Botswana	Currently Botswana does not have a transfer pricing regime. The Botswana Unified Revenue Service (BURS) conducts transfer pricing audits under the general anti-avoidance provisions of the Income Tax Act. Introduction of Transfer Pricing rules in the Income Tax Act that can curb aggressive tax avoidance
Ghana	With a large artisanal diamond mining component, the legal framework and development policy requires refining. The diamond mining sector needs to be better integrated with the rest of the economy.
Liberia	Introduce transfer pricing regulations in the Income Tax Act. Establish a dedicated transfer pricing unit
Namibia	Drafting or filing transfer pricing documentation is not mandatory and there is a lack of formal documentation requirements. Limited participation in global fora.
Sierra Leone	Transfer pricing rules are largely untested and practice notes are scarce that clarify what approach to follow in the implementation of the section dealing with transfer pricing in the Consolidated Income Tax Act 2000. Introduce transfer pricing regulations in the Income Tax Act. Establish dedicated transfer pricing unit. Review excessive incentives in the mining sector, e.g. deduction of expenditure.
South Africa	Lack of transparency in the diamond valuation system creates opportunity for transfer pricing throughout the value chain. South African should consider joining the EITI initiative to increase transparency in the sector and/or to retrospectively value previously exported polished diamonds.
Zimbabwe	Ad valorem based tax system can be considered inadequate because it is based on export values that are affected by price fluctuations. This can result in lower tax revenues through transfer pricing practices. Improvements in the beneficiation policy to diversify and develop the sector.

Source: Author Compilation

[829] Readhead (2016) 2-3.

7.7 Conclusion

The BEPS Project is a recognition that the international rules which allow corporate profits to be artificially shifted to low or no tax environments, still contain some gaps.[830] By June 2017, 99 countries and jurisdictions had formally joined the new inclusive framework on BEPS and had committed to implement the BEPS package.[831] Whether developing countries will indeed benefit from the implementation of the BEPS package is still an open-ended question. In sub-Saharan Africa, few countries have the tax capacity to deal with MNEs effectively, and this is exacerbated by aspects such as the mobility of MNEs and the asymmetrical relationship in as far as information is concerned, especially so in the diamond value chain. In addition, the pressures of tax competition, whereby countries are pitted against each other in attracting investors, make the taxation of MNEs a daunting task.

In view of the above, transfer pricing and trade mispricing practices should remain high on the agenda of developing countries and, in addressing these two risks, there are a number of areas of focus for tax administrations, namely:

- Implementation of programmes and mechanisms that require disclosure of critical taxpayer information (e.g. international transactions and foreign bank accounts) and that promote transparency;
- Improved tax governance processes and compliance risk management programmes;
- Improved cooperation in the exchange of information and joint cross border audits with other tax and customs administrations;
- Review of treaty networks and IIAs to determine whether these are appropriate, or whether they create opportunities for tax avoidance protocols. Some have moved to coordinated approaches with other tax agencies, including the conduct of joint audits.
- Building cooperative compliance relationships to address the problems created by asymmetry in information held by business and government.
- Legislative changes such as assigning the burden of proof in transfer pricing cases to the taxpayer instead of the tax administration.

[830] Inclusive Framework on BEPS composition (OECD 2017).
[831] OECD (2016b); Inclusive Framework on BEPS composition (OECD 2017).

CHAPTER 8:

CORRUPTION, MONEY LAUNDERING AND TAX EVASION: THE INTER-RELATIONSHIPS BETWEEN COMMON FACTORS TO ILLICIT FINANCIAL FLOWS IN THE EXTRACTIVE SECTOR

8.1 Introduction

Corruption is described as "a major impediment to sustainable development for mineral, oil and gas producing countries" in Africa.[832] Within the extractive sector, revenue losses at the expense of society are most often due to corrupt acts within all parts of the extractive value chain. Proceeds of corruption are then hidden through money laundering and tax evasion. The purpose of acts of corruption, money laundering and tax evasion are generally aimed at achieving a financial gain in a manner which aims to hide that gain. The obstacles to different government agencies in addressing that objective are the same, namely, a lack of transparency, excessive secrecy and a lack in institutional responsiveness through coordinated action. Due to the impact of corruption, money laundering and evasion on sustainable development, measures to address such acts are necessarily intertwined. From the perspective of IFFs, many bribes result in capital outflows to tax havens, which are useful for hiding embezzled payments or to syphon off revenue intended for the fiscus.

It is shown that an institutional response which recognizes this inter-relationship is more successful in harnessing a cross selection of preventative measures available to government agencies in dealing with these diverse crimes – thus placing institutions in a better position to address IFFs. In this regard, it is worth pointing out that anti-money laundering (AML) is, for example, a major element in the standard list of interventions available to countries with the potential to reduce IFFs, both into and out of developing countries. AML interventions are also powerful tools to address other elements of IFFs, such as corruption and tax evasion. However, this potential is largely dependent on the implementation of the relevant FATF Recommendations, the level of reporting in administrations and the level of inter-agency cooperation and international cooperation.[833]

[832] NEPAD (2001); OECD (2016a) 10.
[833] Domestic inter-agency cooperation and international cooperation are dealt with in detail in Chapters 10 and 11.

Corruption, estimated at USD 40 billion dollar per year,[834] is given as a primary reason for weak economic performance of resource rich countries, because it manifests in rent seeking and patronage.[835] According to Kolstad and Søreide:

> "resource rents induce rent seeking, as individuals compete for a share of the rents rather than use their time and skills more productively, whilst resource revenues induce patronage as governments pay off supporters to stay in power, resulting in reduced accountability and an inferior allocation of public funds."[836]

The possibility for both tax avoidance and tax evasion is created with the negotiation of contracts with companies seeking a favourable investment climate, and where contractual arrangements are the consequence of corruption (such as payments by companies to public officials to secure better terms). Tax havens become useful for hiding embezzled payments or to syphon off revenue intended for the fiscus.

The FATF holds the view that:

> "… the fight against corruption is inextricably intertwined with that against money laundering in that the stolen assets of a corrupt public official are useless unless they are placed, layered and integrated into the global financial network in a manner which does not raise suspicion."[837]

The FATF also highlights the role of "Politically Exposed Persons" (PEPs) in money laundering schemes. PEPs are deemed high risk due to the positions which they occupy in government, where they have access to public funds and contractual information.[838] PEPs can also influence how contracts are awarded and can therefore award contracts for personal financial reward.[839]

The level of governance, strength of legal controls and cultural aspects, can influence the degree to which corruption is present in a country.[840] The FATF identifies the most prevalent forms of proceeds in the grand corruption context as those which result from accepting bribes, various forms of extortion, self-dealing and conflict of interest and embezzlement from the treasury through fraud.[841] From a tax perspective, two important concerns arise: firstly, tax revenue due to

834 World Bank (2011) ix.
835 Kolstad & Søreide (2009) 214.
836 Kolstad & Søreide (2009) 214.
837 FATF (2011) 5.
838 FATF (2011) 5.
839 FATF (2011) 9.
840 FATF (2011) 9.
841 FATF (2011) 16.

the fiscus is diverted, which affects public spending, and secondly, the proceeds of corruption in the hands of corrupt officials escape taxation if they remain undetected.

The focus of this chapter is therefore on the inter-relationship between corruption, tax crimes and money laundering, in as far the value chain of the extractive sector is concerned. The first part examines the dynamics of corruption, money laundering and tax evasion and how these impact on society. The second part of the chapter looks at regulatory issues, barriers thereto and different preventative measures available to address different aspects of the crimes.[842]

8.2 The Dynamics of Corruption

The World Bank describes corruption as a "complex phenomenon"[843] because its roots may lie deep in government institutions. How corruption affects development is influenced by country conditions and the interventions governments make on policy and contractual levels. For example, in pursuit of financial gain, government officials may intervene in areas where no intervention is required, or they may fail to enact or implement policies.[844] The term corruption[845] covers a broad range of human actions. The World Bank defines it as the "abuse of public office for private gain"[846] and primarily included in this definition are bribery and theft.[847] Bribes can be intended for the bribe taker himself or for a third party – the relationship of the public official to the beneficiary and the reasons why the official might want to benefit the third party is of no relevance.[848] The link between the bribe and the action or omission on the part of an official, is inherent to the definition of bribery, however, the requirement of a causal link between the bribe and the specific action or omission by the official could be extremely difficult to prove. Furthermore, an act or omission by an official does not have to be illegal *per se* or in breach of the official's duties – if the bribe is aimed at inducing a breach in an official's duty, it implies that there is a duty on public officials to exercise judgement or discretion impartially.[849]

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842 There is no internationally agreed definition on corruption; furthermore, different meaning is attached to the term depending on the discipline (e.g. political science, economics, legal or sociological) with which it is approached. Corruption also occurs in business and corporate relationships which exist between private businesses and suppliers. It may also involve illegal behaviour by corporate officials for private monetary gain.
843 UNODC (not dated); World Bank (not dated).
844 World Bank (2016).
845 According to the *Online Etymology Dictionary* "corrupt (adj.)" takes its meaning from Old French *corropt* that means "unhealthy, corrupt; uncouth" and directly from Latin *corruptus*, meaning "to destroy; spoil" or figuratively "corrupt, seduce, bribe."
846 World Bank (2016).
847 The World Bank (2016) states that "bribery occurs in the private sector, but bribery in the public sector, offered or extracted, is the Bank's main concern, since the Bank lends primarily to governments and supports government policies, programmes, and projects."
848 Terracino (2012) 103.
849 Terracino (2012) 104;107.

For a corrupt act to constitute active bribery of a foreign public official, the goal of the bribe "must have been to obtain or retain business or other undue advantage in relation to the conduct of international business."[850] Undue advantage (meaning that the company or person has no legitimate right to it) in the context of business, includes relaxation of regulatory standards or granting undue tax breaks.[851] Tanzi indicates that corruption may have different meaning and context in different countries:

> "The concept of corruption, defined as the act of breaking an accepted social or legal norm, must inevitably recognise that different societies may respect different norms, and that some norms are not legally defined. Therefore, an act that may be considered corrupt in one society may be seen as normal, expected, and tolerated in another."[852]

It is interesting to note that acts of bribery of foreign public officials for non-business purposes are not covered by the definition of transnational bribery and are therefore not criminalized in international law. An example of non-business purposes includes bribery of an official so that an unqualified person is hired and appointed in a position where that person could advance the agenda of the briber. This can be in the form of allowing the briber to evade taxes in return for some personal or political favour, often with tacit approval of the tax administration or finance ministry.[853] Under Article 4 of the AU Convention[854] the scope of application explicitly covers such instances where there is:

> "the offering or granting, directly or indirectly, to a public official or any other person, of any goods of monetary value, *or other benefit*, such as a gift, *favour, promise or advantage* for himself or herself, or for another person or entity, in exchange for any act or omission in the performance of his or her public functions."

Illicit enrichment[855] is a criminal act that is only indirectly related to an illegal act by a public official, but it manifests through a variety of criminal acts such as accepting a bribe or embezzlement. In the case of illicit enrichment, it is not the act as such, but the use of the proceeds from the illegal acts. The reason for the existence of the criminal act of illicit enrichment lies in the difficulty of

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[850] Terracino (2012) 108.
[851] Terracino (2012) 108;109.
[852] (2017) 145.
[853] Everest-Phillips (2012) 74.
[854] AU Convention on Preventing and Combatting Corruption 7.
[855] Under Article 20 of UNCAC it is provided that "Subject to its constitution and the fundamental principles of its legal system, each State Party shall consider adopting such legislative and other measures as may be necessary to establish as a criminal offence, when committed intentionally, illicit enrichment, that is, a significant increase in the assets of a public official that he or she cannot reasonably explain in relation to his or her lawful income."

proving corruption in a court of law, and, by focusing on the unexplained wealth accrued through the illicit enrichment, the burden of proof can be discharged with lesser difficulty.[856]

The government benefits purchased with bribes can vary from large contractual awards to petty corruption such as that found in issuing of licences or fast tracking services.[857] Grand corruption is typically associated with international business transactions which involve government officials, and these are usually concluded outside the official's home country.[858] Whilst instances of grand corruption capture the world's attention, the World Bank cautions that "the aggregate costs of petty corruption, in terms of both money and economic distortions, may be as great if not greater."[859]

Corruption flourishes in environments which are characterised by abuse of office.[860] Some 2,000 years ago, Caesar Augustus recognised that the efficient and honest collection of taxes is of no lesser importance than the tax structure for the fairness of a financial system. Consequently, Augustus attempted a rationalisation of tax collection techniques by making the provincial governors salaried imperial employees, thereby lessening their exposure to the temptation of diverting tax income of their province for their personal benefit.[861]

From a governance perspective, the absence of knowledge of economic causation saw to it that the ancient Roman Empire overextended its state activities to a degree that was never matched by public income. In many instances, public income was recklessly used for the maintenance of a sumptuous establishment of the imperial court; more and better equipped and paid armed forces; and an immensely wasteful bureaucracy which depleted general resources. The conspicuous consumption of the upper classes contrasted with the desperate plight of the masses. The never-mastered economic imbalance grew into a chronic crisis of society at large, whilst a relentless tightening of the tax screw exacerbated the plight of the common people.[862]

Whilst the latter contributed to the fall of the Roman Empire, Roman state practice provided the intangibles for good governance: patriotism, civic virtues of dedication to the community, honesty, probity and disinterested service for the nation.[863] Today it is accepted that "tax systems in

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[856] Most acts of corruption are consensual and there are no "direct" victims – it is society that is affected, but because society is not aware of the corruption, it can be said that it is a victimless crime. The absence of direct victims defies traditional procedures of starting with a complaint by a victim and in many instances there are no witnesses, documents or other means of evidence available.
[857] World Bank (not dated).
[858] World Bank (not dated).
[859] World Bank (not dated).
[860] FATF (2012) 3.
[861] Loewenstein (1973) 304.
[862] Loewenstein (1973) 473.
[863] Loewenstein (1973) 488.

developing countries perform poorly due to weak capacity, corruption and the lack of any reciprocal link between tax and public and social expenditures."[864] Moore[865] proposes that:

> "political regimes are the outcome of tension and conflict between (a) elites who control the state, and wish to remain in power and to exercise that power as freely as possible, and (b) societal actors who want to place restraints on the power of a potentially overweening state."

In this "conflict", revenue is central for two reasons: firstly, it represents a "key strategic resource for state elites" and "if non-state actors can limit and control elites' access to revenue, they enjoy countervailing power in relation to the state."[866] Secondly,

> "if state elites need to depend on general taxation because they lack alternative, easier revenue sources, they generally have to put considerable organisational and political effort into obtaining the revenue, and face strong incentives to bargain and negotiate, directly or indirectly, with at least some taxpayers, rather than simply to extract revenue forcibly."[867]

Moore concludes that "dependence on general taxation provides incentives for state elites and taxpayers to resolve their differences through bargaining."[868]

Encouraging constructive state-society engagement around taxes is one of four channels by which tax reform contributes to state building.[869] This implies the prominence of taxation issues on the public political agenda, and the levying of taxes as "consensually and as transparently as possible."[870] This means that assessments should be raised objectively and there should be equal and fair treatment of taxpayers in the recovery of debt.

According to the World Bank, the causes of corruption are "always contextual, rooted in a country's policies, bureaucratic traditions, political development and social history."[871] Corruption tends to flourish in the presence of weak institutions and where policies are designed to generate economic rents. According to the World Bank, the dynamics of corruption in the public sector can be depicted in a simple model where "the *opportunity* for corruption is a function of the size of the

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864 OECD (2014a) 59.
865 Moore (2007) 14.
866 Moore (2007).
867 Moore (2007) 15.
868 Moore (2007) 15.
869 Fjeldstad & Moore (2008) 242; 255.
870 Fjeldstad & Moore (2008) 255.
871 World Bank (not dated).

rents under a public official's[872] control, the *discretion* that official has in allocating those rents, and the *accountability* that official faces for his or her decisions."[873] The level of discretion of public officials may be too wide (due to a lack of explicit regulations), which in turn can be "exacerbated by poorly defined, ever-changing, and inadequately disseminated rules and regulations."[874] The World Bank identifies several characteristics associated with a lack of institutional integrity:

- Weak accountability with ethical values eroded or never having been established;
- Rules regulating the conduct of officials and management of conflict of interest are not enforced and financial monitoring systems (e.g. mechanisms for recording revenues collected and budgeted expenditures) are dysfunctional;
- Formal mechanisms for holding public officials to account for achieving specific results, are not in place or not applied;
- Oversight institutions (e.g. press, external auditors or ombudsmen) responsible for scrutinizing government performance are ineffective;
- Divergence between the "formal" and "informal" rules in the public sector;[875]
- Special anti-corruption bodies are used as partisan instruments whereby those in government are protected, opposition members are harassed and fraud detection is not prioritised.[876] In South Africa, such actions are described as "state capture" and these actions are evidenced in the appointment of public officials for the sole purpose of promoting the interests of those who appointed them.[877]

The presence of these characteristics requires governments' recognition that a strong legal framework to control corruption is required, and that institutional strength is returned to departments by placing renewed emphasis on the "formal" rules.[878]

Reuter states that "it is fanciful to imagine that Marcos, Mobutu, or Suharto would have allowed the operation of an effective domestic AML, whatever laws they might have permitted to be placed on the books." This predicament repeats itself continuously, as is reflected by recent reports from

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872 Under Section 2(a) of UNCAC, "Public official" shall mean: "(i) any person holding a legislative, executive, administrative or judicial office of a State Party, whether appointed or elected, whether permanent or temporary, whether paid or unpaid, irrespective of that person's seniority; (ii) any other person who performs a public function, including for a public agency or public enterprise, or provides a public service, as defined in the domestic law of the State Party and as applied in the pertinent area of law of that State Party; (iii) any other person defined as a 'public official' in the domestic law of a State Party. However, for the purpose of some specific measures contained in Chapter II of this Convention, 'public official' may mean any person who performs a public function or provides a public service as defined in the domestic law of the State Party and as applied in the pertinent area of law of that State Party."

873 World Bank (not dated).

874 World Bank (not dated).

875 The World Bank describes situations where corruption is systemic as one where the "formal rules remain in place, but they are superseded by informal rules: thus it may be a crime to bribe a public official, but in practice the law is not enforced or is applied in a partisan way, and informal rules prevail."

876 World Bank (2016).

877 Daily Maverick (2017).

878 World Bank (2016).

South Africa relating to delays by the president's office in passing the Financial Intelligence Centre Amendment Bill, which is aimed at bringing greater transparency to the financial system, and complementing government's objective to fight corruption. It gives banks powers to perform due diligence on politically exposed persons, or as termed in the bill, "prominent influential persons". The bill was unanimously adopted by Parliament in May of 2016.[879] In November of the same year, the bill was referred back to Parliament due to the wide formulation of searches without a warrant.[880] Whilst the amendments are in line with the FATF recommendations, the issue of warrantless searches contained in AML legislation came up in other jurisdictions and was restricted by the courts.[881] In the context of political events[882] in South Africa, the referral would have been of serious concern, had the president found the provision relating to, for example, "politically exposed" persons (or "persons in prominent positions" as referred to in the South African legislation) to be unconstitutional.[883]

8.3 The Dynamics of Money Laundering

IFFs are said to "often leave developing countries via the commercial financial system" through which "funds are laundered to disguise their origin."[884] Anti-money laundering (AML) and counter-terrorist financing (CFT) regimes are potentially effective tools to identify and prevent illicit funds from being "held, received, transferred and managed by major banks and financial centres."[885] The latter actions, whereby IFFs are facilitated, can be damaging not only to the financial sector,

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879 Mkhwanazi (2016).

880 Amendment of Section 45B of Act 38 of 2001, as inserted by Section 16 of Act 11 of 2008 proposes under (1C) that "an inspector otherwise required to obtain a warrant under Subsection (1B) may enter any premises without a warrant (a) with the consent of the owner or person apparently in physical control of the premises after that owner or person was informed that he or she is under no obligation to admit the inspector in the absence of a warrant; or (b) if the inspector on reasonable grounds believes that (i) a warrant will be issued under subsection (1B) if the inspector applied for it; and (ii) the delay in obtaining the warrant is likely to defeat the purpose for which the inspector seeks to enter the premises. (1D) Where an inspector enters the premises without a warrant, he or she must do so (a) at a reasonable time; (b) on reasonable notice, where appropriate; and (c) with strict regard to decency and good order, including to a person's right to (i) respect for and the protection of dignity; (ii) freedom and security; and (iii) personal privacy."

881 Federation of Law Societies of Canada v. Canada (Attorney General), [2013] B.C.J. No. 632. The issue revolved around whether Canada's anti-money laundering and anti-terrorist financing legislation, as it applies to the legal profession, infringes the right to be free of unreasonable searches and seizures; and whether legislation infringes on the right not to be deprived of liberty otherwise than in accordance with principles of fundamental justice, and, if so, whether infringements are justifiable. The court argued that these provisions have a predominantly criminal law character, rather than an administrative law character. They facilitate detecting and deterring criminal offences, and investigating and prosecuting criminal offences. There are penal sanctions for non-compliance. These provisions authorize sweeping searches of law offices which inherently risks breaching solicitor-client privilege. The provisions in question were unconstitutional insofar as they applied to lawyers and law firms only.

882 At the time, various allegations of bribery and accepting kickbacks were made against the president resulting from the so-called Gupta Leaks. The leaks consist of a few hundred gigabytes of information containing between 100,000 and 200,000 unique e-mails and a host of other documents. The e-mails portray members of government, a substantial number of ministers and senior state employees illegally sharing confidential state information with members and associates of the Gupta family. Daily Maverick (2016).

883 The bill has since been passed and it is now known as the Financial Intelligence Centre Amendment Act, 1 of 2017.

884 OECD (2014).

885 OECD (2014).

in as far as financial institutions' reputational risk is concerned, but also to entire economies which are dependent on a well-functioning financial sector.[886]

In many countries money laundering is rarely successfully prosecuted, due to the difficulties in proving the offence, capacity constraints and the like.[887] Money laundering refers to any act that that aims to disguise the illicit nature or the existence, location or use of the proceeds of crime.[888] Money laundering legislation typically provides for three substantive offences in respect of the crime of money laundering. These offences are the concealment of criminal property; arrangements made with regard to criminal property; and the acquisition, use and possession of criminal property.[889] For money laundering schemes to achieve their objective, De Koker[890] identifies criteria which they must meet, namely: "they must appear to make commercial sense, be structured in a tax efficient way,[891] have the appearance of legitimacy and be transnational in nature." The aid of professional advisors (also referred to as gatekeepers) in accounting, banking, law and financial services is integral to the success of sophisticated laundering schemes. The socio-economic and political environment also plays a role and a greater incidence of money laundering will be present in countries with high levels of corruption[892] and with a high prevalence of organized crime, specifically through production or distribution of prohibited goods.[893]

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[886] OECD (2014) 15

[887] Schlenther (2013:23) shows that 927 confiscation orders under Chapter 5 and 6 of the Prevention of Organized Crime Act were made in South Africa amounting to ZAR577 million from 2003/04/01 to 2008/04/01. The confiscation data reportedly does not show whether the confiscations were related to money laundering *per se.* It is therefore not known whether these figures are representative of the pervasiveness of money laundering in South Africa. Based on reports for later years, it can be assumed that a small number of confiscations related to money laundering, took place, for the years 2009/2010 and 2010/11. The National Prosecuting Authority (NPA) reported success in 192 trial cases for the latter year, which included 5 racketeering convictions and 25 counts of money laundering. 2009 only delivered 6 finalised money laundering cases. In addition, the FIC Annual Report for 2014/15, makes no mention of successful money laundering prosecution in South Africa for the year under review, however, the NPA's report for the same period indicates that 11 cases involving racketeering and/or money laundering charges were finalised with verdicts (eight of these cases were finalised with guilty verdicts, and the remaining three were acquittals). Five cases involving money laundering were finalised with verdicts (they were all finalised with guilty verdicts). In its 2015/16 Annual Report, the FIC makes mention of the number of investigations they assisted in with no reference to successful prosecutions. For the same period, the NPA reported only 3 money laundering convictions, namely S v Hinzelman; S v Norman and Hendricks and S v Capt. Letsie and others (Annual Report 2016: 24; 47).

[888] De Koker (2007) 1-4.

[889] According to Schlenther (2013:19), "three stages are generally distinguished in the money laundering process, namely placement, layering and integration. During the placement stage, money enters the financial system. The aim of the layering process is aimed at separating the illicit proceeds from their criminal source, which may entail a complex series of transactions which are solely aimed at blurring the money trail. The last stage involves the integration of all the funds – the original amount minus the costs of the laundering process, is amassed and controlled as apparent legitimate business funds."

[890] De Koker (2007) 7.

[891] Schlenther (2013:19) argues that "tax efficiency may not necessarily be a requirement, as paying taxes timeously creates the perception of a compliant taxpayer and with that, brings legitimacy to the criminal enterprise."

[892] The Transparency International Ranking List provides a breakdown of country perception of that which is likely to be most/least corrupt.

[893] The CIA World Factbook (not dated) classifies countries' attractiveness to criminal activity. For example, Ghana is identified as a "major transit hub for Southwest and Southeast Asian heroin and, to a lesser extent, South American cocaine, destined for Europe and the US; widespread crime and money-laundering problems, but the lack of a well-developed financial infrastructure limits the country's utility as a money-laundering center". South Africa is described as "an attractive venue for money launderers, given the increasing level of organized criminal and narcotics activity in the region and the size of the South African economy".

Experience across the globe shows six general money laundering techniques used: (i) investing proceeds of crime in a legal business venture, either through shell or fictitious companies or in genuine companies under a false identity; (ii) acquisition of assets accompanied with payment of the requisite taxes; (iii) deposit of money in tax heavens or in banks in non-cooperative countries, and remittances back to the host country through normal banking channels; (iv) use of the underground banking channels for transfer of funds; (v) over invoicing of goods in import/export transactions; and (vi) routing funds through safe tax heaven countries.[894] These forms of financial system and corporate vehicle abuse can cause extensive reputational damage to institutions, damage the investment climate and can ultimately weaken the financial system.[895]

Money laundering has numerous underlying predicate offences, which need to be established before a charge of money laundering can be pursued – thus the removal of the predicate offence (e.g. tax evasion or corruption) may provide a better long term solution. The FATF recognises the "link between corruption and money laundering" and takes into account countries' compliance with the FATF Recommendations. [896] Some compliance measures include:

- The degree to which the FATF Recommendations are implemented;
- Implementation is measured against the number of money laundering investigations, prosecutions and convictions, as well as the value of assets confiscated, as a result of money laundering or a predicate offence;
- Measures to prevent and combat corruption.[897]

There are several indicators used to measure the strength of the anti-corruption framework. These are the level of transparency, the presence of good governance principles and ethical codes of conduct for officials, as well as the efficiency of the courts and the degree to which court decisions are enforced. 898 These indicators are viewed as significant, because where they are absent or weak, the effective implementation of the FATF Recommendations can be jeopardised.[899]

8.4 The Dynamics of Tax Evasion

There is considerable evidence that tax evasion depends on opportunities for successful evasion and these differ widely, depending on the circumstances of the taxpayer.[900] Tax compliance is

[894] UNAFEI (2000).
[895] UNAFEI (2000).
[896] FATF/OECD (2012) 2.
[897] FATF/OECD (2012) 2.
[898] FATF/OECD (2012) 2.
[899] FATF/OECD (2012) 2. The FATF views the presence of "a proper culture of compliance with AML/CFT standards" as a key component to detect and mitigate corruption.
[900] Slemrod & Bakija (1998) 149.

therefore not solely reliant on the taxpayer's analysis of the benefits and costs of evasion, but also on the presence of a belief that the state lacks legitimacy.[901]

International initiatives to limit tax evasion and address the proceeds of crime are ongoing and are led by the OECD Global Forum on Taxation, the FATF and the UNODC. However, these efforts in curbing IFFs are still being evaluated, but it is clear that any approach will require greater coordination and cooperation around key issues and stakeholders such as the private sector, government, international organizations and civil society.[902]

The predicament posed by tax evasion is well phrased by Everest-Phillips who states that "effective states require effective, efficient, and equitable tax systems. Creating the commitment of citizens not to evade taxation is a political process central to state building; cajoling elites to pay taxes has always been an essential step to any state becoming effective. Bad governance manifests itself through an unjust tax system and rampant tax evasion."[903] The latter then becomes or remains a trigger for or indicator of political instability. Tax evasion, corruption and criminality as the main drivers of illicit capital flows are at the same time "both causes and effects of the fragility of state institutions, and in this sense, are challenges to state legitimacy."[904] Everest-Phillips draws an important correlation between tax evasion and corruption. He states that tax evasion undermines the funding of the state and therefore, the legitimacy associated with the state through the delivery of public services. Corruption in turn, affects the moral legitimacy of the government and criminality becomes a challenger to the legitimacy of the government.[905] It is evident that good governance is an essential element to addressing IFFs and remedies should therefore be more than "technocratic solutions."[906] This requires that the correlations or inter-relationships between tax evasion and corruption are recognised, but also those that include money laundering and other financial crimes over and above evasion and corruption must be recognised.

8.5 Corruption, Money Laundering and Tax Evasion in the Extractive Sector

The extractive sectors in developing countries are prone to illicit financial flows for a variety of reasons:

[901] Everest-Phillips (2012) 73.
[902] World Bank (not dated).
[903] Everest-Phillips (2012) 70.
[904] Everest-Phillips (2012) 71.
[905] Everest-Phillips (2012) 71.
[906] Everest-Phillips (2012) 72.

a) Extractive sectors lean toward having high-levels of discretionary political control. Where there is a high concentration in resource sectors (in terms of geographic location, exploitation, and control of revenues) and the extractives can account for a large component of foreign earnings and fiscal revenues, it makes control over the extractive sector an instrument of economic and political power. Discretionary funds generated by extractive sectors have the ability to increase political leaders' autonomy from the population and external donors, thereby diminishing accountability and openness to reform;[907]

b) There may be a blurring of public, shareholder and personal interests because state companies involved in the extractive sector may be geared toward serving the interests of patronage networks.

c) Where the number of competitors is limited, it may result in less checks and balances than one would normally find in more competitive sectors. Le Billon points out that in stable oligopolies, nominal competitors may promote IFFs through their collaboration.

d) Extractive sectors are usually associated with complexities in financial and technical processes. The expertise necessary to conduct these processes is often only available to mining companies, with the result that the mining companies' accounting work is often not challenged by government. Where an auditing capacity is weak or corrupt, the door is thus opened for manipulation of tax records.[908]

e) The role of contracts involving multi-national corporations. Exploitation is caused by failure to specify clearly the price at which the product (e.g. rough diamonds) is to be exported. Though transfer may be legal, the underlying contract may be a consequence of corrupt dealings between government officials and those representing multi-nationals. These flows can then be classified as illicit.[909]

Specific revenue streams in the extractive sector and associated IFF risks include:

a) Bonuses: these can be in the form of monies paid outside central budget accounts and are associated with political slush funds and embezzlement;[910]
b) Royalties: where they are underreported (volumes) and understated (values);[911]
c) Fees: in the form of petty corruption relating to the issuing of licences;[912]
d) Corporate income taxes: where abusive transfer pricing practices and mispricing/over invoicing practices are present, as well as undue tax exemptions or rebate abuses in the customs area;

[907] Le Billon (2011) 3.
[908] Le Billon (2011) 3.
[909] Reuter (2012) 5. See also Moore (2012) 464.
[910] Le Billion (2011) 3.
[911] Le Billion (2011) 3.
[912] Le Billion (2011) 4. Le Billion refers to "extortion and payment avoidance."

e) Production share: in the underreporting of volumes and/or of the quality by operating company or in inflated operational costs. It can also manifest in embezzlement by state resource marketing entities.[913]

Whilst there are various international initiatives which aim to address IFFs in the extractive sector, the most prominent are the Extractive Industries Transparency Initiative (EITI) which focuses on financial flows between companies and governments and Section 1504 of the US Dodd-Frank Wall Street Reform and Consumer Protection Act.914 Individual countries have also taken measures to address this, for example a recent case resulted in a USD 1.2 billion settlement between US authorities and oil and gas service companies accused of corruption in construction of a liquefied natural gas plant in Nigeria.[915]To illustrate the inter-relationship between corruption, money laundering and tax evasion in the extractive, I discuss the bidding/negotiation and the extraction phases below because this is where the scene is set for corrupt schemes to be implemented.[916]

8.5.1 Bidding and Negotiation Phase

The risk of corruption in the extractive sector appears in the tender process already, where bidding companies in which public officials or their affiliates have a stake may receive preferential treatment, or where the potential for bribes for bid exclusion exists. In some instances, the awarding of a bid may require a joint venture between a foreign entity and a local company or a state owned enterprise. This obligation can however be diverted from the initial objective of empowering the local entity, to one where companies owned by or connected to public officials are favoured.[917] The OECD identifies forms of corruption risks in contract negotiation as trading in influence, political capture and interference. Trading in influence is described as "the process or act by which a person who has real or apparent influence on the decision making of a public official exchanges this influence for an undue advantage."[918] Political/state capture or interference refers to situations where private interests significantly influence decision-making processes of public officials for private gain.[919] In contract negotiations, the typology of corruption risks includes exercising undue influence to obtain favourable contractual terms, to get access to otherwise

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[913] Le Billion (2011) 5.

[914] The act requires the Securities and Exchange Commission (the agency normally charged with policing America's financial markets) to issue regulations requiring firms using "conflict minerals" to investigate and disclose the origin of those minerals. A news report from 2017 suggests that measures contained in the act are making a difference in tracking and tracing specific diamond parcels in Africa. (See: http://www.news24.com/Africa/News/drc-miners-upset-at-us-conflict-mineral-rules-20170504).

[915]Le Billion (2011) 1.

[916] Other prevalent phases are discussed under the heading "Risk Identification" (9.3.2) below where specific risks in the diamond extraction phase are discussed form a corruption, money laundering and tax evasion perspective.

[917] OECD (2016a) 43.

[918] OECD (2016a) 37.

[919] OECD (2016a) 37.

restricted or commercially sensitive information, or to obtain permit approvals. Often “influencing” can be in breach of legislation in that a royalty rate is agreed to, for which it is not provided in law, or a permit is granted in a protected area.[920] In exercising undue influence, companies may:

> “offer or be solicited to provide improper advantages in the form of anything of value, such as illegal commissions, gifts and entertainment (i.e. first class flights, expensive hotels, dining, school fees), job or business opportunities to public officials and politicians or their family members, with a view to unduly influencing the negotiation process.”[921]

During contract negotiations, funds intended for public use can be diverted to benefit private individuals. Such misappropriation of public funds or embezzlement is often exacerbated by a lack of transparency in the contract negotiation phase. This then creates an environment conducive to corrupt activities, which are intended to circumvent or violate existing legal provisions for the payment of taxes and royalties.[922] With regard to the latter, provisions negotiated in a non-transparent way, may set inappropriately low corporate tax rates in comparison to the standard national rates.[923]

It is important to prevent companies from using foreign subsidiaries as intermediaries for paying bribes, since the situation with regard to the liability of the principal for bribery carried out by or through a foreign subsidiary is not clear in cases of trans-national bribery, as international instruments do not specifically address the issue.[924] The liability of parent companies for corrupt acts by their subsidiaries is regulated by national legislation, and in general, the condition for such liability rests on the claim that the subsidiary is so close to the parent that it is merely acting as a local intermediary. When behind the appearance of being an independent subsidiary there is a real relationship of hierarchy with the headquarters, and the parent company must have known about the bribery or controlled expenditure of the subsidiary, the parent company can be held liable for indirect bribery – this is often referred to as wilful blindness or conscious disregard.[925]

Once a contract is in place, facilitation payments can be paid to ensure the “smooth running” of the contract. Facilitation payments are generally small payments that are in conformity with socially accepted practices made to influence public officials to perform their functions – in the

[920] OECD (2016a) 37.
[921] OECD (2016a) 37.
[922] OECD (2016a) 39.
[923] Examples of such practice are cited in the UNECA Report, where one company negotiated a corporate rate of 1.43 per cent and another whereby the royalty rate on mining was set at only 20 per cent of the rate prescribed in legislation (OECD 2016a:39).
[924]Terracino (2012) 95-96.
[925] Terracino (2012) 95-96.

extractive value chain – it manifests for example in the issuing of licences or permits.[926] The OECD identifies the issuing of work permits, tax and customs clearances, as well as permits that relate to local community development, the environment, the quality of operations and health and safety, as areas where the corruption is aimed at speeding up or circumventing procedures for the issuance of those permits.[927]

8.5.2 Extraction Phase

The OECD describes corruption risk in the extraction phase as:

> "bribery of domestic or foreign public officials, collusion, trading in influence, political capture or interference, or extortion, which may be used to influence the decision-making process, circumvent or overlook rules regarding environmental preservation, protection of land rights and land access restrictions to protect important sources of livelihoods for local communities."[928]

Corruption schemes can be wide enough to include both regulatory and policy capture to ensure that benefits accrue to the political elite or the patronage network. These types of capture are accomplished by means of distortions in policy making which shape rules, regulations and policies to facilitate corruption in subsequent stages. [929] They are also geared to obtain consent from traditional leaders to allow mining on their land.[930]

In as far as regulation is concerned, a risk of regulatory capture exists where the interests of groups that dominate the industry or sector are advanced through corrupt acts which intend to influence regulatory design or enforcement. In the customs environment, it manifests through accelerated clearance processes (to which the trader may not be entitled); by-passing inspections or influencing inspection findings; reducing duties or circumvention of restrictions.[931]

The use of corporate vehicles and trusts are established by means of money laundering and are addressed in FATF Recommendations 33 and 34. Shell corporations provide advantages in concealing the identity of the beneficial owner. Shell companies are often used by politically exposed persons (PEPs) to hide wealth, because their careers and reputations are at stake if they are found to be in possession of unexplained wealth. In this sense, "shell companies ensure

[926]OECD(2016a) 60.
[927] OECD (2016a) 60.
[928] OECD (2016a) 60.
[929] OECD (2016a) 60.
[930] OECD (2016a) 60.
[931] OECD (2016a) 58-59.

that specific criminal assets cannot be identified with or traced back to them."[932] The *Panama Papers* again confirmed the trend.[933] Corporate vehicles are therefore a preferred and effective means of separating the origin of the illegal funds from the PEP who controls it.[934]

Those wishing to hide proceeds from corruption or other crimes make use of gatekeepers or skilled professionals to establish corporate structures in offshore jurisdictions, with the sole purpose of disguising the source and ownership of the money. With the focus on foreign PEPs and the requirements of enhanced due diligence regarding the source of funds deposited into financial institutions, corporate vehicles are in high demand.[935]

Due to the high visibility of their office, both within and outside their country, PEPs frequently make use of nominees (middlemen or other intermediaries such as close associates, friends and family) to conduct financial business on their behalf.[936] According to the FATF, the use of middlemen is aimed at sheltering or insulating the PEP from unwanted attention. The use of intermediaries can also serve as an obstacle to customer due diligence where the individual acting on behalf of the PEP has special status such as diplomatic immunity.[937]

The use of cash, and its placement into the financial system, is an established means for laundering the proceeds of crime. Where cash payments are made to a PEP, this entails a break in the chain of bank records, but it exposes the PEP to increased risk, as it "would require the PEP to run the gauntlet of AML/CFT controls designed to combat placement of illegally-derived cash into the system."

Similar to the use of cash, diamonds are particularly vulnerable to money laundering abuse due to their portability, small size and high value. Diamonds are also prone to misuse due to the relative ease whereby they can transfer value and ownership with a minimal audit trail.[938]

The two main methods of tax evasion in the diamond value chain are under valuation of exports and smuggling. Trade mispricing, in which export or import documents carry false prices, is not

932 FATF (2011) 19.
933 ICIJ. The ICIJ describes the Panama Papers as "a global investigation into the sprawling, secretive industry of offshore jurisdictions that the world's rich and powerful use to hide assets and skirt rules, by setting up front companies in far-flung jurisdictions. Based on a trove of more than 11 million leaked files, the investigation exposes the use of offshore companies to facilitate bribery, arms deals, tax evasion, financial fraud and drug trafficking." In November 2017, the investigative unit published the "Paradise Papers" which include "nearly 7 million loan agreements, financial statements, emails, trust deeds and other paperwork from nearly 50 years at a leading offshore law firm with offices in Bermuda and beyond."
934 FATF (2011) 19.
935 FATF Recommendation 6.
936 The FATF cautions that the "use of middlemen is not necessarily an indicator by itself of illegal activity, as frequently such intermediaries are also used when the business or proceeds of the PEP are entirely legitimate" (FATF 2013c).
937 FATF (2013c) 23-24.
938 FATF (2013c) 23.

only a means of tax evasion, but also a channel for movement of illicit funds.[939] Over invoicing of exports also motivates abuse of VAT rebate schemes or export subsidies.[940] According to Zdanowicz, there are inventory practices whereby diamonds are recorded either by price or weight. Such practices create difficulties for tax authorities to verify the level of inventory on the date of reporting, thereby creating room for manipulation of profits and consequent income tax evasion. Other schemes are a combination of the above, whereby diamonds supposedly for export, are instead rerouted to polishing centres where they are sold on the black market.

8.6. Overview: Regulatory measures to address corruption, tax evasion and money laundering

Today corruption is classified as a category of transnational crime (other crimes in this category include drug trafficking, human trafficking and the financing of terrorism).[941] The emergence of the international framework against corruption is the result of convergence of a combination of values (moral and religious) and interests (economic and development). Terracino describes the highly political processes of the negotiation of international anti-corruption instruments as a response of traditional normative values and the interests of global players to corruption.[942] On the African continent, this is reflected by two anti-corruption treaties which were adopted in 2003: the SADC Protocol against Corruption and the ECOWAS Protocol on the Fight against Corruption. Later, in 2003, the AU Convention on Preventing and Combatting Corruption was adopted, whilst the UN adopted the United Nations Convention against Corruption in the same year, which is the most recent and significant international law instrument against corruption.[943] The latter includes provisions on the recovery of stolen assets, and establishes various measures for international cooperation for the purpose of detecting the transfer of proceeds of crime, determining the ownership of assets, as well as their confiscation, return and disposal.[944]

Whilst current international instruments against corruption require state parties[945] to establish a number of offences as crimes of corruption in their domestic laws, the same instruments have taken different approaches to the criminalization of corrupt acts. Some call for the criminalization of the act of bribery and some are broader in scope, requiring the criminalization of embezzlement, trading in influence, abuse of functions and illicit enrichment. Under the UNCAC, it is mandatory to criminalize bribery and embezzlement in domestic law, whilst the criminalization

939 Reuter (2012)11.
940 Zdanowicz (2013) 255.
941 Terracino (2012) 3.
942 (2012) 3.
943 Terracino (2012) 19, 51.
944 Terracino (2012) 52.
945 A ‘state party’ to a treaty is a country that has ratified or acceded to that particular treaty, and is therefore legally bound by the provisions in the instrument.

of the second group of acts is not mandatory, but preferred.[946] The SADC Protocol deals with both the primary and secondary acts, whilst the ECOWAS Protocol covers the same, but without the inclusion of “abuse of function”. The immediate concern flowing from the above is that where acts other than the prescribed ones are not accepted by countries party to UNCAC, their acceptance as corrupt acts at the international level is not clear and can complicate judicial processes. An additional feature to the AU Convention is a monitoring role constituted as the African Peer Review Mechanism (APRM), which is a mutually agreed instrument to which member states can voluntarily accede as a means of self-monitoring to ascertain whether they are in conformity with the agreed political, economic and corporate governance values.[947]

Other international instruments, such as the OECD Anti-Bribery Convention, establish legally binding standards to criminalise bribery of foreign public officials in international business transactions, and are focused on the supply side of bribery transactions. The US Foreign Account Tax Compliance Act (FATCA) targets non-compliance by US taxpayers using foreign accounts. FATCA requires foreign financial institutions (FFIs) to report to the IRS information about financial accounts held by US taxpayers, or by foreign entities in which US taxpayers hold a substantial ownership interest.[948]

Criminalization of corrupt offences in domestic legislation is the first step toward ensuring states’ ability to prosecute and sanction offenders. Part of this obligation is the obligation to criminalize money laundering that has its origins in corrupt acts.[949] Countries accordingly have to apply the money laundering offences to the proceeds of corrupt acts – there are therefore two distinct crimes namely (a) the corrupt act, which is the predicate offence by which the proceeds are generated, and (b) the laundering of such proceeds. As most money laundering cases involve an international element, countries are required to establish the extraterritoriality of predicate offences.

In keeping with the inter-relationships between corruption and money laundering, both the regulatory measures aimed at the proceeds of corruption, as well as the AML measures applicable to the diamond value chain are highlighted below.

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[946] Terracino (2012) 82.
[947] Terracino (2012) 82.
[948] IRS (not dated).
[949] This is covered in specific terms in the UNCAC. Article 23(1)*(a)* (i) Provides for “the conversion or transfer of property, knowing that such property is the proceeds of crime, for the purpose of concealing or disguising the illicit origin of the property or of helping any person who is involved in the commission of the predicate offence to evade the legal consequences of his or her action; (ii) The concealment or disguise of the true nature, source, location, disposition, movement or ownership of, or rights with respect to property, knowing that such property is the proceeds of crime; *(b)* Subject to the basic concepts of its legal system: (i) The acquisition, possession or use of property, knowing, at the time of receipt, that such property is the proceeds of crime; (ii) Participation in, association with or conspiracy to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the offences established in accordance with this article.”

The following FATF Recommendations are applicable to diamond dealers: Recommendation 22 mandates that customer due diligence and record keeping requirements set out in Recommendations 10, 11, 12, 15, and 17 apply to dealers in precious stones when they engage in any cash transaction with a customer equal to or above the applicable designated threshold (USD/EUR 15 000). Recommendation 28 requires that dealers in precious stones be subject to effective systems for monitoring and ensuring compliance with AML/CFT requirements, which should be performed on a risk-sensitive basis by a supervisor or by an appropriate self-regulatory body.[950]

In some instances, countries without national AML/CFT regulations regarding diamond dealers may have national legislation in place for sector regulation. South Africa, for example, does not have industry-specific AML/CFT regulations directed at diamond traders, and diamonds are only covered under the Diamond Act, which deals with the regulation of the diamond industry in its entirety.[951]

The inherent involvement of public officials in corrupt activities in many instances entails jurisdictional privileges and immunities, which can impede efforts to combat corruption. Where immunities are abused by those in public office, immunity becomes impunity and the international legal framework does not address the issue of immunities adequately.[952] Under Article 30 of the UNCAC, jurisdictions "shall consider establishing procedures through which a public official accused of an offence established in accordance with this convention may, where appropriate, be removed, suspended or reassigned by the appropriate authority, bearing in mind respect for the principle of the presumption of innocence." In short, countries are only required to apply an appropriate balance between immunities and adjudication.[953]

Bank secrecy is typically aimed at protecting the financial privacy of citizens from unauthorised access, and its foundation lies in the right to privacy. Different meaning is attached to the protection afforded by bank secrecy laws. On the one hand it is regarded as a private law issue (breach of contract or delict[954] where false reporting of corruption is made), and on the other hand, it is seen as a public interest matter and a breach of secrecy constitutes a criminal offence. From a transnational investigative perspective, jurisdictions cannot deny mutual legal assistance to another jurisdiction on the grounds of bank secrecy.

[950] FATF (2013d) 36-37.
[951] FATF (2013d) 38.
[952] Terracino (2012) 195.
[953] Terracino (2012) 212.
[954] Under Article 5(7) of the AU Convention, provision is made for the adoption of national legislative measures in order to punish those who make false and malicious reports against innocent persons in corruption and related offences.

After the financial crisis of 2008/9, the G20 countries compelled tax havens to sign bilateral treaties providing for exchange of bank information. Policy makers reportedly celebrated this as the momentum required to end bank secrecy. Johannesen and Zucman assessed the impact of tax treaties on bank deposits in tax havens, and found that rather than repatriating funds, tax evaders merely moved deposits to tax havens which are not covered under a treaty with their home countries. What is celebrated as a crackdown, is thus merely a relocation of deposits to the benefit of the least compliant havens.[955]

Liability of legal persons is highly relevant to corruption cases, since these are committed frequently through or under cover of legal entities. With corporate structures becoming increasingly complicated, holding individuals to account for a particular decision has become progressively more difficult. Legal persons have elaborate financial structures (especially in the case of corporates) and accounting practices, which make it easier to conceal corrupt acts and the identity of decision makers.[956] Attribution of responsibility to legal persons is possible through three major approaches; the first is the identification theory which assigns liability to the individual who is in a leading position; the second approach is based on the agency principle which attaches vicarious liability (i.e. an employee acting within the scope of his or her duties and for the benefit of the company). The third approach relates to corporate culture, where “the legal person fails to create or maintain a corporate culture that requires compliance with the relevant laws.”[957]

A legal person is only held responsible for corrupt acts committed by its employees when there is a connection between the act and the legal person – the act must have been committed “for the benefit of the legal person and not in the interest of the employee.”[958] When assessing liability of the legal person, a key test is whether the legal person has exercised due diligence in supervising and controlling its employees.[959]

From a tax perspective, the greatest weapon in the arsenal of the tax authority, is no doubt its ability to tax *all* income – including that generated through illegal means, for example, Section 1 read with Section 23 of the South African Income Tax Act 58 of 1962, which respectively deal with gross income and non-allowable deductions. “Trade” is widely defined to include “every profession, trade, business, employment, calling, occupation or venture...”, whilst Section 23(o) does not allow for deductions “where the payment of that expenditure or the agreement or offer

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[955] Johannesen & Zucman (2014) 65.
[956] Terracino (2012) 255.
[957] Terracino (2012) 258.
[958] Terracino (2012) 258.
[959] Due diligence requires steps such as the implementation and application of a code of conduct, an efficient internal audit control system, compliance programmes as well as effective training and enforcement. In some jurisdictions effective due diligence constitutes a defence (e.g. Italy and Korea), whilst in others it is only a mitigating factor in sentencing (e.g. US).

to make that payment constitutes an activity contemplated in Chapter 2 of the Prevention and Combating of Corrupt Activities Act 12 of 2004." Similar provisions are contained in the new Ghana Income Tax Act[960] which defines income through Section 2(1) as "the assessable income from employment, business or investment".[961] Excluded deductions specifically include bribes and expenses incurred in corrupt practices, as well as interest, penalties and fines paid or payable to a government or a political division of a government of any country for breach of any legislation.

8.6.1 Preventive Measures

Preventive measures have the potential to make corruption riskier in the extractive sector in that they address some systemic weaknesses which facilitate corrupt practices. Their successful implementation could significantly reinforce institutions necessary to prevent corruption.

8.6.1.1 Increased Transparency

There are several international instruments and initiatives that promote transparency. Under Article 10 of the UNCAC, parties to the convention are required to:

> "take such measures as may be necessary to enhance transparency in its public administration, including with regard to its organization, functioning and decision making processes, where appropriate. Such measures may include, *inter alia*: *(a)* adopting procedures or regulations allowing members of the general public to obtain, where appropriate, information on the organization, functioning and decision making processes of its public administration and, with due regard for the protection of privacy and personal data, on decisions and legal acts that concern members of the public; *(b) s*implifying administrative procedures, where appropriate, in order to facilitate public access to the competent decision-making authorities; and *(c)* publishing information, which may include periodic reports on the risks of corruption in its public administration."

In relation to the extractive sector, the Extractive Industry Transparency Initiative Standards (EITI) go a long way toward enhancing transparency, because they require multi-stakeholder oversight. Multi-stakeholder oversight means government, private sector and civil society engagement according to a set workplan.[962] A second EITI requirement speaks to the value chain of extractives, in that disclosure of information related to the rules as to how the sector is managed,

[960] 896 of 2015.
[961] Business income includes income from a trade, profession, vocation or isolated arrangement with a business character; gains from realization of capital assets and gifts received in respect of the business.
[962] EITI (2016) 13.

is required. It is argued that this measure enables stakeholders to understand the relevant legislation and rules governing the awarding of exploration and production rights. The EITI Requirements related to "a transparent legal framework" and the awarding of extractive industry rights, cover aspects such as beneficial ownership, levels of state participation in the extractives, contractual agreements and licence allocations.[963]

A third requirement relates to transparency in exploration and production activities, which includes information about exploration activities as well as production and export data.[964] Related to this is the requirement to have a comprehensive reconciliation of company payments and government revenues from the extractive industries[965] and disclosures of information related to revenue allocations. The purpose of these requirements is to enable stakeholders to understand the way in which revenues are recorded in both national or sub-national budgets.[966]

In many instances corruption is fuelled in part by either the indifference or resignation (or both) of the population. By raising public awareness, it supports measures to combat corruption and, importantly, it increases public pressure on government to commit itself to fully address the problem of corruption.[967]

8.6.1.2 Bilateral and Multi-lateral Treaties

Bilateral and multi-lateral treaties provide mechanisms to police interactions between countries, in that bilateral treaties (BITs) "allow nations that desire to host foreign investment, to attract funds by agreeing to certain constraints to safeguard the rule of law and encourage investment."[968] Campbell points out that where an investing country's BITs put no real pressure on nations to institute internal reforms (e.g. human rights considerations or corporate social responsibility), it becomes problematic because well designed BITs have the ability to promote the rule of law through international arbitration and other conditions.[969] Such conditions may "motivate developing host countries to improve domestic administrative practices and laws to avoid future disputes."[970] It also allows for countries to better deal with negative externalities caused by foreign involvement.[971]

[963] EITI (2016) 17.
[964] EITI (2016) 22.
[965] According to the EITI, this is inclusive of "comprehensive disclosure of taxes and revenues; sale of the state's share of production or other revenues collected in kind; infrastructure provisions and barter arrangements; transportation revenues; SOE transactions; subnational payments; level of disaggregation; data timeliness; and data quality."
[966] EITI (2016) 26.
[967] Terracino (2012) 136.
[968] Campbell (2016) 540.
[969] Campbell (2016) 540-541.
[970] Campbell (2016) 546.
[971] Campbell (2016) 546-547.

The *Model International Agreement on Investment for Sustainable Development* stipulates that host nations cannot waive or derogate from standards (labour, health, etc.) to encourage investment.[972] Newly designed BITs should therefore put additional obligations on investors, which make provision for the monitoring of funds to ensure that such funds are not "simply pocketed by corrupt officials."[973] Campbell highlights that BITs can also be renegotiated to "promote rule of law in host nations" and that this is "mutually beneficial" in that it reduces vulnerability to corruption to which "reform might fall prey if it is carried out purely within domestic political processes."[974]

8.6.1.3 Establishment of anti-corruption bodies

Institutional responses to corruption have come in the form of anti-corruption bodies whereby states attempt to enhance their institutional capacity to prevent corruption. The typical role is assumed by these bodies in implementing and/or overseeing and coordinating the implementation of anti-corruption policies. Implementation of anti-corruption policies is, however, dependent on institutional cohesion (i.e. all government departments need to buy into and support the initiative), since the responsibility for implementation of the individual components of the anti-corruption policy lies with the respective sector or government agency.[975] Functional and financial independence should be established in law (rather than by executive decree) to ensure that the entity is able to carry out its functions unimpeded by undue influences (such as reducing its budget).[976] Campbell[977] argues that an important reason that corruption persists in countries such as Nigeria and South Africa, is "the inability of these countries to establish monitoring bodies that are both effective and independent," and it appears that "comprehensive domestic solutions to the problem of corruption seem a long way off" in that "true government reforms" will be unsuccessful until nations such as China join western countries in policing their companies operating in Africa.[978] Corruption related recovery is low in South Africa, despite a multitude of enforcement bodies being in existence.[979]

[972] Article 21 (A-E).
[973] Campbell (2016) 546.
[974] Campbell (2016) 550-551.
[975] Terracino (2012) 138.
[976] Terracino (2016) 138-139.
[977] Campbell (2016) 534.
[978] (2016) 537.
[979] Campbell (2016) 537.

8.6.1.4 Implementation of a Risk Management Framework

As is indicated above, the typical role is assumed by these bodies in implementing and/or overseeing and coordinating the implementation of anti-corruption policies. The latter, however, requires a formal process to gauge processes of implementation and the measure of how government departments are taking ownership of anti-corruption processes. For instance, in tracking the successful implementation of anti-corruption mechanisms, the following aspects need to be considered:

a) If the country accedes to the UNCAC, have the relevant articles been passed into domestic law?
b) To what extent are corruption cases pursued and what is the quality of judicial rulings, i.e. were there instances of judicial abuse – either procedurally or substantively?
c) What is the monetary value of corruption related freezing, seizing and confiscation of assets?
d) Are anti-corruption bodies fully operational?
e) How operationally functional are FIUs within the larger criminal justice infrastructure in addressing prosecutions linked to public sector corruption through mutual legal assistance and joint investigations?
f) What is the number of requests to other jurisdictions for mutual cooperation in handling transnational corruption cases?
g) To what extent are prevention measures pursued e.g. public information activities that contribute to non-tolerance of corruption, as well as public education programmes?[980]
h) Have departments established appropriate transparency based systems for procurement that promote competition and objective criteria in decision-making? Also, are these systems effective in deterring corruption? Is a system of oversight in place and are risk management best practices applied to ensure a proper control framework?[981]

Buscaglia finds that countries experiencing significant reductions in perceptions of high level corruption and reductions of irregularities in the handling of case files, had successful reforms in a number of areas such as in creating uniform and comprehensive case management and tracking systems, coupled with transparent rules for the assignment of cases; administrative reforms in the public service (personnel, budget, performance based indicators; rewards, and career paths for law enforcement officers); inter-agency cooperation through improved coordination and specialization; task team approaches to treating cases of corruption and frequently implementing complex civil forfeiture of criminal assets linked to high level political

[980] Buscaglia (2011) 461-462.
[981] As envisaged under Article 9 of UNCAC.

corruption.[982] The same areas are also pointed out by the OECD as recommended incentives in as far as the extractive value chain is concerned.[983]

8.6.1.5 Implementation of Anti-Money Laundering Framework

The link between money laundering and corruption is well established.[984] Money laundering provides the mechanism to hide not only the proceeds of corrupt acts, but also the origin thereof. A comprehensive anti-corruption strategy therefore requires a proper functioning anti-money laundering regime. Key elements of a strong AML regime include awareness by government and business as to what it is and why it should be prevented and combatted; implementation of legal and regulatory measures to support AML (e.g. by criminalising money laundering and providing authority to trace, seize and confiscate assets obtained with the proceeds of crime and by creating the legal framework for inter-agency and international cooperation); engagement with all stakeholders (e.g. government agencies, private sector institutions and financial institutions) when key aspects are implemented such as financial transaction reporting systems, customer identification requirements, record keeping standards and the means for verifying compliance.[985]

8.6.1.6 Implementation of Legislative and Regulatory Environment for Revenue Collection

The OECD states that "the lack of a clearly defined legal and regulatory framework may constitute a major driver of corruption."[986] Hobbs and Williams find that even where a strong legal and regulatory framework is on place, an increase in corruption can be seen.[987] For example, despite a vast range of anti-corruption measures in place in Australia, these can become ineffective when they are under-inclusive and unwieldly, specifically if (a) it is not clear to which agency reports should be made to and (b) when it is not clear how federal parliamentarians are held accountable.[988] The problem is exacerbated through the absence of a well-functioning tax administration. In this regard, the *African Tax Outlook*[989] highlights that manual process in taxpayer registration, filing and payment, create opportunities for corruption because the procedures involve person to person inter-action between taxpayers and tax officers. With the proper capacity, the tax system can ensure the kind of regulatory framework and institutional

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982 (2011) 471-473.
983 OECD (2016a) 23-25.
984 FATF (2011) 6; 2003 UN Convention against Corruption Article 14.
985 FATF (not dated).
986 OECD (2014) 67.
987 (2017) 178.
988 Hobbs & Williams (2017) 178.
989 ATAF (2017) 100.

foundations which can help to eradicate or constrain corrupt practices.[990] Some key areas identified by the OECD to improve the legislative and regulatory environment include:

a) Promotion of the use of tax information exchange agreements, as an instrument for fighting cross-border tax evasion in developing countries;
b) Full implementation of the international standards on exchange of information (EOI), expansion of a network of EOI agreements between OECD and developing countries, exploring possible automatic exchange of information where appropriate, and
c) Increased efforts to build capacity in developing countries to enable exchange of information;
d) Expansion of networks of treaties with relevant countries and jurisdictions through instruments such as the Multi-lateral Convention on Information Exchange;
e) Strengthening of institutions and systems to prevent and combat tax evasion. Within tax and customs administrations, post clearance audit (PCA) and risk management capacities are critical in (i) identifying false invoicing; (ii) assessing the risk; (iii) auditing the transactions and entities involved; and (iv) reporting the results in detail to allow the risk management capacity to monitor the type of transactions and entities to identify further/future compliance/non-compliance.
f) Strengthening of the ability to detect and pursue criminal activity, by adoption of a whole of government approach to fighting tax crimes and other illicit flows.[991]
g) Country by Country reporting is a useful tool for providing tax administrations with a means to risk assess MNEs, because it provides data on the overall allocation of profits within the group across multiple jurisdictions. It can also give an indication of whether a bias exists towards low-tax jurisdictions, or whether intragroup trading reflects trade mispricing practices. Therefore, how the information is assessed can point to areas of likely abuse, in order that appropriate measures (re-active or preventative) can be taken.[992]

8.6.1.7 Implementation of Beneficial Ownership Requirements

Corporate vehicles in the form of companies, trusts, partnerships, foundations, or other forms of legal persons and arrangements, are used to conduct a wide range of business activities. Whilst corporate vehicles play an essential and legitimate role in the global economy, they are, however, used in certain circumstances for illicit purposes such as money laundering, acts of corruption, tax evasion, insider dealing, terrorist financing and other illegal activities.[993]

[990] Evans (2017) 140.
[991] OECD (2014) 67.
[992] OECD (2014) 67.
[993] FATF (2014) 3.

The FATF points out that various abuses of corporate vehicles could be "significantly reduced," if information regarding the legal owner and the beneficial owner, the different sources of the corporate vehicle's assets, and its business activity were readily available to the authorities.[994] Radon and Achuthan point out that beneficial ownership information on its own does not provide a complete remedy to address revenue leakage and corruption. It is only effective when it is accompanied by proper and up to date laws; capacitated law enforcement; supported by relevant technology and sustained political will.[995] Beneficial ownership information can be helpful to law enforcement and other competent authorities in combatting financial crimes, harmful tax practices and countering terrorist financing. The value of beneficial ownership information lies in better identification of perpetrators of predicate crimes, and by being able to "follow the money" through identification assets and accounts held through corporate vehicles.[996] Beneficial ownership information in particular, is useful to locate an individual's assets in another country. There are, however, significant challenges when implementing measures to ensure the timely availability of accurate beneficial owner information, especially where multiple jurisdictions and legal arrangements are present.[997]

8.6.1.7.1 Definition of "beneficial owner"

In the Glossary to the FATF Recommendations, "beneficial owner" refers to "the natural person(s) who ultimately owns or controls a customer and/or the natural person on whose behalf a transaction is being conducted." Inclusive in this definition, are those individuals who "exercise ultimate effective control over a legal person or arrangement."[998] Reference to "ultimately owns or controls" and "ultimate effective control" refer to situations in which ownership and/or control is "exercised through a chain of ownership or by means of control other than direct control."[999]

In the context of legal persons, the FATF definition of beneficial owner is distinguishable from the concepts of legal ownership and control. "Legal ownership" refers to the natural or legal persons who, in accordance with the respective jurisdictions' legal provisions, own the legal person. "Control" refers to "the ability of taking relevant decisions within the legal person and imposing those resolutions, which can be acquired by several means."[1000]

[994] FATF (2014) 3.
[995] Radon & Achuthan (2017) 89.
[996] FATF (2014) 3.
[997] FATF (2014) 3.
[998] FATF (2014) 8.
[999] FATF (2014) 8.
[1000] FATF (2014) 8.

The differential aspect of the FATF definition of beneficial owner is that "*it extends beyond legal ownership and control* to consider the notion of ultimate (actual) ownership and control."[1001] This means that the FATF definition does not focus on the legal person, but on the natural person who actually owns and takes advantage of capital or assets of the legal person. It also focuses on that person who, in reality, exerts effective control over the corporate vehicle and its assets. This is irrespective of whether this person occupies a formal position within the legal entity. The focus is therefore not only on the legal or natural persons who are legally and on paper entitled to act on behalf of the entity.

The FATF cites the example of a company which is legally owned by a second company, as reflected through corporate registration data. In this instance, the beneficial owners are the natural persons who are behind that second company, or ultimate holding company, in the chain of ownership, and who are controlling it. In this example, a person listed in the corporate registration data as holding a controlling position within the company, but who is in reality acting on behalf of someone else, cannot be considered a beneficial owner, because he is ultimately being used by someone else to exercise effective control over that company.[1002]

Another aspect to the FATF definition of beneficial owner is that it includes *natural persons on whose behalf a transaction is being conducted*, even where that person does not have legal ownership or actual control over the customer. This reflects the distinction in customer due diligence (CDD) in Recommendation 10, which focuses on "customer relationships" and the "occasional customer." This aspect of the FATF definition therefore targets the individual whom is central to the execution of transactions, even where the transactions are deliberately structured in a manner that attempts to avoid control or ownership of the customer, with the sole intent of benefiting from the transactions.[1003]

The FATF definition of beneficial owner is also applicable to *legal arrangements*, where the meaning of natural persons is contextualised, at the end of the value chain, to include the individual/s "who ultimately owns or controls the legal arrangement, including those persons who exercise ultimate effective control over the legal arrangement, and/or the natural person(s) on whose behalf a transaction is being conducted."[1004] The FATF, however, cautions that in practice, it may be more difficult to identify beneficial ownership. To illustrate the point, the FATF provides the example of a trust, where the legal title and control of an asset is separated from the equitable interests in the asset. The implication thereof is that different persons may own, control or benefit

[1001] FATF (2014) 9.
[1002] FATF (2014) 9.
[1003] FATF (2014) 8-9.
[1004] FATF (2012) 9.

from the trust, depending on the applicable trust law and the provisions of the trust deed. It is also pointed out that in several countries, trust law may allow for both the settlor and beneficiary to be the same person. In some instances, trust law can also include the trustee, together with settlor and beneficiary as the same person.[1005] There may also be variations in trust deeds in as far as provisions are present, which dictate where ultimate control over the trust assets lies – these may include provisions under which the settlor reserves certain powers, such as returning assets or revoking the entire trust.[1006]

8.6.1.7.2 OECD Global Forum on Transparency and Exchange of Information for Tax Purposes and the concept of Beneficial Ownership

The Global Forum's core mandate is to "improve transparency and exchange of information for tax purposes, through its peer review process."[1007] Peer review processes to date focused on the Exchange of Information on Request Standard and have included a focus on legal ownership information (for tax compliance purposes), instead of beneficial ownership. The current focus of reviews has changed with the emphasis shifting to beneficial ownership information. Under the new terms of reference, jurisdictions must have access to information which identifies the real beneficiaries behind legal entities and legal arrangements, and should allow for international exchange of that information for tax compliance purposes. The FATF beneficial ownership definition is also included in the Automatic Exchange of Information Standard, and requires financial institutions to identify and report beneficial ownership information to their tax authorities, for onward exchange in relation to certain financial accounts.[1008]

[1005] FATF (2012) 9.

[1006] FATF (2012) 9. The complexities in dealing with trust and legal and beneficial ownership, are well illustrated in *Krok v CSARS* (20230/2014 and 20232/2014) [2015] ZASCA 107 (20 August 2015). In this South African case, the Australian Tax Office sought assistance from SARS with the collection of income taxes allegedly due by Mr Krok and a preservation order on assets owned by Mr Krok in South Africa. The assets originated from a trust of which MR Krok was a beneficiary. At some point in time, the trust distributed the capital assets to Mr Krok. To avoid South African exchange control implications on this distribution, Mr Krok vested the beneficial interest in the assets and income in a BVI company whilst he retained legal ownership. Shares in the BVI company were held by a Liechtenstein based foundation of which Mr Krok was a primary beneficiary. Under this arrangement he would have no rights to the assets or control over the actions of the foundation. To effect the arrangement, he concluded 2 agreements: the first to sell his right, title and interest to the income from the assets and the second, to sell all his rights in respect of the assets to the BVI company. The debt arising from these agreements was then assigned to the trustees of an Australian Trust. At a later stage, the BVI company was liquidated and a discretionary trust for UK income, inheritance and capital gains tax purposes was established. The ATO concluded that Mr Krok had intended to conceal foreign income and avoid income tax in Australia by using entities established in banking secrecy jurisdictions such as the British Virgin Island and Liechtenstein. The South African Appeal court surmised that although the agreements may have been binding and valid under the law of the BVI, the assets were situated in South Africa and not in the British Virgin Islands. Therefore it found that the law of South Africa (the forum rei sitae) governs and that a preservation order can be granted.

[1007] The OECD Global Forum on Transparency and Exchange of Information for Tax Purposes is described as "the continuation of a forum that was created in the early 2000s in the context of the OECD's work to address the risks to tax compliance posed by tax havens. The original members of the Global Forum consisted of OECD countries and jurisdictions which had agreed to implement transparency and exchange of information for tax purposes. The Global Forum was restructured in September 2009 in response to the G20 call to strengthen implementation of these standards" (OECD).

[1008] FATF (2016) FATF Report to G20 on Beneficial Ownership. 4. Available at: http://www.fatf-gafi.org/media/fatf/documents/reports/G20-Beneficial-Ownership-Sept-2016.pdf.

A welcome change on the philosophy of technical assistance to developing countries came about recently: where the Global Forum originally focussed on the provision of training as its main objective, it is now looking toward tailor made approaches to respond to members' needs. As such, a regional focus and even closer collaboration with other international organisations has become central to the Global Forum's technical assistance activities, e.g. engagement with finance ministries in member jurisdictions, particularly where legislative or policy changes are needed to implement the standards, taking a longer term perspective and incorporating a whole of government engagement.[1009]

8.6.1.7.3 The FATF Peer Review Process to promote adherence to Standards

The FATF, together with its regional network of assessors, assesses the implementation of AML/CFT standards in countries. It also measures compliance with beneficial ownership requirements. With the adoption of the FATF definition on beneficial ownership, the Global Forum now also assesses compliance with beneficial ownership requirements as they apply in the context of transparency and exchange of information for tax purposes. Although the scope of FATF and Global Forum assessments differ, both attempt to ensure that countries receive the same messages and recommendations on how to improve their implementation of the international standards on beneficial ownership for AML/CFT purposes (in the case of the FATF) and for tax purposes (in the case of the Global Forum). This cooperation is aimed at streamlining the implementation processes, in order to avoid confusion on the part of countries as to what they should be doing towards implementation of the standards.[1010]

8.6.1.7.4 The Role of Regional Bodies in promoting Standards: ATAF

The ATAF and the Global Forum share the same vision on the importance of exchange of information in the fight against cross border tax fraud and evasion, as well as the establishment of an environment of fair taxation. Improving access to information on beneficial ownership is a key transparency issue, and is vital in African countries' efforts to address illicit financial flows which occur through money laundering and tax evasion. The global initiatives such as the Global Forum and the FATF work to increase transparency on this issue, and are very important in increasing compliance with beneficial ownership requirements. If African countries are to realise the full benefits of that work, a number of practical challenges need to be overcome. In particular:

[1009] OECD (2016a) Tax Transparency 2016: Report on Progress. 27-28.
[1010] FATF (2016) 5.

- Many African countries have limited exchange of information mechanisms which significantly impact on their ability to detect and combat tax evasion and avoidance. The situation is improving but there is still a long way to go;
- Most African tax administrations have limited IT systems to collate, filter and cross check the bulk data provided to a tax administration by other tax jurisdictions, through Automatic Exchange of Information;
- There is limited capacity within the tax administration to effectively risk assess the data and to audit the individuals who are evading tax in the country.

To address these challenges in Africa requires political commitment to sign the instruments needed to exchange information, invest in appropriate IT systems and in tax administration staffing, and to build the appropriate audit skills. The ATAF is already working to assist its members to build this capacity, and is working with its development partners to increase political awareness of the need to build this type of capacity.[1011]

8.6.1.7.5 Current State of Play

Currently efforts are underway to enhance the cooperation between the FATF and the Global Forum, to further ensure coherence and mutual reinforcement of work. A major focus is on improved transparency in relation to beneficial ownership. Some practical challenges exist, in that countries have different legal and administrative systems and it is therefore important that ways are found by means of which the accuracy of ownership information held in a company registry can be ensured. Considering the overlap between money laundering and tax evasion, it is also important that mechanisms are established to enable ownership information to be exchanged between fiscal and law enforcement authorities, in *both* directions.

Several jurisdictions have implemented adequate legal frameworks to collect and maintain beneficial ownership information, as part of their customer due diligence procedures. The challenge, however, is to improve effective implementation of the measures, specifically in as far as the requirements to ensure the accurate, complete and up-to-date capturing of basic and beneficial ownership information are concerned. It is also important that the information can be made available to the authorities in a timely fashion. The specific operational challenges of preventing the abuse of corporate vehicles can only be achieved with dedicated attention from individual countries.

[1011] ATAF (not dated).

The FATF has recommended that the G20 publicly commit its members to meet the FATF Standards on beneficial ownership, and to commit to lead by example by meeting the FATF Standards on legal and beneficial ownership and the enforcement thereof.[1012] These include:

(a) Full and effective implementation of the FATF Standards on transparency and beneficial ownership (Recommendations 24 and 25) without delay.
(b) Effective monitoring of key gatekeepers, such as lawyers and company formation agents, for compliance with their CDD obligations. It is critical that CDD are enforced by means of identifying and closing down those entities which facilitate the abuse of corporate vehicles.
(c) To address information sharing barriers at a national and global level by reviewing privacy and data protection legislation.
(d) Move toward sharing basic and beneficial ownership information at the domestic and international level in a timely manner, including ensuring that such information remains accurate and up-to-date.

8.6.1.7.6 Africa Country Experience

FATF Recommendation 24 requires that countries ensure complete, accurate and timely information sharing on beneficial ownership and control of legal persons that is accessible by competent authorities. The Recommendation also requires countries to take effective measures to ensure that the issuing of bearer shares or practices pertaining to nominee shareholders or nominee directors, are not for money laundering or terrorist financing purposes. Recommendation 25 requires adequate, accurate and timely information on express trusts, including information on the settlor, trustee and beneficiaries that can be obtained or accessed in a timely fashion by competent authorities.[1013]

The requirement for countries to collect beneficial ownership information on companies, trusts, and other legal entities that are registered within their borders, also implies that such information should be accessible through central registers.[1014] This of course requires that provision is made for the obligation to collect beneficial ownership information in country legislation. Further clarity on what needs to be collected can be done through industry guidance and determinations. For example, Namibia provides industry guidance that:

- Describes misuse of legal persons and arrangements,

[1012] FATF (2016) Report to G20 on Beneficial Ownership. 8.
[1013] FATF (2016) 8.
[1014] FATF (2014) 34.

- Provides a definition of beneficial ownership,
- Provides steps to determine beneficial ownership and guidance on establishing the identity of the legal person;
- Clarifies the meaning of effective control and the benefits of using a risk based approach in verifying beneficial ownership information.[1015]

In addition, certainty on what needs to be collected and the relevant periods for its collection, is provided though Determinations issued under Section 4 of the Financial Intelligence Act.[1016] Equally important is the ability to maintain and monitor the availability of accurate data. Whilst most countries in the developed world have access to legal ownership information of companies, trusts, partnerships, foundations and other organizational structures, this is not necessarily the case in developing countries, which are hampered by systems deficiencies and inadequate resourcing. The importance of a proper oversight programme is essential to verify compliance with the obligation to keep ownership and identity information. It is instructive to see that the Registrar of Companies in Lesotho has recently (2016) conducted a re-registration programme (on all domestic and foreign companies). This resulted in 17029 private companies, 504 public companies and 58 foreign companies being struck off the register.[1017] Whilst the clean-up is a critical step toward building a proper corporate registry, ongoing monitoring on compliance needs to be built into the process.

It is accepted that a legal basis is required for exchange of taxpayer information with other jurisdictions. According to the Commissioner-General of the Ghana Revenue Authority, Mr George Blankson, exchange of information for tax purposes has also become a key part of risk management of revenue collection and administration.[1018] A well-established treaty network is therefore critical in ensuring that exchange of information is directed and indeed possible. Probably the best examples of this on the African continent are South Africa and Nigeria, which have networks of exchange of information with over 90 jurisdictions. Information can be exchanged under DTCs, TIEAs, the *OECD Convention on Mutual Administrative Assistance in*

[1015] FIC (2015) Industry Guidance Note 1 of 2015 on Identification & Verification of Beneficial Ownership.
[1016] Act 13 of 2012. Determination 2 of 2016 provides for the "Registrar of companies and close corporations to ensure that information in respect of each director, shareholder and beneficial owner of all companies incorporated before the FIA became effective is obtained within three months, as at the end of such companies and close corporations' respective financial year end, effective 01 September 2016. The Registrar is to ensure that all companies and close corporations that failed to furnish information required within the above-cited period are de-registered forthwith. The functionaries of respective companies are responsible for ensuring that information in respect of each director, shareholder and beneficial owner is furnished to the Registrar of companies and close corporations within period cited in this determination."
[1017] Global Forum Peer Reviews: Lesotho. Phase 2: Implementation of the Standard in Practice 8.
[1018] Daily Graphic (2016).

Tax Matters[1019] and the ATAF Multi-lateral Agreement on Assistance in Tax Matters (AMATM).[1020] Table 8.1 provides a snapshot of how countries representative of East, West and Southern Africa, see the importance of international agreements in achieving better exchange of information:

Table 8.1: Country Progress in Improving EOI

COUNTRY	DTA	TIEA
Ghana	United Kingdom, France, Italy, South Africa, Belgium and Germany.	OECD MAA*
Kenya	20 bilateral DTA, which include Zambia, Norway, Denmark, Sweden, UK, Germany, Canada, India, France, Mauritius, Iran. Signed but not ratified: South Korea, Qatar; Seychelles; South Africa, UAE, Nigeria; Kuwait; Italy. East African Community "EAC" multi-lateral DTA (Kenya-Tanzania-Uganda-Rwanda Burundi).	OECD MAA (2016) 10 information exchange agreements.
South Africa	More than 60 DTA and Protocols.	OECD MAA, AMATM; US FATCA;
Nigeria	17 DTA: Belgium, Canada, China, Czech Rep, France, Korea, Mauritius, Netherlands, Pakistan, Philippines, Poland, Romania, Slovak Rep, SA, Spain, Sweden, UK.	OECD MAA AMATM (ratified)

Source: OECD Global Peer Reviews (2016)

Notes:

* Second signatory in Africa of the MAA in Tax Matters.

** Draft agreements proposed for negotiation: Ethiopia; Sri Lanka; Turkey; Finland; Russia. Under negotiation 2 (Thailand and India). No TIEA has been signed yet but Kenya has initiated this process with Guernsey, the Seychelles, Singapore and Bermuda. Negotiations are taking place with Jersey, the Cayman Islands, the Isle of Man, Malta, Liechtenstein, Liberia and others. Kenya has also targeted Monaco for negotiations.

Beneficial ownership information is critical to both anti-money laundering initiatives and those aimed at tax crimes. Tools which allow for the sharing of this type of information, such as AEOI, should therefore be seen as indispensable to countries' efforts to fight money laundering, tax crimes and IFFs in general. However, to date, only four African countries have signed up the

[1019] Current signatories to the Convention are: Argentina, Australia, Belgium, Brazil, Canada, Colombia, Costa Rica, Denmark, Finland, France, Georgia, Germany, Greece, Iceland, India, Indonesia, Ireland, Italy, Japan, Korea, Mexico, Moldova, the Netherlands, Norway, Poland, Portugal, the Russian Federation, Slovenia, South Africa, Spain, Sweden, Turkey, the Ukraine, the United Kingdom and the United States.

[1020] Current signatories are South Africa, Lesotho, Mozambique and Nigeria. Ghana, Botswana, Malawi, Swaziland und Uganda have signed an "Intent to Ratify." Enters into force when ratified by 5 countries.

AEOI and have set dates for implementation. The same countries have also been moving toward including the FATF requirements on beneficial ownership in domestic legislation. Below follows a snapshot of progress to date in Ghana, Mauritius, the Seychelles and South Africa.

In 2016 Ghana made a 12-point commitment at the London Anti-Corruption Summit, which includes action on beneficial ownership aimed at preventing the misuse of companies, and legal arrangements to hide the proceeds of corruption; improving tax transparency and preventing money laundering. Ghana has had the opportunity to include beneficial ownership disclosure clauses in its Oil Exploration and Production Bill, as well as the amended Companies Code, but has failed to do so in the past.

The country was aiming to establish a beneficial ownership regime through the law on companies, to enhance transparency and the fight against corruption, by September 2016, at which time Ghana would have undergone an assessment by the Inter-Governmental Action Group against Money Laundering in West Africa (GIABA).[1021]

In Mauritius, competent authorities are able to access up to date information on beneficial ownership, because a good standard of transparency regarding the beneficial ownership and control of legal persons and legal arrangements, is in place. Competent authorities are able to have timely access to current information on beneficial ownership.[1022] A key recommendation by the FATF is that access to beneficial ownership and control for all legal persons should be available in a timely fashion for *all companies,* not only those who are required to have publicly available information at the Company Registrar's Office.

A major deficiency found in the Seychelles was the absence of a requirement for companies registered under the Companies Act, to disclose beneficial ownership information to the Registrar of Companies.[1023] As a consequence, information on the beneficial ownership of domestic companies may not always be available, as there is no requirement for companies registered under the Companies Act to disclose beneficial ownership information to the Registrar of Companies, or to any other competent authority. In 2012 new rules were gazetted to provide a definition for beneficial ownership which is more in line with the FATF requirements. It is worthwhile to note that the Seychelles was formally admitted as a member of the Asset Recovery Inter-Agency Network Southern Africa (ARINSA)[1024] in June 2016.[1025] ARINSA is a multi-agency

[1021] GIABA is a member of the global Financial Action Task Force (FATF) and is a specialized institution of ECOWAS, facilitating the adoption and implementation of policy against money laundering and terrorism financing in West Africa.
[1022] IMF (2008).
[1023] ESAAMLG (2008) Mutual Evaluation Report Seychelles. 145.
[1024] ARINSA is sponsored by the United Nations Office on Drugs and Crime (UNODC), UK Aid and the United States of America.
[1025] http://www.seychellesfiu.sc/.

informal network between participating countries, to exchange information, model legislation and country laws in asset forfeiture, confiscation and money laundering, as well as provide training opportunities for both asset agents and prosecutors.

South Africa introduced beneficial ownership through the Financial Intelligence Centre Amendment Act of 2017.[1026] Implementation of the act ensures that the key FATF recommendation concerning beneficial ownership is addressed.[1027]

The effective use of beneficial ownership information is, to a large degree, dependent on domestic information sharing mechanisms. Traditionally, the obstacles to coordination between government agencies stem from fundamental properties and motivations of organizational systems. These include issues such as (a) each agency seeks to preserve its autonomy and independence; (b) organizational routines and procedures are difficult to synchronize and coordinate; (c) organizational goals differ amongst collaborating agencies and (d) constituents bring different expectations and pressure to bear on each agency.[1028]

With regard to FIUs and tax authorities, many of these obstacles are obsolete. For instance, the objectives of both institutions are broadly the same, namely uncovering hidden wealth, and they go through similar analysis processes to identify the source and beneficial owners of such wealth. Difficulties can be found in aspects such as perceived preservation of autonomy and the pressures of constituents. Solutions for those aspects relate to political will and the ability to seek common ground.

The rationale for coordination stems from three main factors.[1029] Firstly, government has a need to address problems with multiple and interrelated causes – IFFs is a good example. Secondly, to generate economies of scale whereby a sector or area of common interest can be tackled. Thirdly, to reduce policy fragmentation – tax evasion is a predicate offence to money laundering and a third of money being laundered is attributed to tax evasion. A targeted and coordinated approach is therefore necessary to make a meaningful impact.

Tax administrations have a key role to play in addressing serious crime, and this role is often expressed in specific terms in country legislation.[1030] This obligation of sharing taxpayer information with other departments should, however, be measured against the potential impact it can have on the integrity of the tax system. In most jurisdictions, the legal basis for government

[1026] Act 1 of 2017.
[1027] IMF (2015) 8. F.
[1028] Serrano (2003) 2.
[1029] Serrano (2003) 1.
[1030] E.g. in South Africa, through Section 3 of the Financial Intelligence Centre Act (FICA).

agencies to collect information is restricted through accompanying regulations on how government may or may not use that information. Such restrictions can place limitations on government institutions' abilities to share collected information with other parts of government generally, or for purposes other than for which the information was collected.[1031] Similarly, many countries have principles of privacy in place which restrict information sharing. Countries must therefore find a balance between building efficient mechanisms of information collection and sharing and managing legitimate concerns surrounding data protection. This often creates uncertainty and/or hesitation within government departments to share information.

The G20 Communique[1032] provides a fitting conclusion to the importance of identifying beneficial ownership:

> "Financial transparency and effective implementation of the standards on transparency by all, in particular with regard to the beneficial ownership of legal persons and legal arrangements, is vital to protecting the integrity of the international financial system, and to preventing misuse of these entities and arrangements for corruption, tax evasion, terrorist financing and money laundering. We call on the FATF and the Global Forum to make initial proposals by the Finance Ministers and Central Bank Governors Meeting in October on ways to improve the implementation of the international standards on transparency, including on the availability of beneficial ownership information of legal persons and legal arrangements, and its international exchange."

8.7 Conclusion

The underlying conditions that create incentives for corrupt activities are diverse and within the extractive sector, they manifest in rent seeking through payoffs and kickbacks. In order for bribery to be worthwhile to public officials, they must be in a position to create or distribute rents. The economics approach predicts that the higher the rent, the higher the incentive for corruption, and the more managers will be prone to corrupt behaviour.[1033] Good governance requires the implementation of measures which improve the external environment in which enterprises operate, and which improve the effectiveness of institutions which regulate, facilitate and enforce regulations. As acts of corruption, money laundering and tax evasion are generally aimed at achieving a financial gain[1034] in a manner which aims to hide that gain, they are necessarily

[1031] FATF (2012a) 6.
[1032] G20 Communique par. 20.
[1033] Jeong & Weiner (2011) 381.
[1034] The gain could be legal or illegal. Where the gain is legal but the entity attempts to hide the gain from the tax authorities, it becomes tax evasion and therefore illegal.

intertwined. An institutional response should recognize this aspect, in order to deal successfully with these diverse crimes.

Taxation is a key shaper of accountability relationships between citizens and government,[1035] and the anti-money laundering framework can further delineate that relationship by highlighting agreements which are opaque and where beneficial ownership is not transparent. For a tax administration, this may mean better revenue collection and for tax policy greater transparency in the design of, *inter alia*, incentive and/or exemption regimes.

In addressing money laundering and tax evasion, cognisance should be taken of the fact that anti-money laundering and counter terrorist financing regimes support economic development though three primary roles:

a) By serving as an additional tool in combatting and preventing crime and tax evasion;
b) By protecting the financial system from criminal influences and by preventing tainted money from being injected into the economies of countries; and
c) By contributing to good governance and by promoting the rule of law to the benefit of society as a whole.[1036]

In the following chapter, I discuss the importance of a risk management framework to deal with overlaps between corruption, money laundering and tax evasion. I also highlight the importance of risk identification in the extraction phase and how the risk identification process can enable a holistic government approach to deal with these specific risks.

[1035] Knack (2008).
[1036] Yikona, Slot, Geller, Hansen, & Kadri (2011) 5.

CHAPTER 9:
A RISK MANAGEMENT FRAMEWORK TO COMBAT ILLICIT FINANCIAL FLOWS IN THE EXTRACTIVE SECTOR

9.1 Introduction

In the 2012 UNECA Report, it is proposed that “African countries can benefit from the whole of government approach” because combatting IFFs includes a wide range of government actors, including customs, tax, law enforcement, anti-corruption, financial regulation and prosecuting authorities.[1037] There is, simultaneously, a need for improved cooperation between agencies at the national level and the international level, however, because different agencies often work in isolation from each other in pursuing aspects of IFFs, and often without understanding the underlying risks that cut across their respective mandates, governments’ goal to combat IFFs is jeopardized. By following the steps of the risk management process and applying it to IFFs in the extractive sector, this chapter assesses whether risk management is a suitable tool to enable a whole of government approach as a government strategy to address and reduce IFFs.

Risk is dynamic and risk management is not only about identifying potential negative events and taking precautions against them, it is also about understanding the environment wherein an institution or business finds itself, and how it is geared to face internal and external challenges brought about by events such as globalization and the continuously evolving complexities of functional business structures. Individuals, entities and governments alike therefore require informed decision making on the best way forward.[1038]

New forms of risk appear all the time and IFFs are a prime example. By using, exploiting and abusing the financial system, various role players seek to gain diverse objectives such as competitive advantage, higher profits, means of storing or hiding wealth and the means of hiding the proceeds of crime. From the perspective of governments, IFFs pose a risk to the long term stability of a country, and by approaching IFFs as a strategic risk,[1039] the different variables associated with IFFs need to be identified, understood and considered. These include the economic environment, the policy environment and the level of governance. From an entity perspective, strategic risk includes competitor behaviour, technological improvements and reputational exposure – in relation to the latter the corporate governance risk of the organisation includes risk that relates to the reputation of the organisation and the ethical standards with which

[1037] UNECA (2012).
[1038] Roberts, Wallace & McClure (2013) 1/4.
[1039] Strategic risk relates to long-term strategic objectives.

it operates. For MNEs, additional risk management requirements arise through their association with shareholders, business partners, intermediaries, customers and suppliers.[1040]

According to Roberts, Wallace and McClure:

> "all organisations have some degree of exposure, but some are more exposed than others. The importance or significance of the degree of exposure in terms of the risk profile is largely determined by the sensitivity of the various functions. Risk sensitivity is a function of how much a particular 'hit' can hurt the organisation."[1041]

The same argument holds true for countries. In general, bigger companies are able to absorb larger impacts than smaller companies. Similarly, developed countries are better positioned to deal with "hits" than developing countries, due to the availability of better or more resources. For both countries and companies, risk sensitivity is therefore a function of different variables. Roberts, Wallace and McClure[1042] define three variables:

a) The severity of the exposure to different risk occurrences;
b) The likelihood of different occurrences/events happening in isolation or collectively within a given period;
c) The organisation or country's ability to cope with events, or a combination of events where one or more occur within any given period.

Risk management can be described as the process whereby abundant forms of risks are managed, together with all other matters of a business. It is accepted that risks can be reduced and controlled only up to a certain point, and that some risks cannot be eliminated entirely, nor should organisations attempt to do so.[1043] Similarly, the presence of tax evasion does not "imply policy failure" since it is "not optimal to eliminate tax evasion."[1044] Consideration is therefore required as to whether attempts to minimize tax evasion will improve the equity and efficiency of public finances, because minimizing evasion does not come without costs, and such costs must be considered in the development of optimal policy."[1045] The recognition thereof introduces a new set of policy instruments and the optimal setting of those is important, because they should answer questions such as what is the extent of audit coverage, what is the risk selection

[1040] Roberts, Wallace & McClure (2013) 1/6.
[1041] (2013) 1/6.
[1042] (2013) 1/40.
[1043] Roberts, Wallace & McClure (2013) 1/40.
[1044] Slemrod (2007) 43.
[1045] Slemrod (2007) 43.

framework and what is the appropriate penalty.[1046] The same should hold true for anti-money laundering and anti-corruption, since it is not optimal to eliminate, but optimal application of policy instruments is required.

Risk management is ultimately a "control mechanism for ensuring that overall risk magnitude stays within acceptable limits" (these limits are defined in terms of the risk appetite of the entity).[1047] A typical risk management system requires that, as a minimum, only risks that are relevant, are identified. Thereafter proper categorization, analysis and classification (e.g. high, medium, low) can be made of those identified risks, to determine those risks that are acceptable and those that require attention in the form of mitigation actions. An effective risk management system requires that risk is monitored and controlled over a period of time. A standard risk management system consists of an identification process, an analysis and classification process (also referred to as analysis and evaluation), a controlled consideration of organisational attitude or strategy (or reviewing the risk in the context of the organisation), and lastly, risk treatment (this can take the form of a precaution or safeguard related to risk appetite or a firm response to the risk). The risk management function is cyclical, and throughout the process, ongoing control and self-assurance are required.[1048]

9.2 Risk Management Framework

The general standard for a risk management framework was drawn up by the *International Organization for Standardization* and is contained in ISO 31000:2009, *Risk management – Principles and guidelines*, which provides principles, a framework and a process for managing risk. It can be used by any organization, regardless of its size, activity or sector.[1049] For many customs administrations the legal basis for the risk management is the Revised Kyoto Convention ("Kyoto") which is one of the WCO's instruments which underscores the importance of a risk management approach. In terms of Chapter 6 of the General Annex Guidelines to Kyoto, risk management is the key element in achieving the objectives of control, facilitation and protection, and should therefore be integral to the control programme of a modern customs administration.

Most risk management frameworks within tax and customs administrations have the following basic stages: establishing the context, risk identification, risk classification, analysis and

[1046] Slemrod (2007) 43. Slemrod points out that the possibility of corrupt administrators who abuse the system or alternatively, harshly punish someone who makes an honest mistake, may have the consequence that courts may be more cautious in finding the taxpayer guilty of evasion.
[1047] Roberts, Wallace & McClure (2013) 1/40.
[1048] Roberts, Wallace & McClure (2013) 1/34; ISO 31000 (2009) vii.
[1049] ISO 31000 (2009).

evaluation, monitoring and review.[1050] The risk context represents the starting point in the process. Central to the risk management process in tax administrations is the operational context, which can be defined as the "environment" wherein the tax administration operates. A wide variety of environmental and organisational factors exist that have to be considered to establish the context.[1051]

Returning to the topic of IFFs, the first step is to define the risk in a country context, and to determine the extent to which it will affect the country as a whole if it occurs. IFFs constitute a country risk and if this occurs, it has serious, systematic, adverse effects on the economic and political development of many of the poorest countries.[1052] Once the likelihood of the risk occurring is considered, a response process and control framework is required - if the broad risk is IFFs, then an appropriate mitigating strategy to reduce the consequences may be coordinated international action. With the latter as a high level approach, dealing with the risk appears fairly straight-forward. However, once the process of assigning responsibility is pursued, it becomes less clear to which department or agency the task should be assigned.

Therefore, critical to the effective management of strategic risk, is the existence of a control framework or risk register, which contains information and data on the risk, together with its current and desired state. The register will also show who has ownership of the issue and which controls and monitoring are in place.[1053]

9.2.1 Risk Interdependency Fields

Traditional risk management systems consider one particular function, for instance, in the financial sector, people looked primarily at financial risk management. However, with the implementation of AML controls, different inter-dependencies were created within the financial sector because – according to the FATF:

> "the overall effectiveness of a country's AML/CFT regime requires recognition of the important synergies that exist between AML/CFT, prudential and business conduct supervision and between those supervisors and judicial/law enforcement authorities."[1054]

Thus, a shift from a stand-alone functional risk focus is required, to one which takes full consideration of the inter-dependencies between the various functional sections of the

[1050] Roberts, Wallace & McClure (2013) 3/11.
[1051] European Commission Directorate-General Taxation and Customs Union (2006) 12.
[1052] Moore (2009) 458.
[1053] Roberts, Wallace & McClure (2013) 4/6.
[1054] FATF (2015) 3.

organisation – or in the case of IFFs, from a country perspective, departments of governments – and the impacting risks at each level.[1055]

Tax policy, and as a result, also tax laws, typically provide for mechanisms to discourage and address tax avoidance and tax evasion. There are, however, statutory limitations to the tools at a revenue administration's disposal, to collect revenue that is due and payable. The revenue authority may then be required to rely on the efficiencies of other agencies to increase its reach. For instance, financial intelligence units (FIUs) are statutorily enabled under anti-money laundering legislation to take action that may not be allowed under tax laws. In instances where corrupt officials are protected, enablers such as sanctions on "politically exposed persons" may be invoked locally, or by foreign FIUs, to seize proceeds of crimes and to take steps toward prosecution of such persons.

There is also recognition within tax authorities that important synergies exist and that a standard audit is not sufficient to deal with aspects such as aggressive tax planning. Increasing disclosure requirements place an onus on the taxpayer to provide timely, targeted and comprehensive information and thereby increase the compliance burden – at the same time it also places an obligation (at least in theory) on tax administrations to provide tax certainty.[1056] The *OECD Guidelines for Multi-national Enterprises*[1057] contain guidelines and recommendations pertaining to business conduct by MNEs. MNEs are encouraged to "comply with both the letter and spirit of the laws of the countries in which they operate," and it calls on MNEs to handle tax governance and tax compliance as core aspects of risk management and oversight mechanisms that are characterised by boards' adoption of tax risk management strategies aimed at ensuring that regulatory, reputational and financial risks are fully identified and evaluated in as far as tax issues are concerned.[1058]

Managing tax compliance risk effectively is dependent on timely and voluntary disclosure from taxpayers. To encourage this voluntary disclosure, a cooperative approach between tax authorities and taxpayers is required. Perez-Navarro points out the following key attributes which tax administrations should have when dealing with taxpayers:

- An understanding of the taxpayer based on commercial awareness;
- Impartiality, proportionality and openness (disclosure and transparency);

[1055] Roberts, Wallace & McClure (2013) 8/4.
[1056] Perez-Navarro G (2012) 1.
[1057] OECD (2011a) 60.
[1058] OECD (2011b) 60.

- A responsiveness to taxpayers that is founded in a cooperative approach, which has the ability to improve overall tax compliance and tax risk management. Benefits of this approach will accrue to both taxpayer and administration.[1059]

Picciotto[1060] cautions on the outright acceptance of approaches such as cooperative compliance:

> "whilst the primary concern of regulators is likely to be to ensure effectiveness, so that they prioritize consultation with the targets or subjects of regulation, to identify possible responses, and hence improve compliance. However, this again courts the danger of capture, which could obviously compromise the wider social goals, and undermine the legitimacy of the regulatory regime."

Cooperative compliance can lead to a steep decline in both prosecutions and inspections, which Thombs and Whyte argue to be self-defeating, since the reduction of inspections can deprive the authorities of the intelligence essential to targeting interventions.[1061]

Whilst risk inter-dependencies exist between government agencies and the private sector (government to business), there are also synergies between different government agencies with overlapping mandates, as well as synergies between government agencies located in different jurisdictions/countries.

9.3 Applying a Risk Management Framework to address IFFS in the Diamond Value Chain

9.3.1 Establish the Context

According to the WCO,[1062] any effort to manage risk must begin by first establishing what needs to be managed. As a first stage, one needs to define the context in which risk management will take place, the objectives thereof and the risks which are being examined. Determining what needs to be managed helps to set the parameters for the rest of the risk management process. A useful approach, as advanced through the WCO *Risk Management Guide*, is to establish context, outlining both the internal and the external aspects, and to ask questions such as: what is the operating environment; what capabilities and resources are available for managing risk;

1059 Perez-Navarro (2012) 1.
1060 (2017) 687.
1061 Cited in Picciotto (2017) 681.
1062 WCO *Risk Management Compendium* Vol. 1.14.

which criteria will be used to assess risk; what is the scope and limits of risk management; and what are the expectations of stakeholders, government and affected communities.

An outcome of this phase should be a statement of the environmental operating context, which includes a clear indication of the objectives ("risk to what") and the risk areas. In addressing the context for IFFs, it is useful to refer to the UNECA Report,[1063] which identifies specific "push and pull factors" which drive IFFs. The main "push factors" identified are:

- The desire to hide illicit wealth;
- The imperative to conceal the ways and means by which illicit wealth is created;
- The desire to make it difficult to trace the associated money flow.[1064]

An environment which facilitates the "push factors" is characterised by poor governance, where individuals find it easier to enrich themselves through illicit activities, rather than through legitimate business. An environment characterized by generalized corruption also increases such activities, due to weakened institutions and weak or selective enforcement of regulations. According to UNECA, strong legal frameworks and enforcement agencies make it difficult for individuals and companies to move illicit resource, and this point is illustrated by "the relative success of developed countries in tackling IFFs compared with the African experience."[1065]

According to the UNECA Report, weak regulatory structures is another factor relevant in post-conflict countries, where countries were not in position to establish institutions such as a financial intelligence centres or anti-corruption agencies. The report also highlights that "IFFs are facilitated in areas that are not under the complete control of African governments as a result of conflict and insurgency."[1066] Recognition of this problem led to the introduction of, for example, the Kimberley Process, in order to stop the trade in "blood diamonds".[1067]

The UNECA Report also refers to the investment and tax environment of African countries, and specific reference is made to foreign direct investment, weaknesses in double taxation agreements[1068] (DTAs) and the use of tax incentives.[1069] Added to this is the approach followed

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[1063] UNECA (2015) 40.
[1064] UNECA (2015) 40.
[1065] UNECA (2015) 41.
[1066] UNECA (2015) 41.
[1067] UNECA (2015) 41.
[1068] Specific reference (2015:41) is made to "troublesome" provisions such as those that seek to remove or lower withholding taxes on management fees and remove limitations on intra-company loans. Taxing at source is also supported and the point is made that the current state of DTAs underlines the need for Africa to build capacity to negotiate economic contracts effectively.
[1069] Specific reference (2015:42) is made to "tax holidays that enable IFFs, notably through the exploitation of rules relating to change of ownership as well as directly through base erosion."

by a country to increase its treaty network through DTAs. A reactionary stance (merely acceding to requests) should be replaced by a proactive approach, in which treaty partners of importance are identified. Informed decision making on existing trade relations with a proposed treaty partner is crucial in avoiding future pitfalls. An example thereof occurs where the proposed treaty partner merely becomes a conduit for trade and investment, and it may create possible tax avoidance opportunities for the citizens of the contracting state. The latter can then be considered as a further "major enabler or pull factor for IFFs from Africa,"[1070] especially where the treaty partner is a financial secrecy jurisdiction and/or tax haven, which brings about an absence or lack in transparency. A cautionary note in this regard by the UN states that in negotiating tax treaties, it is important to keep in mind that its purpose is to avoid double taxation and to stimulate cross-border activities; it is not to create a situation of double non-taxation. It is also important for a country to be aware of provisions in a treaty which might be misused by business, in order to avoid taxation in the country of source, or even in the country of residence.[1071]

Lastly, reliance on extractive industries for revenue and export earnings in Africa generally implies that the sector may be categorised by a high degree of discretionary power and political influence. This, according the UNECA Report, is the origin of some unequal and secretive contracts that African countries enter into with multi-national mining companies. Such contracts have the ability to undermine accountability and transparency in the extractives industry.[1072]

To summarize, IFFs occur predominantly in the context of an environment which is characterised by weak regulation, control and governance. It also occurs where infrastructure limitations exist, (especially in the case of post-conflict countries), as a weak infrastructure will likely deter new FDI and cripple law enforcement activities – the latter is supported by empirical studies which have shown that "improvements in institutional quality are a key precondition for larger capital flows to developing countries."[1073] A lack in sophistication of the tax environment gives further context to the prevalence of IFFs in developing countries. Resource-rich countries characterised by generalized corruption and political interference provide ample breeding ground for IFFs. The risk posed to governments in developing countries is therefore a risk to its socio economic and political stability through a reduction in domestic resources and tax revenue needed to fund capacity building programmes and infrastructure development.

[1070] UNECA (2015) 41.
[1071] United Nations Social and Economic Affairs (2014) 107.
[1072] UNECA (2015) 56.
[1073] Schularick & Steger (2008) 11.

9.3.2 Risk identification

Risks cannot be analysed or managed until they are identified and described in an understandable way. The risk identification phase identifies and records all potential risks by using a systematic process to identify what risks could arise, why, and how, thus forming the basis for further analysis. Some of the questions asked in this phase could include: what are the sources of risk; what risks could occur, why, and how; what controls may detect or prevent risks; what accountability mechanisms and controls (internal and external) are in place, etc.[1074]

Flowing from the context established above, it is evident that the specific risks underlying IFFs are numerous, and they include weak regulation and governance, weak tax policy and tax administration, corruption and lack of institutional quality. These are strategic risks to a country, which need to be assigned to departments/agencies for them to further refine the broad strategic risks and to determine priority areas for action within their areas of influence.

By limiting the risk management scope of IFFs to the extractive sector, and setting parameters narrowly to deal *only with the diamond value chain*, it is possible to relate the specific strategic[1075] risks identified into a manageable risk register. For purposes of this thesis, corruption, money laundering and tax risks are discussed.

9.3.2.1 Money Laundering Risk in the Diamond Value Chain

The trade in diamonds is described by the FATF as "transnational and complex" and therefore suited to money laundering transactions which are, more often than not, of an international and multi-jurisdictional nature.1076 These characteristics of the trade create challenges for local law enforcement agencies, in that any investigation may necessitate international cooperation between law enforcement agencies across multiple jurisdictions in which the trade is taking place.[1077] The context wherein diamond trade takes place has several unique features that, according to the FATF,[1078] include: business practices characterized by confidentiality in transactions, agreements are concluded verbally, deals are conducted through diamond bourses located in Free Trade Zones (FTZs) and through "memo" transactions.[1079] Together with these

[1074] WCO Risk Management Compendium Vol 1. 12.
[1075] Weak regulation and governance, weak tax policy and tax administration, corruption and lack of institutional quality.
[1076]FATF (2013d) 6.
[1077]FATF (2013d) 6.
[1078]FATF (2013d) 25.
[1079] This practice is defined as follows by the FATF (2013: 21): "the lending of a diamond or a mix of diamonds to others in the diamond industry so that they may have the opportunity to sell them. Under such an arrangement, the conditions of the loan are specified, including for how long the diamond will be lent, the price of the diamond, and the terms of remittance to the owner if the diamond is sold. The vendor who has the diamond on memo may sell the diamond at a mark-up and then pay the owner in the time and amount specified by the memo."

characteristics, the commodity has a high value to mass ratio, which means that diamonds may be transported across borders either legally or illegally (e.g. smuggling) with relative ease.[1080] A huge secondary global market also exists in the form of recycled diamonds (e.g. manufactured jewellery), which is estimated to be worth billions in USD. The latter is described as a unique feature of the trade, since diamonds do not need to go through any preparations to be returned to the market, because they can be easily placed into new jewellery or be sold as an investment.[1081] These characteristics of the diamond trade mean that diamonds are a commodity which is susceptible to exploitation by transnational crime syndicates or terrorist groups, because they are an easy means "to transfer value or legitimise illicit transactions and profits."[1082] It also implies that there are several difficulties in monitoring the trade by regulators and law enforcement agencies.

The diamond value chain has the following steps: (a) production (this includes mining, sorting and valuing); (b) rough diamond trading or sales; (c) cutting and polishing; (d) sales of polished diamonds; and (e) jewellery manufacturing and jewellery retail sales.[1083] Each step also has specific risks to it, for example:

a) *Mining*: At the mining stage, common risks that can occur include theft, illegal mining, and commingling of legal and illegal diamonds.
b) *Rough diamond trading*: Risks manifest in the import or export of diamonds that is conducted without KP certificates, and in instances of local trading (where a KP certificate is not required). There is also a risk of rough diamonds being smuggled and then cut and polished as a means to conceal their illegal origin. This is so because a KP certificate is not required when stones are cut and polished locally and then exported.[1084]
c) *Trade centres for rough and polished stones*: There is a risk of tax avoidance practices in that over or under invoicing of stock can occur with affiliate diamond companies based in free trade zones. Such practices make it possible to move profits from diamond companies in high tax countries to free trade zones, and to thereby avoid taxes or perpetrate activities supporting money laundering or terrorist financing.[1085] Trade can also facilitate corruption through under invoicing of the rough diamonds in source countries, in that "acquired margins may be created to facilitate payments to politically exposed persons (PEPs), military or other invisible stakeholders in the transaction."[1086]

[1080] FATF (2013d) 10, 25.
[1081] FATF (2013d) 25.
[1082] FATF (2013d) 10.
[1083] Bain (2011) 19.
[1084] FATF (2013d) 60.
[1085] FATF (2013d) 61.
[1086] FATF (2013d) 61.

d) *Cutting and polishing*: As shown in (b) above, once cut, there are no KP certificate requirements to be met, which makes it easy to move and conceal high value diamonds.[1087] This feature assigns similar characteristics to polished diamonds, as one would have with cash. The diminishing traceability makes it easier to move the diamond "up the supply chain through trade centres for polished diamonds, without the ability to verify the origin of the diamond," and in big markets with little supervision, it is much easier to move the diamonds.[1088]

Globalization and the complexity of the global trade in diamonds means that risks and vulnerabilities may differ through the stages of the value chain, and from one country to another. Risks such as smuggling, theft and commingling of legal and illegal diamonds can occur throughout all stages of the trade.[1089] As a result of the these risks and vulnerabilities, diamonds have been recognised by the Financial Action Task Force (FATF) as a "vehicle to generate criminal profits, as well as the vehicle to launder them," and for this reason, diamond dealers are included in the definition of Designated Non-Financial Business and Profession (DNFBP).[1090] From a regulatory perspective, the FATF makes specific mention that "Recommendation 22[1091] on customer due diligence (CDD) for DNFBPs, and Recommendation 23[1092] on other measures for DNFBPs are only based on cash transactions" and that "all other transactions in which diamond dealers are or could be engaged, are not covered."[1093] With regard to Recommendation 32,[1094] diamonds are not included in the definition of currency or bearer negotiable instruments, and therefore countries are not required to have measures in place to detect the physical cross-border transportation of diamonds through a declaration or disclosure system. According to the FATF, reported cases show substantial use of cross-border value transfer by means of using diamonds.[1095]

[1087] FATF (2013d) 62.
[1088] FATF (2013d) 62.
[1089]FATF/Egmont (2013d) 130.
[1090] FATF (2013d) 9, 10.
[1091] Recommendation 22 (c) provides for: "Dealers in precious metals and dealers in precious stones – when they engage in any cash transaction with a customer equal to or above the applicable designated threshold."
[1092] 23(b) provides that: "Dealers in precious metals and dealers in precious stones should be required to report suspicious transactions when they engage in any cash transaction with a customer, equal to or above the applicable designated threshold."
[1093] FATF (2013d) 131.
[1094] The Recommendation provides that: "Countries should have measures in place to detect the physical cross-border transportation of currency and bearer negotiable instruments, including through a declaration system and/or disclosure system. Countries should ensure that their competent authorities have the legal authority to stop or restrain currency or bearer negotiable instruments that are suspected to be related to terrorist financing, money laundering or predicate offences, or that are falsely declared or disclosed. Countries should ensure that effective, proportionate and dissuasive sanctions are available to deal with persons who make false declaration(s) or disclosure(s). In cases where the currency or bearer negotiable instruments are related to terrorist financing, money laundering or predicate offences, countries should also adopt measures, including legislative ones consistent with Recommendation 4, which would enable the confiscation of such currency or instruments."
[1095] FATF/Egmont (2013d) 132.

Where FATF Recommendations have not been implemented, overall compliance cannot be assessed properly. Country legislation and/or requirements requiring licencing of business activity in pursuit of diamond trade is not uniform – some do and some do not. In instances where supervisory bodies are imposed, the FATF found that no sanctions were imposed for a two-year period for transgressions.

In as far as money laundering risk is prevalent to the diamond value chain, the FATF highlights some major concerns related to KP certificates:

a) Enforcement activities related to diamonds are not aimed at identifying and addressing the predicate crimes such as tax evasion, fraud, smuggling and money laundering itself, but more towards ensuring compliance with the KPCS requirements.[1096]
b) There is a lack of transparency for border officials because the KP scheme does not have a prescribed universal standard on the format and specifications that a KP certificate should have. This deficiency makes it very difficult for customs inspectors to recognize forged certificates.[1097]
c) The relative ease with which new certificates can be issued by authorities create opportunities to hide the origin of diamonds. The KPCS process dictates that certificates which accompany imported diamonds are to be kept in the importing country and not sent with the next or following export of the consignment. A new certificate is issued by the exporting country, and this aspect is highlighted as a risk because the actual origin of the rough diamonds can be concealed.[1098]
d) The requirement of KP certificates only for imports and exports of rough diamonds creates a money laundering risk, because the KP certificate might serve "unintentionally as a money laundering tool, as the existence of the certificate may signify that the source is legitimate, thereby overlooking ML/TF considerations."[1099]

Importantly, the FATF points out that where there is a downstream beneficiation process, it can undermine the purpose of the certificate, because exports will then favour polished diamonds (for which no certificates are required). Whilst beneficiation promotes economic development, it may also increase the risk of illegal diamonds entering the global value chain, because it is potentially easier to then hide rough diamonds purchased with cash proceeds of crime, by having the diamonds cut and polished locally and by exporting the polished diamonds without the need to issue a KP certificate.[1100]

[1096] FATF (2013d) 57.
[1097] FATF (2013d) 57.
[1098] FATF (2013d) 59.
[1099] FATF (2013d) 59.
[1100] FATF (2013d) 60.

9.3.2.2 Corruption Risk in the Diamond Value Chain

Surprisingly, up to 1997, only the US prohibited bribery of foreign officials. With the OECD Anti-Bribery Convention in 1997 and a consequent United Nations Convention against Corruption in 2005, most of the 168 country signatories seek to prohibit private sector bribery. The African Union (AU) adopted the Convention on Preventing and Combatting Corruption in 2003, which required member states to adopt regional anti-corruption standards, including codes of conduct for public servants, mutual law enforcement assistance and the strengthening of national anti-corruption authorities. Also included are national control measures which bind foreign countries to national legislation, and in this regard, it is worthwhile to note that that the UK Bribery Act condemns all forms of bribery, including corporate offences such as negligent failure to prevent bribery.[1101]

Corruption has a major distortionary effect on incentives and creates inefficiencies in an economy. It provides public officials with excessive discretionary powers, in as far as regulation is concerned. Abusive actions by public officials can cripple already weak institutions and strip their ability to address structural problems. This in turn can perpetuate a negative cycle of corruption and bad governance. Corruption then becomes a barrier to entry for businesses where there may be lucrative opportunities. Opportunity cost can manifest itself in various ways through discouraging legitimate investment and business transactions. Individuals and entities that engage in corruption spend large portions of their time in building relationships with individual government officials, with the aim of speeding up processes in favour of the briber and slowing down the process for competitors.[1102]

A review of peace-building and development dimensions of the diamond sector in four African states found that in all but one, there was a high increase in tax receipts, even a quadrupling thereof in one of the three. Economically all but one showed increased industrial production and stability in the artisanal mining sector.[1103] Regarding political legitimacy and conflict in the sector, all four were marked by corruption and conflict, ranging from human rights abuses, continued links to armed factions, violence between industrial companies and artisanal miners, demonstrations and vandalism.[1104]

[1101] Hameed (2014) 4.
[1102] Hameed (2014) 9.
[1103] The countries covered were Angola, the DRC, Liberia and Sierra Leone. The dimensions used were economic, fiscal, conflict and violence, political legitimacy and main policies
[1104] Vlassenroot & Bockstael (2008) 204.

The starting point of the diamond value chain is diamond mining, which normally requires the awarding of mining concessions by the state. In this context, a simple model illustrates the dynamics of corruption in the public sector: "the *opportunity* for corruption is a function of the size of the rents under a public official's control, the *discretion* that official has in allocating those rents, and the *accountability* that official faces for his or her decisions."[1105]

Thus the first level risk which can be identified is the potential for *bribery of public officials*. Sub level risks to bribery in the extractive industry value chain identified by the World Bank[1106] include:

a) *Government contracts.* Here the intention of the bribe is to influence a government's choice of companies for the supply of goods and services, in addition to the terms of their contracts. Bribes can also be intended to win contracts and to ensure that there is toleration of breaches in contracts.[1107]
b) *Lower taxes.* Bribes are paid to minimise or negate the payment of taxes and fees and can be proposed or solicited from either a tax official or taxpayer. In this sense, the tax obligation is negotiable. According to the World Bank, it is routine practice for miners, producers and exporters in many countries to bribe officials to under report either on the value or volume of the resources.[1108]
c) *Licences.* The issuance of a license may be subject to a payment of a bribe, especially where such conveys an exclusive right, for example, the exploitation of a natural resource or "licencing" illegal resource exploitation outside of concession areas. According to the World Bank, politicians or public officials may intentionally put policies in place that establish "control rights" from which they can profit when these control rights are sold.
d) *Time.* The offering or solicitation of bribes to speed up the process in granting permission to carry out legal activities (e.g. construction permits or company registration). Bribes can also be solicited by a threat of delay or general inaction.[1109]

A second first-level risk is embezzlement by corrupt officers, which can take the form of misstating the country's production share through "deliberate misreporting on volume or quality by operating company, inflation of operational costs, or revenues accrued to the state resource marketing entity."[1110]

[1105] World Bank (not dated).
[1106] World Bank (not dated).
[1107] World Bank (not dated).
[1108] Le Billion (2011) 4.
[1109] World Bank (not dated).
[1110] Le Billion (2011) 5.

9.3.2.3 Tax and Customs Risks relevant to the diamond value chain

In 2011 Global Financial Integrity (GFI) estimated that trade mispricing accounted for an average of 54.7 per cent of cumulative illicit flows from developing countries over an eight-year period.[1111] This high rate is assigned to mispricing that is caused by the falsification of imports and exports through practices such as inaccurate or false reporting on quality and quantity of goods, or by creating fictitious transactions. It is often difficult for tax administrations to detect false invoicing, due to a lack of supporting documentation or poor risk based targeting by administrations. According to research by GFI, some 45 to 50 per cent of trade transactions could potentially be falsified by an average of more than 10 per cent, and 60 per cent of trade transactions in Africa are potentially mispriced by an average of more than 11 per cent.[1112] Whilst these are estimates, they can provide governments with impetus to address trade malpractices that contribute to IFFs.

Cross-border transportation of diamonds falls under customs control and, whilst there are regulations pertaining to the import and export of diamonds in place, there may be differences in application of controls, especially in as far as polished stones are concerned. The subjectivity in the valuation of diamonds poses severe difficulties to customs officials as they, more often than not, do not have expertise to value diamonds. In countries where the tariff for customs declarations is based only on carat, a gap can be created within the import/export system which may be exploited through under or over valuation. A means to address this gap is by having risk-based inspections by expert gemmologists working within or on behalf of customs. Such interventions can potentially have a considerable impact on reducing price manipulation through international trade.[1113]

The internet is a further trade platform and vulnerabilities with sales and purchases make “know your client” and due diligence procedures difficult to conduct, due to anonymity of the customer. Another typology which manifested itself is the laundering of stolen diamonds via the *Dark net*, where any commodities including diamonds are bought and sold using e-currency (e.g. bitcoin which is deemed to be legal tender and as such, taxable).

The diamond trade is associated with both the flow of finances and goods, which makes it subject to tax and customs control measures. The following general risk indicators exist from a customs and tax perspective:

[1111] Kar & Curcio (2011) vii
[1112] Eurodad (2011) 7-12.
[1113] FATF (2013d)133-134.

a) There is *no commodity or market price* or "price list" for diamonds, since there is “no specific product.”[1114] Trade in parcels of bulk diamonds is a feature of the industry. Parcels can include diamonds of different size and quality, so it may be very difficult or even impossible for a diamond valuer to examine each and every stone that is to be exported.[1115]

b) *False records and invoices and lack of detail.* A lack of detail leaves room for manipulation, because import information such as value or volume can be left out and thereby make it difficult for customs officers to determine whether criminal activity is present.[1116]

c) *Lack of skills in administration.* Diamond valuing requires specific skills which are rare and expensive to obtain.

d) *Variance in inventory practices.* In valuing diamonds, there are implications on profits and taxes due, due to the way diamonds are registered in the inventory – this can be done by piece or by weight. This leaves room for manipulation of taxes due, owing to the difficulties for tax administrations to verify the inventory levels at the reporting date.

e) The *subjectivity of valuation* of diamonds. The FATF points out that the “per carat price of a diamond can vary considerably, based on the crystalline shape, the carat weight, the colour and the clarity” (referred to as the 4 C’s).[1117] Each of these qualifiers “imparts an individual measure of a diamond, while also affecting the valuation of the other qualifiers; each measure is subjective and cannot be precisely stated (except carat weight).”[1118]

f) *Transfer Pricing*. Over and under invoicing of diamonds with affiliate diamond companies located in, for example, free trade zones, may make it feasible to shift profits from diamond companies in high tax rate countries to avoid taxes.

In relation to tax avoidance practices, Van Gelder *et al*[1119] suggest the following as risk indicators:

a) *A subsidiary located in a tax haven*: one or more subsidiaries of the mining company, or the ultimate holding company, shareholder or mine owner, are legally incorporated or located in a tax haven.

b) *A foreign holding or financing company*: where a limited liability company is immersed in the corporate structure between a local mining company and the ultimate foreign holding company of the mining group. Such a structure can facilitate the channelling of dividend and interest payments, as well as management fees, through the foreign holding entity, to lower the overall tax burden of the mining group.

c) *A foreign cooperative company or a trust acting as director*.

1114 FATF (2013d) 51.
1115 FATF (2013d) 51.
1116 FATF (2013d) 55.
1117 (2013d) 50.
1118 FATF (2013d) 50.
1119 (2016) 17-24.

d) *Under reporting export profits or over reporting imports*: profits can be shifted to entities in countries which have lower applicable tax rates by under reporting exports. This can take the form of under reporting exports between entities within the same corporate structure, and between entities that do not belong to the same corporate structure. In the first instance, the gross profit of the corporate structure remains the same, however, when profits are moved to jurisdictions with lower taxes, the net profit increases. In the latter, the gross and net profits of the corporate structure decrease, while the profits of the external trading partner increase. This can work to the advantage of the owner of the corporate/s, when an indirect ownership relationship exists with the trading partner and that trading partner is located in a country that has a low profit tax rate.

e) *Under reporting production*: production which is under reported reduces the actual amount of revenues and profit in the country where minerals are extracted, thus minimizing the tax burden of the corporate structure. This strategy can take place with activities such as smuggling.

f) *Under valuing the quality of the minerals*: this practice is highlighted as a high-risk indicator during the start-up phase. The risk lies therein that a mining company can request or negotiate an advanced tax ruling, due to an asymmetry in access to information where the government does not know what the actual value of the minerals is or what it will be.

g) *Payments for patents and royalties to a jurisdiction with a lower profit tax*: profits in the mining country can be shifted to a related entity in a jurisdiction where a lower tax rate applies, by allowing the local mining company to pay considerable amounts of royalties to the related entity for the use of certain patents on products or production technologies. Royalty payments for the use of brand names and other forms of intellectual property are managed by a related company located in a jurisdiction with a lower profit tax.

h) *Intra-group loans and interest payments*: intra-group loans result in interest payments between different entities belonging to the same corporate structure. Providing intra-group loans may be used to move costs from an entity in a country where the profit tax is relatively high to an entity in a country which has a lower income tax rate. This type of tax avoidance strategy is likely to occur when the interest rate applied on the intra-group loan is clearly below or above the market rate, or when thin capitalization is applied where the local mining company is being financed with relatively more debt (intra-group loans) and less equity than that which is common business practice.

i) *Redirected dividend payments:* companies in the corporate structure will normally pay part of their profits as dividends to the ultimate parent company, via the hierarchical structure of the group (dividend payments to the holding company of a business segment, which pays dividends to the ultimate holding company). The dividends constitute the disposable profit of the ultimate parent company, and if the dividend payments in the corporate structure do not follow hierarchical lines but are redirected, via entities in countries such as the Netherlands (which combine a participation exemption with a beneficial network of tax treaties), tax avoidance could possibly occur. The same applies when the redirected dividend payments do not reach the ultimate parent company, but are collected by a related entity in a jurisdiction which has relatively low income taxes. This entity could then reinvest the collected dividends on behalf of the parent company.

j) *Payments to government officials*: mining companies can influence government decisions through the payment of bribes to get more favourable contractual terms and/or a reduced tax obligation.

k) *Management fee payments to a jurisdiction with a lower profit tax*: Profits can be reduced in the country where mining takes place, by paying management fees to a related entity registered in a country which has a lower rate of profit tax.

l) *No country by country reporting*: The absence of country by country reporting standards point to a risk of tax avoidance. Standard practice in the financial reporting of international companies or groups of companies, is to do a consolidation of all financial data pertaining to all entities in the corporate structure. This practice may, however, conceal tax avoidance strategies, which can be uncovered through country by country reporting.

m) *Limited number of employees*: entities within a corporate structure (shell companies) that does not have a large staff compliment, but still has a relatively high turnover, can point toward the presence of avoidance risk.

n) *Accelerated depreciation of assets*: by accelerating the depreciation of its assets, a mining company can ensure that its reported profits remain negative for a considerable number of years.

o) *Holding many immaterial assets*: a local mining company can minimize its tax obligations by attracting a high number of immaterial assets such as mining rights, for the purposes of using the depreciation of such rights to minimize its profits which are taxable.

p) *A difference between the reported and taxed income*: Van Gelder *et al* maintain that "companies that increase the reported income to shareholders (legitimately or illegitimately) more often report lower fiscal profits to the tax office due to (legitimate or illegitimate) tax planning."[1120]

q) *Tax efficiency reasons* are indicated for the choice of corporate structure.

r) *Advance tax ruling in the mining country*: can be a risk indicator, specifically in the negotiation phases before development of the mine begins.

s) *Rounded tax return* in the mining country: can be an indicator that amounts were manipulated, because they were not derived from a "natural calculation process."[1121]

[1120] (2016) 24.
[1121] (2016) 24.

t) *Unknown Ultimate Beneficial Owner*.

u) *Compliance record of owner*: weak PIT compliance of owner can be indicative of weak CIT compliance by company.

An additional indicator can be found in negative media attention. This aspect is well demonstrated by media leaks such as the Panama Papers insider information, which was leaked to the media. In these instances, companies allegedly engage in tax avoidance or tax evasion strategies, and the reaction from the authorities can be immediate. An example was the French police raiding the offices of the Society Générale, to identify account holders that were implicated in the media leaks.

9.3.3 Risk Register

The outcome of the risk identification process is a register of risks, which documents the risks and ensures that the entire risk spectrum is considered. Based on the risks considered above in relation to IFFs in the extractive sector, a basic register to address risks relating to IFFs should contain some of the following:

Table 9.1 Risk Register

	OBJECTIVE	RISKS	TREATMENT	RISK OWNER
1.	Reduce money laundering in the diamond value chain which contributes to IFFs	1.1 Memo transactions 1.2 Illegal mining/comingling 1.3 Smuggling 1.4 Cash transaction 1.5 Valuation 1.6 Policy weaknesses	1.1 KYC/CDD 1.2 Risk based approach 1.3 Risk based approach customs 1.4 FATF Recommendations 1.5 KYC/Cooperative compliance/MAA 1.6 Implementation of FATF recommendations/ amendment to FATF Recommendations	1.1 FIU; RA 1.2 IS, Police, FIU 1.3 Customs, Police 1.4 FIU 1.5 FIU; RA 1.6 FIU; FATF
2.	Reduce corruption (bribery and embezzlement) in the diamond value chain which contributes to IFFs	2.1 Government contracts 2.2 Under-reporting of values and volumes 2.3 Licencing of concessions 2.4 Embezzlement of funds	2.1 Oversight and Transparency 2.2 Cooperative compliance e.g. EITA Standard 2.3 Transparency in licencing and contracting phase 2.4 MAAs; DTAS, AML Recommendations on PEPs; country by country reporting	2.1 Treasury 2.2 RA 2.3 Treasury 2.4 FIU; RA, Customs. Police, Anti-Corruption Agencies

	OBJECTIVE	RISKS	TREATMENT	RISK OWNER
3.	Reduce tax evasion and avoidance in the diamond value chain which contribute to IFFs	3.1 Transfer Pricing 3.2 Valuation: no price list for diamonds Inventory variances; No agreed tariffs for rough or polished stones 3.3 FTZs 3.4 Tax policy weaknesses: (royalties/incentives/ tax holidays) 3.5 Smuggling 3.6 Memo Transactions	3.1 MNEs to address financial, regulatory and reputational risks associated with TP; 3.2 Cooperative compliance to obtain industry assistance in valuation and to build in house expertise; 3.3 Increased Transparency and oversight; KP process requisites 3.4 Review policies 3.5 Risk based approach 3.6 KYC/CDD	3.1 RA 3.2 RA; Customs 3.3 RA; DTI; KP 3.4 Treasury; RA 3.5 RA/Customs; FIU; Police 3.6 FIU; RA; CB

Source: Author's own compilation

List of abbreviations: Financial Intelligence Unit (FIU); Revenue Authority (RA); Kimberley Process (KP); Department for Trade and Industry (DTI); Central Bank (CB); Know Your Customer (KYC); Customer Due Diligence (CDD); Mutual Assistance Agreements (MAAs); Double Taxation Agreements (DTAS).

A cursory glance at the risk register shows several areas of overlap between different government agencies. Pursuing the different risks in isolation or in a silo approach will not necessarily allow the government to achieve the threefold objectives set out in the register. This is so because limiting all forms of illicit financial flows requires state building legitimacy and continuous improvement in economic and political governance. The state building role of taxation is underscored by various authors and institutions.[1122] Empirical data shows that there is a direct correlation between "the perceived quality of governance" and "tax compliance."[1123] In this regard, the perception of the public on what the level of corruption is, has an impact on tax compliance because in the "face of rampant corruption, criminality, and waste in the public sector," taxpayers may see tax evasion as a legitimate response to corruption.[1124]

In Chapter 8 it was pointed out that the FATF recognises the link between corruption and money laundering, and takes into account countries' compliance with the FATF Recommendations. This is done by looking at specific country indicators such as how many investigations were conducted in a given period, the number of prosecutions and money laundering convictions achieved from those investigations, as well as the value of assets seized and/or forfeited. These indicators can

[1122] Supra 5.
[1123] Leite (2011) 73.
[1124] Leite (2011) 73.

relate to both the predicate offences and to money laundering.[1125] A further consideration is whether the country can demonstrate that it has a sound framework of measures which can help to prevent and combat corruption. Such measures include good governance principles, respect for transparency, high ethical and professional requirements, efficiency of the judiciary and the enforcement of judicial decisions.[1126] These elements point to the level of state building and are important because significant weaknesses or shortcomings in these areas are obstacles to the effective implementation of the FATF Recommendations.[1127]

Leite indicates that "low tax collection rates occur more often in countries where fundamental issues of tax administration and institutional weaknesses tend to severely complicate the enforcement of the existing tax regime, regardless of choices on tax policy."[1128] This, in turn, poses operational challenges in the form of capacity and organisational design. The latter includes aspects such as governance, the nexus between policy and administration, as well as risk management practices, whilst the former entails the effective use of audit tools and application of legal principles.[1129]

A further aspect which influences tax collection rates is tax certainty. Tax certainty provides companies with a greater incentive to comply with legal requirements, especially where these are effectively applied and enforced, in order to minimise the possibility of negative media coverage or incurring penalties for non-compliance. By adopting "clear and globally consistent transfer pricing regulations," developing countries can move MNEs toward cooperative compliance, which in turn will allow revenue authorities to re-direct scarce resources.[1130] The adoption of regulations should be accompanied by effective enforcement. This can be achieved through a multi-level cooperative approach that includes inter-agency and international cooperation, as well as government to business engagement.[1131] Leite emphasises that where such approaches are embedded in a risk management framework, agencies can "dramatically increase compliance levels and contribute to state building."[1132]

1125 FATF/OECD (2012) 2.
1126 FATF/OECD (2012) 2.
1127 FATF/OECD (2012)2.
1128 (2011) 255.
1129 Leite (2011) 255.
1130 Leite (2011) 255.
1131 Leite (2011) 255.
1132 (2011) 255.

9.3.4 Monitoring and review

Monitoring and review should include all aspects of the risk management process, including the performance of the risk management system, the changes which might affect it, and whether the original risks remain static. Some of the questions asked at this stage could include whether assumptions about risks are still valid; whether any new risks have emerged; have the identified treatments for minimizing risks been effective and efficient; are the mitigation steps cost effective; are there adequate management and accounting controls; are the risk treatments in line with legal requirements and lastly, how can the system be improved?[1133] To illustrate, there are three important reasons for tax administrations to measure the rate of non-compliance, or, as it is generally referred to, the tax gap: (a) it measures the performance of the administration through the comparison of actual collections against the compliance or tax gap; (b) it allows for understanding of patterns of non-compliance, in order that resources are optimally allocated; and (c) it provides a guide for taxpayer services, such as directed education and assistance to address areas of non-compliance.[1134] In a similar vein, it is argued that "a measure of how much money is laundered is required to determine the effectiveness of the AML regime and the reduction of money laundering in targeted areas."[1135] Predicate crimes are typically targeted in AML regimes for obvious reasons – if the predicate crime is addressed there are fewer proceeds to launder. Acts of corruption and tax crimes are predicate offences to money laundering, therefore an understanding of the levels of corruption and the volume and value of tax evasion, may allow for some measurement of the scale of money laundering – or at least of two of its components (tax crimes and corruption).[1136]

To monitor and review the results and progress with the treatments implemented, a robust evaluation framework is needed, with criteria against which the outcomes are compared. The framework may include various measures aimed at outlining the direct and related results and effects of the chosen actions, enabling comparison of the pre- and post-treatment results. Different compliance measurement activities such as campaigns, random checks or other types of statistically valid analysis methods or surveys can all be potential tools for measurement in the operational context.[1137]

[1133] WCO Risk Management Compendium. 14.
[1134] Mikesell & Birskyte (2007) 1049.
[1135] Schlenther (2013) 20.
[1136] Schlenther (2013) 20.
[1137] WCO Risk Management Compendium.19.

9.3.5 Control Measures

9.3.5.1 Customs Control Programmes and Risk Management

International trade is a key driver of economic growth and development. It raises living standards in both developed and developing countries, contributes to the reduction of poverty as well as creating a more stable, secure and peaceful world.[1138]

According to the World Customs Organization (WCO), there are five key customs responsibilities, namely revenue collection, protection of society, trade facilitation, trade security and collecting trade statistics. The Revised Kyoto Convention (Kyoto) is one of the WCO's instruments which underscores the importance of a risk management approach. In terms of Chapter 6 of the General Annex Guidelines to Kyoto, which relates specifically to customs control, customs should place less emphasis on customs gateway controls. Instead, customs should implement more audit-based controls in the place of movement controls, which should occur through a process of risk management. Chapter 6 states that: "Risk management is the key element to achieve this objective and should therefore be integral to the control programme of a modern customs administration."

To assist international customs administrations, the WCO has developed a further instrument, namely the SAFE Framework of Standards to Secure and Facilitate the International Supply Chain (SAFE Framework) as a guideline for its members. One of the four core elements of the SAFE Framework is a risk management approach, whereby countries should commit to risk management practices to mitigate security and revenue threats. Such commitment requires the consistent application of risk management principles in dealing with all aspect of customs business.

Risk management is critical to customs operational success, as it allows for the detection of customs contraventions (commercial fraud detection) through assessing client risk in terms of licensing and registration requirements, duty exemption regimes, valuation provisions, rules of origin, trade restrictions and security regulations. As an end-to-end process, risk management is essential in assessing clients' transactions holistically, inclusive of their position/s in the supply chain and in view of Approved Economic Operator (AEO) or other preferential treatment requirements. Implemented properly, it becomes a force multiplier by enabling customs authorities to focus resources according to priorities identified through the risk management approach.

[1138] WCO (2012) vi.

Many customs administrations aspire to developing partnerships with all supply chain stakeholders, in order to facilitate legitimate trade, while combating illicit trade. In this regard the South African Revenue Service (SARS) recognizes – through its strategic planning objective setting – the level of interconnectivity in global trade and the need to build and maintain good relations with other tax and customs jurisdictions. It sets the aim of collaboration with the FATF (Financial Action Task Force), in order to support its mandate in implementing global safeguards to protect the integrity of the financial system, in order to meet the objectives of tackling money laundering. This is particularly relevant to SARS, since it considers tax crime as a predicate offence to money laundering and smuggling offences.[1139]

Trade compliance is the process by which companies that ship goods internationally strategize to comply with all laws and regulations of the destination countries, and the role of customs is to manage compliance in accordance with legislation in a manner which supports trade facilitation.[1140]

Compliance is measured across all steps of the value chain, from registration to declaration and payment and for customs audit. Compliance is mainly determined by verifying whether goods imported/exported were properly declared in respect of valuation, origin and classification. (The three major determinations for imposing a duty are the determination of the proper classification, the customs value of imported goods and the determination of the origin of the goods imported).

9.3.5.2 Compliance Programmes: Approved Economic Operator (AEO)

The AEO concept establishes a partnership between customs and business, with both parties being responsible for identifying and managing risk in the supply chain – this requires the ability of risk identifiers and auditors to understand different risks associated with different supply chains. Mutual recognition is one of the major benefits for businesses applying for AEO status. Every country that has launched, or is about to launch, an AEO programme aspires to conclude mutual recognition agreements (MRAs) with its major trading partners. The SAFE Framework defines mutual recognition as "an action or decision taken or an authorization that has been properly granted by one customs administration and is recognized and accepted by another customs administration."[1141] The SAFE Framework also states that mutual recognition can serve as a means whereby duplication of security controls can be avoided, and as a means of contributing to the control and facilitation of goods moving in the global supply chain.[1142]

[1139] SARS Annual Plan.
[1140] WCO (2012) 93.
[1141] SAFE (2012) 34.
[1142] SAFE (2012) 34.

9.3.5.3 Anti-money laundering Control Framework and Risk Management

Awareness and understanding of the risks associated with the trade in diamonds is a key requirement for governments, financial institutions and the private sector to mitigate illegal trade. Some key aspects identified which require understanding are:[1143]

a) Recommendations 22 and 23 only refer to cash transactions, and therefore only cover cash based transactions between a dealer and a customer. This implies that most of the trade in terms of value and volume is not covered by AML/CFT requirements;[1144]
b) In some instances, AML/CFT due diligence duties are dependent on the form of payment. In many instances, this is not known and may only come to the fore a considerable time after the sale of diamonds. The use of diamonds as alternative currency may require it to be treated as both a cash and a bearer negotiable instrument;
c) Definition of a diamond dealer: the FATF does not define a dealer in precious stones and that may result in different laws and interpretation of a dealer. Entities such as retailers and pawnshops are not viewed as dealers and therefore do not fall under AML regulation;
d) Lack of transparency: The FATF describes the sector as specialised with significant barriers to entry. The authorities are not necessarily familiar with the legitimate commercial practices for diamonds, which include the required knowledge on the KPCS process requirements;
e) Difficulties exist in as far as international exchange of information is concerned, and the use of tax havens in financing deals is a major obstacle in detecting and prosecuting money laundering through the trade in diamonds;
f) Multi-jurisdictional implications require international co-operation and information sharing;
g) The regulatory playing field between countries' AML regimes contains various discrepancies and as a result, some may attract criminal elements;
h) The sector is characterised by relationships built on "trust and long lasting partnerships" which cause difficulties from an AML/CFT perspective, because dealers are obligated (through the due diligence requirements) to collect client information and to report suspicious activities or transactions. The FATF identifies this aspect as having "a large impact on the competitiveness *vis-à-vis* diamond dealers in other countries who are not subject to similar obligations."[1145] It also makes the observation that increased regulation "may have the adverse effect of diverting the diamond trade to less regulated jurisdictions, and generating higher levels of ML/TF risks associated with the diamonds trade;"[1146]

[1143] FATF/Egmont (2013) 139.
[1144] FATF/Egmont (2013)140.
[1145] (2013) 138.
[1146] FATF/Egmont (2013) 138.

i) In some jurisdictions, the diamond trade is a significant part of the economy. This necessitates that relevant national authorities include the diamond industry in an assessment of national risk.[1147] Such an approach should be holistic and should incorporate all enforcement and regulatory measures across relevant departments such as tax, customs, FIU's and minerals departments.

Three players, namely corporations, banks and government bear the responsibility to identify these risks and to deal with them. It is, however a reality that any of these players could be either involved or have knowledge of criminal acts or transgressions of civil liberties associated with the mining sector and trade in natural resources. Public officials in resource rich countries may accept bribes, embezzle state assets and launder the proceeds thereof. In bribing foreign government officials, multi-nationals may implicate themselves in conspiring to commit bribery or embezzlement and in "secondary wrongdoings such as the failure to disclose material information to investors and regulators."[1148] The financial sector has a critical role to play as gatekeeper for tainted money out of the financial system. An anti-money laundering framework is therefore only as good as the risk management practices applied by financial institutions in combatting money laundering.[1149]

9.3.5.4 Risk-based Approach

Since 2006 the FATF has produced best practice guidance on dealing with money laundering schemes. Its 2008 guidance is quite powerful in setting specific risk indicators, which are not only relevant to FIUs, but also to revenue authorities, enforcement agencies, companies, traders and the financial services sector. Each of these role players need to have an understanding of the sector risks which can be attained through some of the following basic steps:

a) identification of individual transactions which allow for the illegal transfer of value across borders;
b) enhanced verification procedures to exchange customs data with other countries;
c) comparing domestic and foreign import and export data to identify any discrepancies in the Harmonized Tariff Schedule or by broker, importer or exporter, port of import/export, country of origin, commodity, manufacturer, compliance history over a given time period and unit price.

[1147] FATF/Egmont (2013) 138.
[1148] Tamm, Lucky & Humphreys (2005) 11.
[1149] Tamm, Lucky & Humphreys (2005) 11.

d) analysing financial data and information collected by the FIU, with the purpose of identifying patterns or trends in relation to export or import of currency, deposits of currency with financial institutions, suspicious activity reports; and

e) cross-comparison of known typologies of risk with trade data, information on cross-border monetary transfers and other information or intelligence on assets or bank accounts.

Part of the ongoing monitoring process as advanced through the WCO *Risk Management Compendium* and the FATF *Risk Based Approach* is to take appropriate action where discrepancies or anomalies in financial transactions and trade are identified. Therefore, depending on the circumstances, appropriate follow-up action could include requesting additional documentation from the trader or auditing those traders whose records show discrepancies or conflicting information. Such audits can include, for example, verification steps concerning volumes (in turnover and in goods traded), frequency of trade and type of goods. Further monitoring and verification steps advised by the WCO and FATF should include some of the following:

> "Examining cargo movements through the comparison of import/export documentation between two counties, to verify that the data reported to one country's authorities matches the data reported to the other country's authorities; comparing information such as the origin, description and value of the goods, particulars of the consignee and consignor, and the route of shipment with intelligence information in existing databases to detect any irregularities, targets or risk indicators; comparing export information with tax declarations to detect discrepancies, paying particular attention to trade transactions that display known red flag indicators of TBML/TF activity and assessing whether any connections with organised crime are present."[1150]

In assessing potential risk in the commercial stream, the *Standardised Framework for Risk Management in the Customs Administrations of the EU*[1151] provides a set of risk indicators relevant to cross border movement of goods. The potential risks include "those connected to companies or operators; those connected to customs and the economic environment; those connected to imported and exported products and the regulations which apply to them."[1152] The risks connected to a company or operator relate to the general data for the operator and their activity. The *EU Standardized Framework for Customs* provides a breakdown of specific risk areas which may require further attention in as far as it relates to a business:

[1150] FATF (2008) 3.
[1151] EU Commission (2007) 11.
[1152] EU Commission (2007) 11.

Table 9.2: Customs Specific Risks

CORPORATE STRUCTURE RISK	RISK INDICATORS
(a) Commercial Structures	Where a monopoly or quasi-monopoly is present; if the company is held in a natural person's name, if the company is owned/affiliated to a national or multi-national group, the choice of marketing company, broker, producer, onward processor, manufacturer and choice of foreign licence.
(b) Financial Structure	Balance sheet (fixed assets, inventory, debts, cash assets), taxable income (profits and losses).
(c) Organisation	Methods of supply, logistics, service location, identification of responsibilities within the company, reliability of the internal management system, circulation of documents and links between the various departments, levels of qualification of the customs representatives and goods accounting.
(d) Trade Structure	The significance of the trade with foreign countries in comparison with national activity, development of its imports and exports (passage through a subsidiary company, change in tariff classification, change in values declared etc.), ratio of duties and taxes paid compared with the value of purchases abroad normal methods of transport and contract (can be inclusive of cost, insurance or freight [CIF] or free on board[FOB]), type of financial security put in place (overall, flat-rate).
(e) Customs Strategy	The customs clearance procedures used (common law, domiciled, simplified), the customs clearance conditions for the products (time slots), changes in locations for customs clearance (single, multiple, frequently altered) as well as the customs procedures used: direct imports, imports for subsequently putting into free circulation in another state, inward or outward processing, warehouse, etc.
(f) Change in Behaviour	Changes in behaviour following the development of a regulation affecting the imported or exported products (e.g. change of supplier, countries and of tariff classification.

Source: EU Commission (2007)[1153]

Assessing risks connected with products includes considerations of complexity, the nature of the product, the procedures and regimens used, product-country pairing and the tax differential. Further specifics include the volumes transported (if they are too large, there is a risk of fictitious deliveries).[1154]

In 2013, the WCO Secretariat arranged *Operation Cullinan*, an international joint-control operation aimed at the rough diamond trade. This event was proposed during the KP Enforcement Seminar held in Washington D.C. in November 2012. The operation was intended for rough diamonds subject to the KPCS (HTS Codes 7102.10, 7102.21 or 7102.31). The operation focused on illegal cross-border movements of rough diamonds involving air passengers, and postal and express

[1153] EU Commission (2007) 12.
[1154] EU Commission (2007) 12.

courier shipments. Participating countries provided information on smuggling trends detected for use by the WCO and international participants in support of targets for this operation.[1155] It is thus evident that, with the necessary capacity in place, the requirements of the KPSC can be addressed within the day to day operations of customs authorities.

9.4 Conclusion

The UNECA Report proposes that African countries can benefit from the whole of government approach as promoted by the Oslo Dialogue of the OECD for the following reasons: (i) the wide range of issues and related institutions pertaining to IFFs, including anti-corruption, customs, tax, law enforcement, financial regulation and prosecuting authorities; and (ii) the need for improving cooperation between agencies (responsible for addressing the issues listed above) at the national level and between countries.[1156]

The complexities of value chains in different industry sectors and the diverse government agencies responsible for facilitating trade and for protecting society require a holistic government approach, one which considers globalization, national regulations and international obligations. The OECD correctly points out that the whole of government approach to combatting financial crimes involves recognising limited resources and ensuring that separate authorities do not operate in isolation. Officials in authorities including the tax and customs administrations, the financial intelligence unit (FIU), the police and specialised criminal law enforcement authorities, the public prosecutor's office, and financial regulators recognise that the information, knowledge and skills required to most effectively combat financial crimes are often spread across several authorities.[1157]

The importance of tax policy in this regard needs to be underscored: the amount of the rents from natural resource endowments captured for the state, depends on the actions of government authorities. The predominant objective remains raising of revenue (balanced against national priorities such as employment and income growth, environmental considerations and future wellbeing of its citizens). The payment of royalties, a standard corporate income tax (CIT) and a tax targeted explicitly to rents, are standard tax responses to raising revenue. However, as is illustrated through the diamond value chain, there are various risks which, if not addressed, will negate or skew the objectives of the tax regime. For instance contracts may be approved by corrupt politicians, allowing for unreasonable exemptions thus affecting the taxation of profits; the environment may be uncontrolled to the extent that smuggling of the commodity deprives the

[1155] USCBP (not dated).
[1156] UNECA (2015) 44.
[1157] OECD (2015b) 7.

state of ample revenue; the collection of taxes may resort under different ministries where the collected revenue does not find its way to the treasury,[1158] and weak institutions can furthermore fail to detect outflows which escape taxation - either through tax evasion or avoidance strategies. Government agencies therefore need an instrument or management tool which allows them to identify the risks they face, how these will be addressed, by whom and with which resources. Risk management is a formal process by which government can assess a variety of risks faced and, based on its risk appetite, its agencies can be mobilised on a common line sight and through shared resources. The risk management process has the necessary components to allow for an understanding of risk posed by IFFs, and it provides mechanisms to manage and mitigate those risks. Risk management is a strategy enabler, and it can serve as a valuable tool to underpin a whole of government approach as a strategy to address and reduce IFFs.

[1158] In Zimbabwe the collection of revenue in the diamond fields is controlled by the minerals department. Production in the Marange fields started in 2006, and estimates of its potential ranged from 25 to 36 million carats per year, with total gross revenue of USD 1-2 billion, which could be sustained for 14 years. However, the 2013 national budget for Zimbabwe shows that Treasury only received USD 41 million from diamond mining in 2012. Zimbabwean President Robert Mugabe revealed in 2016 that diamonds worth more than $15 billion were looted in the eastern mining area of Marange (ANA 2016).

CHAPTER 10:
DOMESTIC COOPERATION TO ADRESS ILLICIT FINANCIAL FLOWS

10.1 Introduction

The relationship between different spheres of government is characterised by layers of inter-dependencies because it is not possible to have complete separation of policy responsibilities and outcomes amongst different levels of government.[1159] Producing deliverables and achieving government objectives requires coordination between government agencies. The OECD defines this as a complex relationship, because it is at the same time vertical (across different levels of government), horizontal (amongst the same level of government) and networked, as the lines of communication and co-ordination for an agreed policy objective may traverse as it involves a multitude of actors and stakeholders in the public and private sectors.[1160]

In addressing the above problem – which has all the hallmarks of a wicked problem – the OECD identifies five dominant challenges to multi-level governance. These are described as information gaps, capacity gaps, fiscal gaps as well as administrative and policy gaps. The *information gap* refers to "information asymmetries between levels of government when designing, implementing and delivering public policy."[1161] A *capacity gap* refers to a lack of human resources, knowledge and skills and supporting infrastructural resources. The *fiscal gap* represents "the difference between sub-national revenues and the required expenditures for sub-national authorities to meet their responsibilities."[1162] An *administrative gap* refers to a disjoint when administrative boundaries do not correspond to functional economic areas at sub national levels, whilst a *policy gap* arises when strictly vertical approaches to cross-sectoral policy are taken by ministries.[1163] It can be argued that an administrative and policy gap arises when there is no nexus between the heads of administrations and policy setters (i.e. a horizontal approach is taken without considering the vertical relationships).

Moore points out that revenue administrations are highly networked and dependent on active cooperation from a variety of stakeholders that may include ministries of finance, commerce and trade, justice as well as functionaries responsible for registering property, new businesses, motor vehicles, public utilities and public procurement agencies.[1164] In addition to these stakeholders

[1159] OECD (2009) 8.
[1160] OECD (2009) 8.
[1161] (2009) 8.
[1162] (2009) 8.
[1163] OECD (2009) 8.
[1164] (2013b) 8.

are the police, the judiciary, public prosecutors, security agencies, tax administrations of other countries, financial services industries, business associations and professional associations of accountants and auditors.[1165]

The level of cooperation between tax administrations and other domestic law enforcement agencies is critical in countering financial crimes. Recent international strategies in addressing financial crimes and illicit flows have primarily focused on achieving greater synergies in information exchange. However, traditional concerns on taxpayer confidentiality and society's best interest have impeded cooperation in many jurisdictions, whereas others have found innovative solutions to resolve this conflict. The current state of affairs in domestic cooperation shows that whilst there are several limitations on the scope of cooperation, opportunities do exist in the form of existing cooperation models, the use of task forces and fusion centres, and in applying international best practice.

Tax administrations have a key role to play in addressing serious crime, and this role is often expressed in specific terms in country legislation.[1166] This obligation of sharing taxpayer information with other departments should however be measured against the potential impact on the integrity of the tax system. The FATF points out that in most countries, there are regulatory restrictions in place which govern the collection and use of information (whether from the public or from other government agencies).[1167] Such restrictions can limit an agency's ability to share information with other government agencies, and countries therefore have to find a balance between data protection rights and efficient mechanisms of information sharing.[1168] This requirement often creates uncertainty within government departments regarding the sharing of information, and may lead to a situation where no sharing whatsoever is taking place.

The ability of government institutions to share relevant information is often a key indicator of the effectiveness of a department to pro-actively identify risks pertinent to its mandate. Failure to relate its core functions and mandate to that of similar departments will not allow for a common line of sight desperately needed in countering financial crime. According to Hobbs and Williams a "multi-faceted approach is not automatically a comprehensive approach."[1169]

In 2011, the first International Forum on Tax and Crimes was held in Oslo, with the aim of finding more effective ways to use a "whole of government" approach in countering financial crimes. In

[1165] (2013b) 8.
[1166] E.g. in South Africa through Section 3 of the Financial Intelligence Centre Act (FICA), which singles out the tax authority next to law enforcement agencies.
[1167] FATF (2012a) 6.
[1168] FATF (2012a) 6.
[1169] (2017) 179.

response, the OECD[1170] produced an in-depth analysis of inter-agency cooperation in fighting financial crimes in 32 countries, wherein four different models of cooperation are mapped.[1171] These are discussed in the next section.

10.2 Models for Cooperation

Strategies for combatting financial crimes are dependent on the ability to share information, and that then becomes a necessary pre-condition for inter-agency cooperation. Such cooperation is required over various stages including prevention, detection, investigation, prosecution and recovery of proceeds of crime. From the perspective of combatting financial crimes, a number of government agencies need to be involved in part or throughout an investigation, depending on the circumstances.

The OECD identifies the key agencies[1172] involved in the different stages of combatting financial crimes and identifies frameworks that support arrangements for inter-agency cooperation.[1173] It further identifies information flows of importance that enable different agencies to combat financial crime effectively, whilst describing the "legal gateways" in countries which make or which need to make information flows possible.

In assessing the ways in which countries have allocated responsibilities for countering tax crimes, four models were identified:

- In the first model the tax administration has the responsibility for directing and conduction investigations (Model 1);[1174]
- In the second scenario, tax administrations conduct investigations under the auspices of the public prosecutor (Model 2);[1175]
- A third way identified is where a specialist tax agency is constituted outside the tax administration, but under the auspices of the finance ministry, to conduct investigations (Model 3);[1176]

[1170] Through the Rome Report of 2012.
[1171] OECD (2013b) 8.
[1172] These agencies can include the tax and customs administration/s, anti-money laundering authorities, police, specialised law enforcement units, the public prosecutor's office and financial regulators.
[1173] (2013b) 8.
[1174] Applied in a number of Commonwealth countries (including the UK, Australia, Malaysia, South Africa, New Zealand, Uganda and India), Japan, South Korea, Switzerland and the United States.
[1175] E.g. applied in Austria, Spain, Portugal and the US. The US is included in both Models 1 and 2, as two types of criminal investigations are conducted: (i) administrative – conducted by the tax administration and handed over to the prosecutor's office; (ii) Grand Jury investigation initiated and conducted under the direction of a prosecutor.
[1176] Ghana, Greece, Iceland and Turkey.

- The fourth model is one where the police or the public prosecutor has the responsibility for conducting investigations (Model 4).[1177]

All countries assessed by the OECD have "legal gateways" in place to allow tax administrations to share information collected for the purpose of a civil tax audit, or law enforcement agencies that conduct tax crime investigations.[1178] Shortcomings, however, exist regarding the sharing of non-tax information by tax administrations with the police or public prosecutor.[1179] Some countries explicitly prohibit tax administrations from sharing information relevant to non-tax crimes. Four countries assessed have prohibitions on the Financial Intelligence Units (FIUs) from obtaining tax information from the tax authority.[1180] Wider information sharing is possible, in as far as customs information is concerned for tax and non-tax crimes. In the case of the latter, the customs mandate includes facilitation of trade, collection of duties and security, which puts it in a position where it will always collect both tax and non-tax information.

Cooperation between customs and tax can create financial and efficiency gains in the collection of duties and taxes, exchange of information and a coordinated approach in pursuing common objectives such as improving compliance, fostering cross border trade and supporting economic development.[1181] Effective cooperation can bring about better deterrence of tax and customs fraud, through the holistic application of risk management methodologies. In this regard, import and export data and purchase and sales data can be matched to improve risk identification of under-declaration practices. When verifying the customs value for related party transactions involving multi-national enterprises, customs administrations can benefit from information derived from the transfer pricing studies which have been developed for profit tax purposes, and which are generally based on the application of the OECD Transfer Pricing Guidelines.[1182]

The WCO[1183] identifies the following underpinning enablers for effective and sustained cooperation and information exchange between tax and customs administrations:

[1177] E.g. Belgium, Brazil, Burkina Faso, Denmark, Finland, France, Iceland, Norway, Slovenia and Spain. Spain is included under Models 2 and 4, as it can conduct investigation under direction of an examining judge or, because a case was initiated outside the tax administration, it may fall under the direction of the police.
[1178] (2013b) 14.
[1179] OECD (2013b) 14.
[1180] OECD (2013b) 14-15.
[1181] WCO (2016) 5.
[1182] WCO (2016) 5. Both the OECD transfer pricing Guidelines and the WTO Customs Valuation methodology are designed to ensure that related party prices are comparable with those between unrelated parties. The WCO notes that there are opposing risks, i.e., the risk to Customs is generally undervaluation of imported goods to reduce Customs duties, whereas the tax risk is overvaluation of goods and services to reduce the taxable profit.
[1183] (2016) 7-8.

a) Political will and executive commitment are required: because once a policy decision is taken, it is the commitment and involvement of heads of both authorities that provide credibility and the necessary drive to ensure that officers in both administrations understand the importance of cooperation and information exchange, and that they can actively pursue that agenda through a sustained process;
b) Legal framework: this is required for effective exchange of information and protection of data;
c) Governance processes and resources: an adequately resourced governance process laying down detailed cooperation mechanisms and designated contact points should be put in place;
d) Cross-sectoral understanding: both administrations should develop and enhance their capability to identify information of use that may be held by the other administration;
e) Data confidentiality and protection: proper legal safeguards governing data privacy and protection are required and both administrations need to promote an organizational culture of data confidentiality.
f) Standardization of communication protocols (inclusive of information technology systems);
g) Data analytics: big data requires robust data analytics capability and analytical techniques including predictive analytics will assist in identifying patterns/trends, compliance and/or non-compliance history, gaps, risks and modus operandi.
h) Information and system security management.

Legal gateways are available in all countries to allow the police and/or public prosecutor to provide relevant information to agencies conducting tax crime investigations, although this may be limited to *request-based only* in some countries.

In as far as information sharing between tax administrations and FIUs is concerned, several variations were identified. In some countries, the tax administration has direct access to FIU information, whilst in others the FIU does not share information with the tax administration for the purposes of making tax assessments. In six countries assessed, the FIU is prohibited from sharing information with the customs administration.[1184] In most countries, legal gateways are in place for FIUs to provide information on possible tax offences to the responsible agency, though in many instances, the FIU is able to exercise discretion as to what information it makes available.

From an African perspective (of the countries assessed) only Uganda allows tax crime investigators to have direct access to information obtained by the tax administration for purposes of administering and assessing taxes. Ghana operates on a *request based only* premise and South Africa is able to share information spontaneously (under no obligation to do so and may exercise discretion in choosing whether to do so).[1185]

[1184] OECD (2013b) 16.
[1185] OECD (2013b) 49, 51.

Financial regulators are in general not obliged to provide information to tax administrations for the purposes of assessing taxes. Of the countries assessed in the OECD Report, four imposed such an obligation, whilst eleven had an express prohibition for doing so. With regard to information on tax and customs crimes, most have legal gateways in place for sharing information.

Agencies have found various ways of working together to address financial crimes such as joint investigation teams, joint training interventions (e.g. Iceland and Latvia),[1186] inter-agency centres of intelligence/fusion centres, secondments of personnel (e.g. Italy, Ghana, Korea and Japan),[1187] use of shared data bases, joint committees to coordinate policies in areas of shared responsibility and inter-agency meetings and training interventions.

10.3 Strategies for cooperation

In 2009, the OECD described the rationale for "whole of government" work as recognition of the interdependence amongst levels of government.[1188] In Chapter 2, the term "whole of government approach" is described as a resurgent form of coordination between government agencies, and the spectrum can range from improvements in horizontal coordination between different policy areas in the central administrative apparatus, to improved inter-governmental vertical coordination between ministries and agencies.[1189] The intent behind this greater recognition of the existence of inter-dependencies is generally aimed at achieving better regulation and enhancing performance, effectiveness and efficiency.

The whole of government approach requires a particular way of working, which involves various managerial inputs. Firstly, joining up policy making at the centre is required, to achieve "a shared vision in support of implementation" – this means that all stakeholders should have the same understanding of the problem and the "same vision and buy-in to the same strategic priorities" where they are part of the consultation process, from the agenda setting stage right through to policy development.[1190]

Colgan, Kennedy and Doherty make the point that whenever complex policy and policy implementation decisions are taken, there needs to be recognition of inter-dependencies between government agencies, which is followed up by effective management between different

[1186] OECD (2013b) 232, 265.
[1187] OECD (2013) 251, 218, 258, 254.
[1188] Supra 10.1.
[1189] Christensen & Laegreid (2006) 6.
[1190] Colgan, Kennedy & Doherty (2014) 4.

government departments and the different levels of government, in order to make the implementation work.[1191]

10.3.1.1 Joint Investigation Teams

A working example of an integrated task team is *Project Wickenby,* which is run under the auspices of the Australian Tax Office (ATO).[1192] The ATO is included as part of the Commonwealth's Organised Crime Strategic Framework as “an agency with shared responsibility for addressing the impact on Australia of serious and organised crime.”[1193] The ATO has direct access to information collected by the Australian FIU (AUSTRAC), which accords with the relevant provisions of the Financial Transactions Reports Act (FTR) and a memorandum of understanding between AUSTRAC and the ATO. There are no specific restrictions on the use of information by the tax authorities, as the principle object of the FTR is to facilitate the administration and enforcement of tax laws. Under AML/CFT legislation the tax authorities are allowed to access AUSTRAC information for any purpose that relates to facilitating the administration or enforcement of tax provisions.[1194]

The ATO’s role is explained by “the profit driven nature of organised crime” and that the necessary skills are available to the ATO to help with the identification of unexplained wealth which is generated through the proceeds of crime.[1195] The basis of this framework is the understanding that law enforcement agencies have different powers and responsibilities, and that these can be maximised through inter-agency cooperation. By having a framework in place to combat organised crime, a collaborative and integrated Commonwealth approach can be initiated and sustained for the purposes of reducing the “social and economic impacts of organised crime on the Australian community, by targeting the most significant threats.”[1196] Whilst tax secrecy provisions are designed to keep protected tax information confidential, limited circumstances allow for the disclosure of protected information by the tax authority to other agencies. Such circumstances include the investigation of serious offences, or when the disclosure is in relation to a prescribed taskforce that has the mandate of protecting the fiscus.

[1191] Colgan, Kennedy & Doherty (2014) 4.
[1192] ATO (no longer available).
[1193] ATO (no longer available). This situation is largely enabled by Section 3E of the TAA 1953 that allows the ATO to share information on serious offences with law enforcement agencies. The ATO was thereby included in the “armoury of State and Commonwealth law enforcement.”
[1194] Mathias & Esposito (2015) 284.
[1195] ATO (no longer available).
[1196] ATO (no longer available).

10.3.1.2 Taskforce and the Fusion Centre Concept

In the case of Australia, legislation enables information sharing for enforcement purposes by ATO officers whereby they pursue criminal assets through taxation remedies. The taskforce's law enforcement impact comes from integrating government resources, and by having an integrated approach to criminal asset confiscation. In 2010, the National Criminal Intelligence Fusion Centre was established and is described as an important component of the Commonwealth Organised Crime Strategic Framework. The concept (fusion centre) is designed to bring together information, skills and knowledge, data and technology across government departments. The fusion centre integrates information and intelligence at a central or national level, in order for "real time" intelligence to be generated on risk areas such as organised crime. It also draws a variety of skills together in a single environment, which allows for better collaboration and for an improved view of factors associated with organised crime, such as risks, threats and vulnerabilities. From these factors, targets common to all participants can be identified.[1197]

The United States (US) established the Organised Crime Drug Enforcement Task Force Fusion Centre (OCDETF-FC) in 2006 under the auspices of the Department of Justice, Homeland Security and the Department of Treasury. The task force/fusion centre serves as a central point for developing and utilising technologies which provide analysis of law enforcement and intelligence data to support inter-agency cooperation.[1198] Through the fusion centre, law enforcement data is shared, and different agencies derive different benefits from the centre. For example, the Internal Revenue Service Criminal Investigation's (IRS-CI's) involvement at the OCDEFT-FC is focused on money laundering activities, and it does not make tax information available.[1199] The OCDEFT-FC's design is aimed at generating cross-agency integration and analysis of narcotics and related financial data, in order to build comprehensive intelligence pictures of targeted entities. The IRS-CI contributes resources and information for the purpose of generating analytical products, investigative leads, target profiles, strategic reports and field query reports.[1200] This contribution is important because it is an acknowledgement that the pursuit of national objectives relies on collaboration. As such, it provides a basis to address risks such as IFFs through a whole of government approach in the form of fusion centres or task teams.

In Sierra Leone, the Extractive Industry Revenue Taskforce (EIRT) is credited with having significantly improved inter-agency cooperation, especially in as far as implementing the mining fiscal regime is concerned. Formed in 2013, the EIRT brings together the National Minerals

[1197] ACIC (2016).
[1198] OECD (2013b) 117.
[1199] OECD (2013b) 117.
[1200] OECD (2013b) 117.

Agency (NMA), the National Revenue Agency (NRA), the Revenue Tax Policy Department, the SLEITI and others. Readhead indicates that the taskforce has "greatly improved cooperation at the technical level with respect to revenue collection and is a valuable by-product of the EITI."[1201]

10.3.1.3 International developments in domestic cooperation

In 2013, the Netherlands Tax and Customs Administration's criminal investigations leg established a *Centre for Intelligence and Operational Excellence,* which includes all national agencies involved in countering money laundering.[1202] Its objectives are to:

- Enhance ongoing work on anti-money laundering activities,
- Improve seizure and confiscation procedures,
- Centralise the management and preparation of money laundering cases,
- Optimise resources, and
- Continuously identify ways to strengthen the process of combating money laundering though improved inter-agency and international co-operation.

In achieving these goals, the centre acts as nodal point for case management and evaluation of completed cases; for developing a network of cooperation; establishing and maintaining partnerships and the sharing of information. The centre is also responsible for exploration of new strategies and techniques for addressing money laundering, including the use of digital technology and social media.[1203]

In 2011 the Grey Economy Information Unit (GEIU) was established in Finland, as a means to address the grey economy.[1204] The unit's mandate to collect information is described as "the right to receive, on request, necessary information held by other authorities, even where that information would not normally be available to the tax administration due to secrecy provisions."[1205] A key role of the unit is to produce compliance reports requested for purposes of levying taxes, enforcement of tax controls and the prevention or investigation of money laundering or terrorism.[1206]

[1201] Readhead (2016a) 7.
[1202] OECD (2013b) 20.
[1203] OECD (2013b) 115 – 116.
[1204] The grey economy is defined as "any activities that result in the failure to meet legal obligations for payment of taxes, customs fees or to obtain unjust repayment."
[1205] OECD (2013b) 203.
[1206] OECD (2013b) 203.

France views cooperation between the tax authority and customs as a critical aspect in the fight against tax evasion. This is recognized through a national agreement between the agencies. Cooperation is based on a legislative framework that enables receipt of information on request by the tax authority, and also provides for spontaneous reporting by customs to the tax authority of information collected in the course of conducting customs activities.[1207] Under Ghana's anti-money laundering legislation, the Ghana Revenue Authority must spontaneously provide all information concerning suspicious transactions to the FIU. The framework for enhanced cooperation is by means of the governing body of the FIU, which includes representatives of the various agencies combatting financial and tax crimes.[1208]

India constituted a High-Level Committee in 2011 under the Chairmanship of the Secretary (Revenue), with representatives of the reserve bank, the intelligence agency, the enforcement directorate and other relevant agencies, following the recognition that a multi-disciplinary approach was required for coordination of investigations into incidences where funds are generated illicitly within the country, or where these are illicitly moved to foreign jurisdictions.[1209]

In October 2012, Mexico published a law (which came into effect in 2013) on the Federal Prevention and Identification of Operations from Illicit Resources, which contains provisions to improve cooperation in information sharing and in the prevention, detection and combatting of money laundering between government agencies.[1210] New Zealand's information exchange is largely case specific, and the means of transfer of information is dependent on the type of data required.[1211] In 2011, Switzerland placed a duty on every federal civil servant (including tax officials) to report to the police or public prosecutor, "suspicions of all misdemeanours or felonies which they come across in the course of their professional activity."[1212]

From the country selection above, it is quite evident that many jurisdictions have recognised the need for an effective response to financial crime, which is best achieved through a "whole of government" approach, and which is premised on better gathering and sharing of information to allow for quicker responses through the pooling of resources.

[1207] OECD (2013b) 209.
[1208] OECD (2013b) 218.
[1209] OECD (2013b) 249.
[1210] OECD (2013b) 288.
[1211] OECD (2013b) 299.
[1212] OECD (2013b) 22.

10.3.1.4 FATF Best Practice – Principles for Sharing Information and Joint Operations

The FATF *Best Practice on addressing proliferation finance* provides useful guidance in as far as principles for sharing of information and joint operations are concerned. These best practices can be applied to a variety of target areas, including financial crimes, as they allow for joint analysis, co-ordinated and complementary operations, and more developed policy positions. The FATF points out that some of the benefits of joint initiatives are relationship and confidence building measures, which bring representatives of various government agencies together.[1213] Some common issues, identified by FATF, that can be addressed through joint initiatives, include:

- Monitoring and analysis of risks, threats, changing patterns and vulnerabilities;
- Policy development on combating financial crime and illicit flows;
- Recommendations of suitable responses for competent agencies to take action;
- Identification of key intelligence gaps related to financial crimes and illicit flows and development of possible solutions to close those gaps;
- Consideration of potential interdiction opportunities to prevent and disrupt financial crimes and coordination of actions that enable financial crimes;
- Coordination and "de-conflicting" the activities of competent agencies (including financial, intelligence and law enforcement agencies) in terms of combating the problem;
- Coordination and de-conflicting of financial, intelligence and law enforcement agencies in terms of potential plans to identify individuals and entities who may be involved in or supporting financial crimes; and
- Review of mechanisms to ensure effective monitoring and analysis of suspicious activity reports.[1214]'

Underlying these principles is whether the necessary information management systems are in place, and whether risk management practices are followed. Similarly, the WCO[1215] points out that joint tax and customs activities may potentially include activities such as:

- Joint risk profiling/analysis for the identification of potential risk areas;
- Joint investigations or audits;
- Joint identification of measures and their application in the fight against customs duty, tax offences and transnational crime (e.g. money laundering);

[1213] FATF (2012a) 9-10.
[1214] FATF (2012a) 9-10.
[1215] (2016).

- Coordination of control and compliance activities within free trade zones;
- Coordination on transfer pricing and customs valuation matters;
- Integrated programmes on approved economic operators (AEO) and cooperative compliance;
- Joint research and analysis on tax and customs topics; joint training initiatives to enhance the understanding of each other's roles and responsibilities and to educate officers on cross-sectoral risks and challenges;
- Joint approach on legislative/policy matters and taxpayer education;
- Secondment programmes involving officers being exchanged between agencies to enhance cross-sectoral capacity.

Such initiatives should be backed by a proper risk management framework which provides for clear terms of reference for the setting up of risk committees and periodic meetings. These meetings will have the responsibility of assessing how well such programmes are performing, and to make operational decisions to address high risk operators or tax entities identified.

10.3.1.5 Limitations on the Scope of Cooperation

The obligation of sharing taxpayer information with other departments in addressing serious crimes should be measured against the potential impact on the integrity of the tax system. A 2012 New Zealand study found that a tax administration's partaking in information sharing to address serious crime is acceptable, as long as it is "fit for purpose."[1216] Aspects considered in the sharing of information include:

- Balancing the individual's right to privacy and the benefits to society;
- The seriousness and nature of the crime and the scope of the information required;
- The authority of the information and the ability of the tax administration to provide it,
- The intended use and potential use of the information,
- The risk and error of misuse.[1217]

When the above is considered in the context of Recommendation 2, a twofold question can be posed, namely to what extent is information available and to which extent is it shared? For example, the FATF shows that while South Africa has "most of the necessary legal tools and funding to combat money laundering, there is a very low number of ML investigations and prosecutions, despite an acknowledged level of organised crime and predicate offences."[1218] A

[1216] OECD (2013b) 20.
[1217] OECD (2013b) 20.
[1218] FATF (2009) 67.

key constraint identified is insufficient recording of statistics to allow for a pro-active pursuit of money laundering offences.[1219] Recommendation 2 requires countries to have national AML/CFT policies in place, which are informed by (a) the risks identified (requires accurate information to be available) and (b) mechanisms in place to enable policy makers, FIUs and law enforcement authorities to cooperate. In addition, mechanisms should be in place on a domestic level for coordination in developing and implementing AML/CFT policies and activities, both on policy making and operational levels.[1220] Recommendation 2 should also be viewed in the context the prevalence of corruption and a country's structural deficiencies.[1221] The FATF methodology provides as follows:

> "An effective AML/CFT system normally requires certain structural elements to be in place, for example: political stability; a high-level commitment to address AML/CFT issues; stable institutions with accountability, integrity, and transparency; the rule of law; and a capable, independent and efficient judicial system. The lack of such structural elements, or significant weaknesses and shortcomings in the general framework, may significantly hinder the implementation of an effective AML/CFT framework; and, … other contextual factors which might significantly influence the effectiveness of a country's AML/CFT measures include the maturity and sophistication of the regulatory and supervisory regime in the country; the level of corruption and the impact of measures to combat corruption…"[1222]

In taking a whole of government approach to addressing financial crimes, Recommendation 29 clearly sets the requirements for effectiveness in respect of information sharing:

> "The FIU should: (a) in addition to the information that entities report to the FIU, be able to obtain and use additional information from reporting entities, as needed to perform its analysis properly; and (b) have access to the widest possible range of financial, administrative and law enforcement information that it requires to properly undertake its functions."

The OECD[1223] advances that if the ongoing objective of a whole of government approach is to identify ways in which agencies can work together in combatting crime, in order that better results are attained over shorter time frames and with less costs, it may be opportune to consider

[1219] FATF (2009) 67-69.
[1220] FATF (2013b) 6.
[1221] The importance of structural reforms and good governance can be ignored at a country's own peril. For instance, by implementing OECD governance principles, Mauritius overtook South Africa in 2013 to become the most competitive economy in sub-Saharan Africa.
[1222] FATF (2013b) 6.
[1223] (2013b).

extending the application of FATF Recommendations to include the public-sector institutions, especially in relation to:

- Secrecy laws should not constrain implementation of the FATF Recommendations;[1224]
- Suspicion or reasonable grounds to suspect that funds are the proceeds of a criminal activity, should be a mandatory reporting requirement.

The underlying rationale is that institutions of government daily come across information that may be relevant in addressing financial crimes. Without such information being channelled to a central repository for analysis and interpretation, a vast knowledge base is foregone. For example, suspicious activity which may come to the attention of any agency/department official, which requires further scrutiny, could be any of the following:

- Transactions outside the normal service are requested;
- Transactions outside the company's relationship with the client;
- A person entered into a business relationship for a single transaction;
- Extensive and unnecessary foreign travel;
- Loans to government employees.

Indicators within the scope of tax administrations:

- Transactions for which no reasonable explanation can be found;
- A person's use of offshore accounts, trusts or companies which does not support such economic requirements;
- Tax schemes involving suspect jurisdictions;
- Over-complicated tax schemes;
- Unrealistic wealth compared to the client's profile;
- Short life businesses involved in imports/exports;
- Cash transactions instead of appropriate financial instruments.[1225]

The inclusion of tax crimes as predicate offences to money laundering has put the exchange of information high on the agenda of many countries. Most countries make provision for the protection of taxpayer information, for example, in South Africa, Section 71 of the Tax Administration Act[1226] provides for disclosure in criminal, public safety or environmental matters,

[1224] FATF Recommendation 9.
[1225] Young & Cafferty (2005) 107.
[1226] Act 28 of 2011.

if so ordered by a judge, whilst Section 70 makes provision for disclosure to other (specified) entities. Section 69 contains the prohibitions on information sharing.[1227] Similarly, in terms of the Customs Control Act,[1228] "no SARS official, customs officer or person referred to in Section 12(3)(a), and no person who is such an official, officer or person, may disclose any information acquired by him or her in the exercise of powers or duties, in terms of this act or the Customs Duty Act, concerning the private or confidential matters of any person,[1229] except to the extent that such disclosure is made in the exercise of those powers or duties, including for the purpose of any proceedings referred to in Chapter 36."

Section 22(1) provides that any disclosure in terms of Section 21(e) "to … (i) an organ of state referred to in Section 20(j) must be confined to information necessary for enforcing the legislation administered by that organ of state, regulating the movement of goods or persons into or out of the Republic"; and Section 22(2) provides that "an authorised recipient may use the information disclosed in terms of Subsection (1) only for the purpose for which the information was disclosed." "*Authorised recipient"* under Section 20 includes "the police, the public prosecutor, the FIU and any organ of state administering legislation applicable to the crossing of goods or persons into or out of the Republic."[1230]

Section 12(2) makes the following provision: "A customs officer may, subject to Subsection (1) and Sections 690 and 715, perform an enforcement function[1231] at any time and without a warrant or previous notice"; and Section 12(3) states that: "When performing an enforcement function, a customs officer may (a) be accompanied and assisted by any interpreters, technicians, workers, police officers or any other persons whose assistance may reasonably be required for the performance of that function." Section 12(4) provides that "a person assisting a customs officer in terms of Subsection (3)(a) must, whilst and for the purpose of assisting, be regarded to be a customs officer under the supervision of the customs officer that person is assisting."

[1227] 69. (1) A person who is a current or former SARS official must preserve the secrecy of taxpayer information and may not disclose taxpayer information to a person who is not a SARS official.
(2) Subsection (1) "does not prohibit the disclosure of taxpayer information by a person who is a current or former SARS official—*(a)* in the course of performance of duties under a tax Act, including—(i) to the South African Police Service or the National Prosecuting Authority, if the information relates to, and constitutes material information for the proving of a tax offence; (ii) as a witness in civil or criminal proceedings under a tax Act; or (iii) the taxpayer information necessary to enable a person to provide such information as may be required by SARS from that person;"
(b) under any other Act which expressly provides for the disclosure of the information despite the provisions in this Chapter; *(c)* by order of a High Court; or *(d)* if the information is public information.
[1228] Act 31 of 2014.
[1229] "Such official, customs officer or person may be obliged to disclose such information in terms of other legislation e.g. the Financial Intelligence Centre Act, 2001."
[1230] Act 31 of 2014. Section 20.
[1231] "Enforcement function", in relation to the customs authority or a customs officer, means a power or duty assigned to the customs authority in terms of this Act or assigned or delegated to a customs officer in terms of this Act to(a) implement and enforce this Act or a tax levying Act; or (b) to assist in the implementation or enforcement of other legislation referred to in Chapter 34 or 35.

An enhancement of the OECD Report is the acknowledgement that customs administrations are key in addressing financial crimes, due to the records it holds regarding individuals, companies, transactions and indirect taxes.[1232] In addition, its control and security function should also entail a vast repository of information on crimes, such as smuggling, money laundering and false declaration.

10.4 Conclusion

In meeting the challenge of strengthening their independent institutions and agencies of government responsible for preventing IFFs, countries are required to identify frameworks and mechanisms for information sharing and coordination. This Chapter highlights some fundamental aspects that are necessary for inter-agency cooperation. It is shown that various models and gateways for cooperation are available in most countries and that strategies for cooperation should be founded on a shared commitment to inter-organizational cooperation. This commitment should be reflected in common understanding of the goals and objectives as well as a unified effort through a whole of government approach. Countries should therefore recognize that the foundation for cooperation lies first and foremost in information sharing through appropriate legal gateways and thereafter, in collaboration which is premised on a common line of sight.[1233]

Because the relationship between different spheres of government is characterised by layers of inter-dependencies, an optimal effort toward reducing illicit financial flows, should be premised on common areas of interest and knowledge. Collaboration between different agencies therefore requires:

- Common understanding of the problem;
- Identification and inclusion of all relevant stakeholders;
- Policy coordination that supports nexus between administrations and policy setters;
- Horizontal and vertical alignment between the goals and objectives of different agencies;
- Defining and implementing the strategies for cooperation; and
- Implementing or revising existing legal gateways to streamline cooperation.

Fundamental to successful cooperation, is the ability of heads of agencies and ministries to personally work together in a manner that is consensus seeking where such consensus leads to implementation of strategies and actions that allow agencies to work together to address IFFs.

[1232] OECD (2013) 8.
[1233] I use the term "common line sight" because cooperation goes further than having shared objectives – there should also be a shared view on how those objectives are to be achieved, in other words, an inter-departmental alignment of both goals and objectives in furtherance of a commonly understood strategic imperative, is required.

CHAPTER 11:
INTERNATIONAL COOPERATION TO ADDRESS ILLICIT FINANCIAL FLOWS

11.1 Introduction

International cooperation to address IFFs reveals itself as another wicked problem, in that an international organisation will have to:

> "perfectly grasp the tax system of a specific country, propose the best solutions for an efficient and equitable system in compliance with the rule of law, assess the complexity of these solutions and the consequences for the taxpayer and the tax administration, and in order to carry out this task it will have to deal with the plural legalities in force and be sure that a specified country has a constitutional system and procedural rules that will guarantee a genuine argumentative interaction before exchange of information is approved."[1234]

In assessing international institutions such as the OECD's Global Forum against this standard, it may yet take some time before it attains global legitimacy. Nevertheless, such broad frameworks can establish of "global meta-regulation" that "effectively encourage the adoption of corporate self-regulation and create requirements for a wide range of national measures to comply with international standards, generally developed by global standard-setting organizations, often dominated by experts from business and industry."[1235] As pointed out by Picciotto, process-oriented regulation can delegate material responsibility to the corporations in the industry concerned, although backed by legal sanctions. However, their failures, such as the 2009 financial regulatory failure, can inflict considerable social and economic damage.

It should also be considered that globalisation brought about technological advances that facilitate multiple cross border enterprise and trade. There are expectations that globalization must influence the distribution of income and that all countries will benefit in as far as the distribution of income between countries is concerned. However, globalization also brings about increased possibilities of tax crimes and opportunities for corruption. Therefore, extensive international agreements, in the form of tax information sharing, joint cooperation in investigations and good governance are required, to ensure that globalization brings about equal benefits to

[1234] Dourado (2013) 3.
[1235] Picciotto (2017) 690.

countries. It is, however, not clear what form such agreements should have and what their basis should be. For example, much of the complexity of regulating international corporate taxation has resulted from basing it on the legal fiction of separate corporate personality.[1236] That, in turn, encourages MNEs to avoid tax by establishing complex corporate group structures that exploit the indeterminacy of abstract concepts of income and residence. Consequently, the anti-avoidance rules developed in response are becoming more elaborate despite being formulated and applied by "a closed community of tax specialists."[1237] It is also clear that most African countries do not have the capacity, resources and skills to effectively deal with such issues, thus allowing profit shifting to continue unabated.

Tax transparency and the fight against tax crimes have remained on the agenda of recent G20 Summits, and are also central to the work of the Organisation for Economic Cooperation and Development's (OECD) Global Forum on Transparency and Exchange of Information for Tax Purposes. The initiatives serve a dual purpose: (a) fighting tax evasion as a means of reducing a fiscal deficit, without raising taxes in an economically depressed environment characterized by a shrinking tax base; and (b) addressing weakening tax compliance in times of crisis.[1238] In addition to this, transparency and the degree of information sharing remain the main considerations in identifying a country's status as a non-cooperative jurisdiction - thus it is imperative that emphasis must be placed on the legislative frameworks which permit information sharing.[1239]

In the outcome documents of major UN conferences and summits on social and economic matters, the trend since 2002 is that the relationship between the mobilization of financial resources for development and international tax cooperation features prominently.[1240] These documents express the need for countries to strengthen international cooperation in tax matters, especially in light of low growth trajectories, large financing needs requirements, increased public awareness of the economic and social impact of tax crimes, political pressure in as far as base erosion and profit shifting (BEPS) by multi-nationals is concerned and renewed private sector awareness of the reputational risks associated with the effects of aggressive tax planning. This is of particular importance within the African context, because it is estimated that a significant amount of revenue, to the value of billions of dollars, is forfeited annually by developing countries.[1241]

[1236] Picciotto (2017) 693.
[1237]Picciotto (2017) 693.
[1238] Mathias & Esposito (2015) 278.
[1239] Arnold & McIntyre (2002) 139.
[1240] United Nations (not dated).
[1241] Oxfam (2014) 6.

11.2 Legal Framework

11.2.1International Institutional Mechanisms to address IFFs

The reality of a global economy necessitates cooperation amongst countries on fiscal issues, and also for countries to concern themselves with the laws of other countries. This is of particular relevance in the face of a plight towards the regional integration of African countries. A number of international organisations are engaged in addressing gaps and deficiencies in international tax cooperation. In this regard Schlenther points out that:

> "the International Monetary Fund (IMF) is primarily concerned with the prevention, detection and reporting of financial system abuse; the OECD seeks to identify tax provisions or preferential regimes which can lead to harmful tax competition and to establish international standards on the exchange of information in all tax matters."[1242]

Article 7(1)(b) of the United Nations Convention against Transnational Organised Crime provides for the sharing of information at domestic and international levels, in an effort to tackle money laundering. Article 18 provides for mutual legal assistance, Article 26 provides for the inception of measures to enhance cooperation with law enforcement authorities, and Article 27 concerns the provision of legal assistance amongst the member states. The Financial Action Task Force (FATF) seeks to identify financial centres that can be abused for money laundering purposes.

In 2016, the World Bank and partner multilateral institutions launched the *Platform for Collaboration on Tax* in response to G20 calls for sharing information and developing tools and guidance on tax reforms.[1243] This platform builds on the achievements of the 2015 Addis Tax Initiative (ATI), which sought to mobilize funding and ownership for tax systems strengthening in developing economies. Within the World Bank, the Global Tax Team (GTT) was established, as a focal point for joining up activities aimed at domestic resource mobilization.[1244]

[1242] Schlenther (2013) 20.

[1243] These tools include the Tax Policy Assessment Framework (TPAF) and the IMF Tax Administration Diagnostic Assessment Tool (TADAT). The latter is a means to provide an objective and standardized assessment of the relative strengths and weaknesses of the administration of a country's tax system. It offers an integrated monitoring framework that measures performance of a country's tax administration at a point in time. The TADAT specifically assesses the performance outcomes achieved for the major direct and indirect taxes critical to central government budget outcomes. The TPAF (in development) is a diagnostic framework to provide systematic and structured assessment of a country's tax policy system, and to develop options for improving such system, given a set of policy objectives; specifically, how a country's tax instruments, rates and structure align with principles of efficiency, equity, neutrality, revenue adequacy and administrative feasibility (World Bank 2017:19).

[1244] World Bank (2017) 8.

On a regional level, the African Tax Administration Forum (ATAF) seeks to enhance efficiency within African tax administrations, by endeavouring to improve the capacity of African tax administrators, providing a platform for dialogue amongst tax administrations and promoting cooperation amongst African states.[1245] It is important to note that the international tax initiatives undertaken by these different groups cannot be referred to as international law, but rather the beginning of a form of global tax governance.[1246]

Other arrangements such as the India Brazil South Africa Dialogue Forum (IBSA) seek to enhance cooperation in various international issues amongst its members, and other, "less developed" countries.[1247] In an effort to achieve its goal, IBSA has established a compendium of working groups including the revenue administration working group (RAWG). The RAWG endeavours to formalise bilateral mutual administrative assistance agreements, develop an exchange of information standard on tax modernisation, incept an electronic connectivity pilot project, perform synchronized audits, increase administrative capacity and adopt collective stances on international matters.[1248]

The United Nations (UN), through its Economic and Social Council, has sought to strengthen the role of the UN in international tax cooperation. One of the issues identified by the latter, which affects international cooperation, is that there is no single entity in existence with the global legitimacy, resources and expertise to serve as a single coordinating body for international tax cooperation. Other gaps identified include:

- insufficient partaking in tax cooperation forums by least developed countries;
- lack of coordination and cooperation between donors and providers of technical assistance;
- irregular monitoring and evaluation of technical assistance that is received by developing countries (such information is critical to inform future activities and to draw from lessons learnt);
- paucity of tax data that is necessary to inform tax policy and tax administration issues;
- the lack of technical skills in tax administrations, especially in relation to identifying and combatting tax evasion and avoidance; and
- the paucity of information in tax administrations that is required to inform taxpayer compliance levels.

[1245] ATAF (not dated).
[1246] Wouters & Meuwissen (2012) 1.
[1247] IBSA.
[1248] IBSA.

The OECD Global Forum on Transparency and Exchange of Information for Tax Purposes aims to address tax crimes through better sharing of information. The Global Forum now has 142 members (25 from Africa)[1249] on "equal footing" and is, according to the OECD website, "the premier international body for ensuring the implementation of the internationally agreed standards of transparency and exchange of information in the tax area."[1250] By introducing an in-depth peer review process,[1251] the Global Forum aims to ensure that members' implementation of the standard of transparency and exchange of information to which they have committed, is monitored. The forum is also intended to establish a level playing field, even amongst countries which have not as yet joined it, as part of its agenda toward achieving inclusive growth.

Exchange of information as a standard is a condition for balanced allocation of taxing rights, since it will lead to transparency on the tax burden raised by each jurisdiction and to fair competition amongst the jurisdictions wanting to attract investment.[1252] Daurer and Krever point out that a number of African countries have taken the approach that strategic and economic benefits from signing tax treaties are more important than the immediate fiscal cost of sacrificed tax revenue.[1253] Country representatives generally draw on two model treaties designed by the OECD and UN respectively when negotiating tax treaties. Whilst the OECD treaty "shifts more taxing powers to capital exporting countries," the UN treaty "reserves more for capital importing countries."[1254] Both the UN and OECD model advance that tax treaties should ideally contribute to the furtherance of the development aims of developing countries, and that those treaties should also seek to improve cooperation between taxing authorities, in carrying out their functions, through the sharing of information aimed at prevention of tax crimes and aggressive tax avoidance strategies.

There are currently various OECD initiatives running that are intended to promote information sharing. It is therefore important for countries to determine how these are related and which ones should be prioritised, because there are cost and resource implications associated with each. The first OECD initiative is EOI, which essentially underpins the other initiatives such as the Inclusive Framework (IF) for BEPS implementation.[1255] The latter falls in the domain of the OECD's

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[1249] As at July 2017.
[1250] OECD (2013) 1.
[1251] According to the OECD, the Forum has completed 198 peer reviews and assigned compliance ratings to 80 jurisdictions that have undergone Phase 2 reviews. Of these, 21 jurisdictions are rated "Compliant", 46 are rated "Largely Compliant", 10 are rated "Partially Compliant" and 3 jurisdictions are "Non-Compliant". A further 11 jurisdictions are blocked from moving to a Phase 2 review, due to insufficiencies in their legal and regulatory framework.
[1252] Dourado (2013) 4.
[1253] (2013) 4.
[1254] The bias in favour of capital exporting nations exists because "the model was explicitly intended for use between OECD member states who had similar levels of industrialisation and trade, and it follows that if cross-border investment flows between a range of treaty partners that overall are not dissimilar, all countries using a similar set of allocation rules should end up in almost the same position they would be if the treaties had allocated greater taxing rights to source countries" (Daurer & Krever 2012:5).
[1255] Monitoring implementation and the impact of the different BEPS measures is a key element of the OECD's deliverables. The OECD has established "an inclusive framework on BEPS, which allows interested countries and

Committee on Fiscal Affairs, which essentially applies the BEPS processes. Both the IF and BEPS build on the exchange of information initiative. The OECD has also launched the Multi-lateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS,[1256] that is intended to transpose results from the OECD/G20 Base Erosion and Profit Shifting Project into more than 2,000 tax treaties globally.

Thus, each country needs to recognize that there are both risks and gains in joining these initiatives. For instance, joining the inclusive framework will require that a country needs to assess its own position, because there is no one size fits all recipe. For example, a country can opt-out of the country by country (CbC) reporting minimum standard where it does not have the appropriate transfer pricing legislation or treaties in place, without which it cannot benefit from CbC. The resource and cost issues need to be considered, as well as knowledge gaps. Alternative approaches are also possible where the Minimum Standard is adopted, without joining the Inclusive Framework. For example, the successful implementation of a Technical Committee on Cross Border Taxation set up by the OECD in cooperation with ATAF, allowed effective input of African countries into the BEPS process. Also by introducing EOI (which underpins the Inclusive Framework) countries can ensure that the building blocks toward greater participation are put in place.

11.2.2 International Instruments to address IFFs

There is a range of legal instruments available for international cooperation in combatting illicit financial flows. These are international treaties - which can be either bilateral or multi-lateral, domestic laws and memoranda of understanding (which are not legally binding). The OECD groups these under taxation (inclusive of customs), money laundering, corruption, regulation and supervision, and other areas of mutual legal assistance.[1257]

11.2.2.1 Tax Related Instruments

11.2.2.1.1 Bilateral Tax Treaties

Bilateral tax treaties are usually based on either the OECD and/or the United Nations Model Tax Convention. A double tax treaty is an agreement between two states to coordinate the exercising of their taxing rights, with a view to reduce or eliminate double taxation "either by allocating

jurisdictions to work with OECD and G20 members on developing standards on BEPS related issues and reviewing and monitoring the implementation of the whole BEPS Package" (OECD).

1256 OECD (not dated).

1257 OECD (2012) 13.

exclusive taxing rights to one of the contracting states, or obliging one state to grant double taxation relief."[1258] Double tax treaties are the legal basis for competent authorities of contracting states to cooperate on matters of taxation, whether or not they are within the scope of the treaty. Double tax treaties can also make provision for assistance in the collection of taxes.[1259]

The general objective of a bilateral tax treaty is to ensure the protection of taxpayers against "international juridical double taxation, with a view to improving the flow of international trade and investment and the transfer of technology."[1260] They are also aimed at preventing tax evasion.[1261] Furthermore, treaties are considered to have auxiliary objectives, which include the elimination of discrimination in the tax treatment between foreign investors and local taxpayers, and the provision of legal and fiscal certainty to serve as a framework wherein international operations can be carried on with a certain degree of confidence.[1262] The provisions of this exchange of information are contained in Article 26 of the OECD Model Tax Convention on Income and on Capital. From the perspective of many developing countries, Article 26 is important for the curtailing of cross-border tax evasion and avoidance, as well as the curtailing of capital flight, often accomplished through evasion and avoidance. Information exchange articles seek to achieve this by providing for the exchange of information required for the administering of the taxation provisions contained in the DTAs, in addition to providing the information necessary for the administering of the domestic tax laws of contracting states. Furthermore, the OECD uses information sharing as one of the indicators of harmful tax practices. The inability of a country to exchange information effectively is a factor considered in determining whether the country in question is compliant with transparency standards.[1263] Therefore, it is pivotal that countries are capacitated with effective information exchange frameworks.

11.2.2.1.2 Tax Information Exchange Agreements (TIEAs)

TIEAs are bilateral agreements between two jurisdictions and provide a legal basis for administrative co-operation in tax matters.[1264] TIEAs are generally based on the model issued by the OECD in 2002, and their number has grown exponentially in recent years. TIEAs provide for exchange of information *on request,* and may be subject to certain conditions such as the presence of foreign officials in relation to a specific tax investigation.[1265]

[1258] OECD (2012) 13.
[1259] OECD (2012) 13.
[1260] UN Model Double Taxation Convention par 6 at vii.
[1261] Gravelle (1988) 522.
[1262] Amatucci *ed.* (2012) 165.
[1263] Arnold & McIntyre (2002) 139-141.
[1264] OECD (not dated).
[1265] OECD (not dated).

11.2.2.1.3 Multi-lateral Tax Treaties

There are various multi-lateral tax treaties which provide for international cooperation, with the two most important ones being the Convention on Mutual Administrative Assistance in Tax Matters (as amended in 2010), and the International Convention on Mutual Administrative Assistance for the Prevention, Investigation and Repression of Customs Offences which provides for mutual assistance, with a view to prevent, investigate and repress customs offences. The MAA in Tax Matters expressly provides for "all possible forms of administrative co-operation between states in the assessment and collection of taxes."[1266] This cooperation can range from an exchange of information – both automatic and spontaneous, joint investigations or audits and recovery actions of foreign tax claims.[1267] On a regional level, multi-lateral cooperation can be achieved through instruments such as the Mutual Administrative Assistance in Customs Matters issued by the Economic Community of West African States.[1268]

The African Tax Administration Forum (ATAF) has developed the ATAF Agreement on Mutual Assistance in Tax Matters (AMATM). This multi-lateral instrument also allows for exchange of information, joint audits and investigations, sharing of expertise and mutual administrative assistance amongst African countries, and may have the potential to become a critical tool to combat BEPS in Africa.[1269]

11.2.2.1.4 Domestic Laws

Some countries enact domestic legislation which permits their tax authorities to exchange information with certain jurisdictions on a unilateral basis.[1270] However, the absence of a signed treaty may make it difficult for another country to rely on and to enforce provisions which are wholly contained in a country's domestic law. A bilateral or multi-lateral agreement will thus carry more weight than unilateral commitments through domestic legislation. However, domestic legislation may bring about measures that would otherwise not have been available and, as such, can create viable options to address gaps in a country's existing treaty network.[1271]

1266 OECD (2012) 14.
1267 OECD (2012) 14.
1268 OECD (2012)14.
1269 OECD (2012 14.
1270 OECD (2012) 14 where it is stated that legislation generally "specifies details such as the overseas countries to which it relates, applicable procedures, conditions or limitations and safeguards."
1271 OECD (2012) 15.

11.2.2.2 *Anti-money laundering and counter-terrorist financing instruments (AMLCTF)*

11.2.2.2.1 Multi-lateral Treaties

Various international conventions and directives to combat money laundering are in existence and the most relevant are:[1272]

- The Vienna Convention[1273] that defines the concept "money laundering" and which forms the basis for all anti-money laundering legislation;
- The Palermo Convention[1274] that creates "four distinct criminal offences"[1275] in jurisdictions that are signatories. It also provides for mutual legal assistance, transfer of proceedings and joint investigations;
- The UN International Convention for the Suppression of the Financing of Terrorism;
- The Council of Europe Convention on the laundering, search, seizure and confiscation of proceeds from crime and on the financing of terrorism.[1276]

Measures provided for in these conventions are aimed at the prevention, investigation and prosecution of specific offences, and, in addition thereto, provision is made for confiscation, extradition and mutual legal assistance.

11.2.2.2.2 Memoranda of Understanding

There are instances where international cooperation in AML initiatives is based on a memorandum of understanding (MoU) between competent authorities. A model agreement was designed by the Egmont Group, which contains basic rules for the exchange of information between FIUs. The rules pertain to aspects such as facilitation of investigations and prosecutions in pursuit of money laundering convictions.[1277]

11.2.2.2.3 Domestic Laws

Cooperation in the anti-money laundering and combating of the financing of terrorism area is often based on domestic legislation. Weaknesses in domestic legislation have led to international

[1272] BBA (2008) 2-25.
[1273] United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances.
[1274] United Nations Convention against Transnational Organised Crime.
[1275] Participation in organised criminal groupings, money laundering, corruption and obstruction of justice.
[1276] Council of Europe (2005).
[1277] OECD (2012) 16.

initiatives whereby country assistance in preparation or upgrading of legislation in line with the FATF Standards, is provided. For example, in 2005 the IMF issued “Model Legislation on Money Laundering and Financing of Terrorism” which is largely based on the relevant international instruments regarding money laundering and the financing of terrorism, and it incorporates the pre-2012 FATF Recommendations.[1278]

11.2.2.3 Anti-corruption related instruments

11.2.2.3.1 Multi-lateral Treaties

There are several multi-lateral treaties in existence which cover the mutual exchange of information in anti-corruption matters. The United Nations Convention against Corruption (UNCAC) has the following aims:

- To promote and strengthen measures aimed at preventing and combating corruption more efficiently and effectively;
- To promote, facilitate and support (e.g. asset recovery) international cooperation and technical assistance aimed at preventing and combatting corruption;
- To promote integrity, accountability and proper management of public affairs and public property.[1279]

Another key international instrument is the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. This convention requires signatories to address bribery in international business transactions by criminalising bribery of foreign public officials. It furthermore provides standards for consultation, mutual legal assistance and extradition as co-operative measures.[1280]

Regional instruments which provide for mutual legal assistance include the African Union Convention on Combating and Preventing Corruption (2003), the Economic Community of West African States Protocol on the Fight against Corruption (2001) and the Southern African Development Community Protocol against Corruption (2001).[1281]

[1278] OECD (2012) 16-17.
[1279] UNCAC Section 1 (a) – (c).
[1280] OECD (2012) 17.
[1281] OECD 92012) 17.

11.2.2.4 Regulation and Supervision Related Instruments

11.2.2.4.1 Mutual Administrative Assistance Agreements (Customs)

The basis for mutual administrative assistance, in customs matters, [1282] is the World Customs Organization's (hereinafter WCO) Model Bilateral Convention on Mutual Administrative Assistance in Customs Matters. The model is used by signatory countries as a basis for negotiating Mutual Assistance Agreements (hereinafter referred to as MAAs) with other foreign administrations.[1283] These agreements are recognized by domestic and foreign courts as legal bases for wide ranging cooperation, including information sharing,[1284] intelligence sharing and exchange of documentation required in the prevention and investigation of customs offences.[1285]

MAA's are not only request driven. Administrations can,[1286] at their own initiative:

> "…provide the customs administration of the other contracting party with information on activities, planned, on-going, or completed, which present reasonable grounds to believe that a customs offence has been committed or will be committed in the territory of the other contracting party."[1287]

Customs authorities are moving to a standardized way for exchange of information through the Globally Networked Customs (hereinafter GNC) concept. Just as with other WCO instruments, there will be a set of protocols, standards and guidelines for WCO members to follow. It entails customs to customs information sharing, which includes data obtained from commercial sources; speeding up of the time between agreeing on an exchange of information arrangement and implementation, whilst aiming to lower implementation and operation costs. The GNC is premised on "utility blocks," which differentiate the customs processes in order to allow customs authorities to be selective about what business process and associated information they choose to share, and to speed up networking arrangements.[1288]

[1282] MAA's differ from "mutual legal assistance agreements" which are used to request information that is required in evidential form for the purposes of criminal proceedings.

[1283] The core provisions of the model for a sound legal basis for the exchange of information are the provisions contained in Articles 1 to 5, 8 to 11, 19, 20, and 24 to 33 and should form part of a bilateral agreement.

[1284] Under Article 1(f): "information" shall mean "any data, whether or not processed or analysed, and documents, reports and other communications in any format, including electronic, or certified or authenticated copies thereof".

[1285] Another relevant instrument is the Nairobi Convention of 1977, or the International Convention on Mutual Administrative Assistance for the Prevention, Investigation and Repression of Customs Offences, which is aimed at facilitating a multi-lateral approach to mutual assistance in customs matters.

[1286] WCO Model Bilateral Agreement on Mutual Administrative Assistance in Customs Matters

[1287] WCO Model Bilateral Agreement Article 5.

[1288] WCO (not dated).

11.2.2.4.2 The Multilateral Convention on mutual administrative assistance in tax matters (the "Convention"), as amended in 2011

The OECD hails the convention as the most efficient multi-lateral exchange instrument to establish automatic exchange relationships, as it provides for all forms of administrative cooperation assessment (including collection of taxes, with a view to specifically combating tax avoidance and evasion). It contains strict rules on confidentiality[1289] and proper use of information, and permits automatic exchange of information with the added advantage of "global reach".[1290] The convention is described as "a freestanding multi-lateral agreement designed to promote international cooperation for a better operation of national tax laws, while respecting the fundamental rights of taxpayers."[1291]

According to the OECD, the convention constitutes a:

> "preferred legal basis for CRS and the US Foreign Account Tax Compliance Act (FATCA), through Inter-Governmental Agreements (IGAs), which are based on the automatic exchange of information from the tax administration of one country to the tax administration of the residence country."[1292]

The OECD makes the point that whilst all forms of exchange of information require a legal basis, such as that available under Article 26 of the OECD Model Tax Convention, the implementation of a single global standard through a multi-lateral instrument may be more efficient. The OECD states that it is already commonly accepted in principle that the convention should be the preferred instrument, because it also opens the door to the multi-lateral CAA agreement. [1293]

Under Article 2 of the convention, information exchange on most taxes is covered, however, customs duties are specifically excluded.[1294] Customs and other import duties are defined as "all levies collected on goods that are entering the country, or services delivered by non-residents to residents." These are inclusive of "levies imposed for revenue or protection purposes and

[1289] Taxpayers' rights are protected under Article 22 of the convention as it provides that "information shall be treated as secret and protected in the receiving state in the same manner as information obtained under its domestic laws. If personal data is provided, the party receiving it shall treat it in compliance, not only with its own domestic law, but also with the safeguards that may be required to ensure data protection under the domestic law of the supplying Party."
[1290] The convention was developed jointly by the OECD and the Council of Europe in 1988 and amended by Protocol in 2010. The convention is, according to the OECD website, the most comprehensive multi-lateral instrument available for all forms of tax cooperation to tackle tax evasion and avoidance, which is a top priority for all countries. In 2011 the convention was amended to align it to the international standard on exchange of information on request and to open it to all countries, in particular, to ensure that developing countries could benefit from the "more transparent environment".
[1291] OECD (not dated).
[1292] OECD (not dated).
[1293] OECD (not dated).
[1294]Article 1(b) (iii).

determined on a specific or *ad valorem* basis, as long as they are restricted to imported goods or services."[1295] A customs duty can be regarded as a specialised tax, but with a variety of applications, and this is what distinguishes it from the other "main stream" tax types. Customs duty was once the principal source of revenue in many countries but that has changed.[1296] In developed countries the emphasis falls on protection, whilst in developing countries, across Africa, customs duties are still a primary revenue contributor. In view of the high estimates of trade mispricing, a portion of this revenue is further eroded through illicit cross border transfers. It is within this context that the question must be asked as to whether it is not opportune that a multi-lateral convention on mutual administrative assistance in customs matters is developed.

According to a WCO survey, customs duties still account for on average between ten per cent and 30 per cent of national revenues in developing countries. In the case of nine per cent of the countries surveyed (seven countries including DRC, Ethiopia, Gabon, Lesotho, Côte d'Ivoire and Liberia), more than 30 per cent of national tax revenues came from customs duties. In 40 per cent of the countries surveyed (31 countries including CAR, Burkina Faso and Algeria) over ten per cent of national revenues were derived from customs duties. In 32 per cent of the countries surveyed (25 countries, including South Africa)[1297] less than five per cent of national revenues were derived from customs duties. Several African countries derived between five and ten per cent of national revenues from customs duties, for example, Kenya, Tanzania and Angola. Compared with the year 2009, a similar trend is observed. Rough estimates by Global Financial Integrity (GFI) indicate that between 2002 and 2011, USD 60.8 billion moved illegally into or out of Ghana, Kenya, Mozambique, Tanzania, and Uganda, using trade miss-invoicing.[1298]

11.2.2.4.3 The Standard for Automatic Exchange of Financial Account Information in Tax Matters: Building on the AML foundations of the FATF

According to the OECD, Automatic Exchange of Information (AEOI)[1299] is necessary and beneficial for the following reasons:

[1295] World Bank.
[1296] Changes in international trade have resulted in a major shift in the responsibilities allocated to customs. According to the WCO, there are five key customs responsibilities, namely, revenue collection, protection of society, trade facilitation, trade security and collecting trade statistics. The WCO further identified globalization, increased international trade, international terrorism, international organized crime, limited resources and budget constraints, as some of the challenges faced internationally by customs administrations.
[1297] South Africa is part of the SACU and collects and distributes duties to SACU members where such distribution accounts for revenue in excess of 40% of national revenue for Lesotho, Swaziland and Namibia.
[1298] GFI (2015).
[1299] Automatic Exchange of Information (AEOI) is "the routine and periodic transmission of information about non-resident persons, sent by the jurisdiction in which income or assets are located to the jurisdiction in which the person may owe tax. The exchange of information is automatic in that it occurs on a regular basis (e.g. annually) and the scope of the information to be reported has been agreed in advance, rather than being preceded by a specific request. The information may already be held by the tax administration, or be provided by third parties, such as financial institutions" (OECD 2014c: 3).

a) Tax is a critical source of development finance. However, in developing countries, revenue mobilisation as a percentage to GDP is comparatively low in comparison to developed countries;

b) AEOI permits tax administrations to request information from treaty partners (e.g. on wealth held/concealed offshore) and it can serve as a deterrent for future non-compliance;[1300]

c) International engagement in AEOI can potentially contribute to improvements in the integrity of international financial and tax systems;

d) AEOI can supplement EOI on request and international transparency agendas, such as anti-money laundering and anti-corruption.[1301]

The standard provides for annual automatic exchange between governments of financial account information of taxpayers, which includes balances, interest, dividends and sales proceeds from financial assets. Such information must be reported to governments by financial institutions and cover accounts held by individuals and entities, including trusts and foundations.[1302] The OECD points out that the standard does not restrict other types of AEOI, but merely sets out a minimum standard for the exchange of information. Jurisdictions can also elect to provide information additional to that which the standard defines.[1303]

The standard consists of the following elements:

a) the Common Reporting Standard (CRS) that contains the due diligence rules which financial institutions must follow in order to collect and then report the information that underpins the AEOI;[1304]

b) the Model Competent Authority Agreement (CAA) that links the CRS to the legal basis for exchange, specifying the financial information to be exchanged;[1305]

c) the Commentaries that illustrate and interpret the CAA and the CRS; and

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1300 OECD (2014c) 3.

1301 OECD (2014c) 3.

1302 OECD (2014c) 3.

1303 OECD (2014c) 3.

1304 OECD (Not dated). Implementation Handbook. 7. The term "financial information" means "interest, dividends, account balance, income from certain insurance products, sales proceeds from financial assets and other income generated with respect to assets held in the account or payments made with respect to the account. The term "reportable account" means accounts held by individuals and entities (which includes trusts and foundations), and the standard includes a requirement to look through passive entities to report on the relevant controlling persons."

1305 There are several notifications which are to be filed by each jurisdiction: "(i) a confirmation that domestic CRS legislation is in place and whether the jurisdiction will exchange on a reciprocal or non-reciprocal basis, (ii) a specification of the transmission and encryption methods, (iii) a specification of the data protection requirements to be met in relation to information exchanged by the jurisdiction, (iv) a confirmation that the jurisdiction has appropriate confidentiality and data safeguards in place, and (v) a list of its intended exchange partner jurisdictions under the CRS MCAA. A particular bilateral relationship under the CRS MCAA becomes effective only if both jurisdictions have the Convention in effect, have filed the above notifications and have listed each other" (OECD).

d) the Guidance on Technical Solutions to be used for exchanging the information, including an XML schema and standards in relation to data safeguards and confidentiality, transmission and encryption.

The scope of accountholders subject to reporting is wide, and due diligence obligations follow the FATF's anti-money laundering Recommendations and "know your client" (KYC) requirements.[1306] The standard aims to establish comprehensive reporting regimes that require detailed reporting on individuals, as well as ability to restrict opportunities for taxpayers to circumvent reporting through the use of interposed arrangements or legal entities.[1307] This requires financial institutions to "look through shell companies, trusts or similar arrangements, including taxable entities, to cover situations where a taxpayer seeks to hide the principal but is willing to pay tax on the income."[1308]

There are four requirements for implementation of the standard, namely:

a) Translating reporting, due diligence and implementation rules into domestic legislation;
b) Choosing an appropriate legal basis for implementation of AEOI;
c) Providing administrative and IT infrastructure as well as human resources; and
d) Safeguarding data and ensuring confidentiality of taxpayer data.[1309]

From the perspective of developing countries, the third requirement is most likely to pose insurmountable challenges to administrations. More often than not, administrations are not able to finance modern IT infrastructure or capacitate such. In addition, existing infrastructure may not even contain detailed and accurate data for purposes of AEOI. These factors will make adoption of AEOI in the near future, impossible in many countries. The number of African countries committed to AEIO is limited, even as estimates on IFFs from developing countries suggest that that the continent has much to gain from AEOI. Signatories from Africa of the MCAA on Automatic Exchange of Financial Account Information - with intended first information exchange date - are Ghana, Mauritius (both September 2018), the Seychelles and South Africa (both September 2017).1310

1306 See Annex to Common Standard on Reporting and Due Diligence for Financial Account Information ("Common Reporting Standard") Section III C 2c; Section IV A; Section IV D; Section VI.
1307 OECD (not dated) Implementation Handbook. 7.
1308 OECD (not dated). Implementation Handbook. 7.
1309 OECD (not dated) Implementation Handbook. 9.
1310 OECD (2017).

11.2.2.4.3.1 Key components of a global model of automatic exchange of financial account information

The OECD advances that for an AEOI model for sharing financial information to be effective, it must take into account the tax compliance of a residence jurisdiction, rather than be a by-product of domestic reporting.[1311] Since tax evasion is a global issue, it is important that the model has a global reach, in order for offshore tax evasion to be addressed and not merely relocated to another jurisdiction. Its design should therefore be standardised to the extent that it benefits most jurisdictions, whilst acknowledging that some issues remain to be decided by local implementation.[1312] Some advantages associated with standardization lie in lowered costs for all stakeholders concerned, as well as process simplification and increased effectiveness. Where a proliferation of differing and inconsistent models arises, it can potentially mean significant costs to government and business in the collection of information to operate the different models. Should this occur, the standards will become fragmented, introduce higher costs of compliance, introduce conflicting requirements and diminish effectiveness.

The critical role of due diligence procedures should not be discounted, because these ensure quality in reporting and exchange. This implies that officials conducting any intervention must report the outcomes (in detail to include names of offenders, type of offence, place and date of occurrence, etc.) of such intervention onto a central platform, where it can be accessed by risk assessing staff. Without a disciplined reporting culture within an administration, its information holdings will be weak and of little value when information is requested. Countries should therefore highlight errors in exchange to the requesting or receiving party, as part of their quality assurance processes.

The complexities of beneficial ownership[1313] enquiries, requires that financial institution staff (e.g. deposit taking institutions; custodial or investment entities and insurance companies) do more than follow a tick box approach in checking reportable accounts.[1314] They must screen all passive entities to identify and report the names of the individuals who are the controlling persons.[1315] The latter is emphasised in the Declaration on Automatic Exchange of Information in Tax Matters,[1316] wherein signatories declare their resolve to implement the new single global standard speedily, on a reciprocal basis. This should be translated into domestic law with assurances that beneficial

[1311] OECD (2013c) 7.
[1312] OECD (2013c) 7.
[1313] Beneficial ownership is defined in the FAFT recommendations referring to “the natural person on whose behalf a transaction is being conducted. It also includes those persons who exercise ultimate effective control over a legal person or arrangement”.
[1314] Reportable accounts include those held by individuals and entities (inclusive of foundations and trusts).
[1315] OECD 1. Common standard on reporting, due diligence and exchange of information par 12.
[1316] That was adopted in May of 2014.

ownership information on both legal persons and arrangements is collected and exchanged according to the requirements of the standard.[1317]

11.2.2.4.3.2 Implementation of the Five Stepped Approach

The OECD identifies the key challenges faced by developing countries in implementing AEOI as:

a) There may be other urgent basic domestic reforms required;
b) Information technology infrastructure is cost intensive and requires long term funding;
c) Human resources require the necessary skills to analyse and interpret received data effectively;
d) Difficulties may be experienced in translating the standards into law;
e) There may be limited awareness of exchange of information practices; and
f) Ensuring that legal and practical frameworks will meet with data protection and confidentiality standards.[1318]

The OECD proposes a five-stepped approach to enable developing countries' participation in the standard. This approach is informed by the following perspectives: firstly, steps developing countries may consider taking, secondly, steps that the Global Forum can take and thirdly, steps that G20 members and other developed countries may consider taking, in order to assist developing countries in building their capacity.[1319] Overlaps in the stepped approach will be avoided through proper coordination.

The stepped approach entails that (a) membership of the Global Forum is obtained; (b) political support is built; (c) participation on a voluntary basis in a pilot project is undertaken; (d) building blocks are developed and lastly (e) there is implementation and peer review.[1320] Becoming a Global Forum member achieves three goals:

- It aims to ensure the effective implementation of the standard of EOI on request and participation in the peer review process;
- It helps to build the stepped approach;
- A country can potentially benefit from AEOI pilot projects.[1321]

[1317] Meeting of the OECD Council at Ministerial Level Paris, 6-7 May 2014.
[1318] OECD (2014c) 12.
[1319] OECD (2014c) 14.
[1320] OECD (2014c) 15.
[1321] OECD (2014c) 15.

According to the OECD, the first step in implementing the standard, is detailed understanding of the purpose and context thereof. This understanding needs to be shared by tax, AML, relevant government officials, as well as financial services bodies and, as such, it underscores the relevance of a whole of government approach in tackling issues which have a cross cutting nature and impact.

An understanding of the legal framework is also required to identify areas for revision. Such areas may include both international agreements as well as domestic laws. Where international agreements are already in place, an enquiry as to whether it meets the standard on EOI on request, may be needed. Further points of enquiry can include whether Article 26 provisions (which govern exchange of information generally and permit AEOI) are included under existing DTAs, based on the OECD Model Tax Convention or the UN Model Tax Convention; or whether the country is signatory to the Multi-lateral Convention on Mutual Administrative Assistance in Tax Matters as it also permits AEOI.[1322]

Tax Information Exchange Agreements based on the OECD Model generally do not permit AEOI, whilst regional multi-lateral treaties and directives may allow for this.[1323] It is important that the relevant international agreement is supported by a Competent Authority Agreement. The latter essentially operationalises the automatic exchange by stipulating the practicalities for the transmission of information. This can occur on a bilateral or multi-lateral level. The multi-lateral Competent Authority Agreement enters into force bilaterally when two signatories both implement the required legislation, specify their required data transmission methods, meet the required confidentiality and data protection standards and specify that they wish to exchange information with the other.[1324]

11.2.2.4.4. Miscellaneous International Law Instruments Allowing for Information sharing

11.2.2.4.4.1 SADC treaty

The first non-tax related international instrument that warrants consideration is the SADC Treaty Article 21(3)(f) of the SADC Treaty, which provides for the coordination of members on information sharing regarding matters pertaining to the treaty. However, the article does not elaborate this provision further, and the type of information to which this article applies remains uncertain. The

[1322] The OECD ((2014c:15) points out that "given the large and growing number of jurisdictions covered by this agreement, becoming a party can assist in quickly building a broad treaty network covering a range of international cooperation mechanisms for tax purposes, and for developing countries may be a more efficient path than separately negotiating bilateral treaties."
[1323] OECD (2014c) 17.
[1324] OECD (2014c) 18.

term “coordination” is not defined and it is thus uncertain which mechanisms may be employed to this end. Article 7 elucidates the areas of cooperation, one of which is the cooperation on industry, trade, investment and finance. In the light of this, a protocol on finance and investment was adopted in terms of Article 22. This protocol is implemental through annexures. Article 5 of the protocol allows for the coordination in tax and tax related matters, and Annexure 3 to this protocol provides for the legal framework for such cooperation. Article 3 pronounces envisaged strategies to be employed in efforts to achieve coordination. These measures include the inception of a publicly accessible database containing seminal tax information applicable within the region, the enhancing of capacity building and the harmonization of taxes and administrative procedures. In an effort to enhance information exchange, a SADC model tax agreement and a SADC agreement concerning the assistance on tax matters have been formulated. Despite the conclusion of the formulation of these agreements, they have yet to be endorsed by the SADC member states, and thus remain dormant.

11.2.2.4.4.2 Domestic tools for cross-border information sharing

Within the South African jurisprudence, information sharing is provided for in domestic tax legislation. Section 3(3) of the Tax Administration Act[1325] provides for the exchange of information with foreign revenue authorities. This section requires that where SARS receives a request for the sharing of information in terms of an international agreement, such information must be obtained as though it were pertinent to the enforcement of domestic tax provisions. Section 108(5) of the Income Tax Act[1326] allows for the breach of the tax secrecy provision contained in the legislation. This section provides that where the request for information is pursuant to an agreement, the duty to treat the information of the taxpayer as secret will be subject to limitation. However, the limitation to such secrecy pertains only to information that is pivotal to the determination of immunity or relief sought, or that which is pivotal for the enforcement of the agreement in question. Section 75 of the Value-Added Tax Act[1327] provides for the entering into agreements concerning value added tax administration, with foreign revenue authorities. Subsection 5 provides for the limitation on the duty to treat taxpayer information as secret by stipulating that the preservation of secrecy “shall not prevent disclosure of information to any authorized officer of a signatory country.”

[1325] Act 28 of 2011.
[1326] Act 58 of 1962.
[1327] Act 89 of 1991.

11.2.3 International Instruments in Use

In this chapter, numerous international instruments are discussed that can assist countries to improve international cooperation in the form of information sharing and joint interventions. Assessing the seven selected countries against what is available and where they are in implementation it is evident from the table below that, with the exception of South Africa, most African countries need to do far more to increase their international reach. For example, Liberia and Sierra Leone have little coverage from a tax treaty perspective to promote investment and to provide tax certainty to potential investors. Namibia, Sierra Leone and Zimbabwe have not joined the Global Forum and may therefore not benefit from aspects such as peer review that can bring about better legal frameworks and information sharing. Namibia is not a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes, it has not signed and ratified the OECD Multilateral Convention on Mutual Administrative Assistance as amended, it does not apply the BEPS minimum standards and did not commit to addressing these issues by 31 December 2019. Furthermore, the Council of the European Union found that Namibia has harmful preferential tax regimes and that the country did not commit to amending or abolishing such by 31 December 2018.[1328] The country now finds itself on the EU list of non-cooperative jurisdictions for tax purposes. Namibia arguably is at higher risk of IFFs (than the other six countries) where tax evasion is estimated at nine per cent of GDP.[1329]

Table 11.1: Use of International Instruments

COUNTRY	Global Forum	Inclusive Framework	CbC MCAA	EOIR	AEOI	OTHER
Botswana	✓	✓	-	✓ **	-	DTAs[1330]
Ghana	✓	-	-	✓ **	Sept. 2018*	DTAs[1331]
Liberia	✓	✓	-	✓ ***	-	DTAs[1332]
Namibia	-	-	-	-	-	DTAs[1333]
Sierra Leone	-	✓	-	-	-	DTAs – UK and Norway

[1328] EU (2017).

[1329] Yikona, Slot, Geller, Hansen, & Kadri (2011) 76. With a GDP of USD 10,2 billion in 2016, IFFs due to tax evasion alone can be close to USD 1 billion per annum.

[1330] DTA Zambia, Swaziland, Sweden, Mauritius, France, UK, Zimbabwe, South Africa, Namibia, Barbados, India.

[1331] UK, France, Italy, Germany, South Africa, Belgium, Netherlands, Switzerland, Denmark, Mauritius, and the Czech Republic.

[1332] Germany, Sweden.

[1333] Botswana, Malaysia, South Africa, France, Mauritius, Sweden, Germany, Romania, United Kingdom, India, Russian Federation.

COUNTRY	Global Forum	Inclusive Framework	CbC MCAA	EOIR	AEOI	OTHER
South Africa	✓	✓	✓ 2016	✓ **	Sept. 2017*	AMATM, DTAs[1334]
Zimbabwe	-	-	-	-	-	DTAs[1335]

*Intended date of first exchange.

** Peer reviewed Phase 1 and 2.

***Peer reviewed Phase 1 + supplementary

11.3 Conclusion

According to Keen and Ligthart, the issues which information exchange on tax matters aim to address are not new – what has changed are the advances in information technology that make it possible for individuals and entities to hide income or wealth in offshore jurisdictions that offer low or zero tax rates.[1336] In this context, strengthened domestic and international cooperation amongst competent authorities, effective information sharing practices and effective enforcement measures are essential, in order to mitigate tax crimes and aggressive tax planning practices.

Success is often measured in terms of number of prosecutions, and international cooperation should therefore enable the prosecution of persons that are out of reach of administrative sanctions. In addition to the measures contained in the convention and the Common Reporting Standard (CRS), domestic and international cooperation exist within the AML space, which provides alternative mechanisms to investigate, prosecute and convict persons viewed as out of reach of the tax administration.[1337] The use of AML tools may be a preferable route in instances where sensitive criminal investigations into tax evasion and money laundering are conducted. For example, where an investigation is at an advanced stage, the authorities do not want the suspect to be tipped off. In addition, wide international cooperation options are available under AML legislation, such as asset recovery, which ensures a relatively strong enforcement and deterrence message.[1338]

Furthermore, it is evident that a multiplicity of information sharing international instruments exists. However, the practical implementation of these information sharing provisions, particularly within

[1334] South Africa has an extensive treaty network consisting of more than 60 countries. See http://www.sars.gov.za/Legal/International-Treaties-Agreements/Pages/default.aspx.
[1335] United Kingdom, Germany, Netherlands, Sweden, Malaysia, Mauritius, France, Canada, Bulgaria, Norway, Poland, South Africa.
[1336] Keen & Ligthart (2005) 1.
[1337] While there are jurisdictions that are legally obliged to notify the person supplying information and/or the taxpayer, such procedures should not be applied if they (under the circumstance of the case) will compromise or frustrate efforts of the requesting state to prevent tax avoidance or tax evasion.
[1338] Mathias & Esposito (2015) 280.

the African context, is limited. It can be argued that the creation of an effective information sharing framework requires not only the harmonization of domestic legal frameworks, but also the synchronising of administrative processes mechanisms. With the MCAA on AEIO, tax administrations are moving toward what are essentially administrative measures of cooperation. In this sense, information sharing can serve as a substitute for coordination of tax systems, which has less distortionary effects on national sovereignty.[1339]

Lastly, it is submitted that the provisions contained in the international sharing instruments do not take cognisance of challenges inherent to African countries, such as low tax compliance on a domestic level, the existence of huge informal sectors, the fundamental rights constructions adopted by the various countries and the disparity in legal systems emanating from varied historical influences.

[1339] Keen & Ligthart (2005) 21.

CHAPTER 12:
ILLICIT FINANCIAL FLOWS: A CONVERGENCE OF RIGHTS

12.1 Introduction

Tax policy creates and reflects relationships between the market, the citizen and the state. As a result, traditional tax policy discourse centres around the premise that decisions about taxation should be made exclusively within nations, independent of outside concern and interference.[1340] According to Christians, this view of "sovereign autonomy over taxation" is increasingly lacking consistency with a global economic reality, wherein market and regulatory relationships have been and are being fundamentally rewritten.[1341]

This chapter focuses on the impact of increased calls for transparency in the public interest, on the principle of taxpayer confidentiality. Confidentiality of taxpayer information is a cornerstone of tax systems, because for taxpayers to meet their tax obligations, they need to be confident that their sensitive personal information (financial or otherwise) is not disclosed inappropriately, either negligently or intentionally.[1342] Confidentiality supports other essential features of the system, such as voluntary compliance and self-assessment. Without the continued application of the confidentiality principle, countries run the risk of undermining voluntary compliance with the tax system.[1343]

There are, however, circumstances under which disclosure of taxpayer data will be required, and Ring identifies some pervasive questions in relation to transparency and disclosure of taxpayer information:

a) What is the type of information that should be provided?
b) How much difficulty will the taxpayer have in providing that information?
c) In what format through which means will the information be provided?
d) What are the technological infrastructure requirements that taxpayers and government need to meet in order to implement this system?
e) Who should receive the information?
f) What is the permissible use of the information?
g) To which degree is the country capacitated to meaningfully use the information? and

[1340] Christians (2009) 1.
[1341] Christians (2009) 1.
[1342] OECD (2012) 5.
[1343] ATO (2015).

h) How will taxpayer privacy and data protection be ensured?

The responses to these questions will, according to Ring, determine "the success, failure and impact of a given regime for providing tax information."[1344] Ring cautions that different responses are possible to these questions. Therefore, information regimes, whether new or existing, should be assessed against these questions, in order that a jurisdiction can choose the best path toward appropriate protection of its tax base.[1345]

12.2 Taxpayer rights to privacy

It can be argued that the legitimate use of corporate entities for holding passive investment assets or undertaking a trade or one-off transaction, whether for tax planning purposes or maintaining confidentiality, is a right that must be upheld. There are instances where confidentiality is the primary driver to the establishment of an offshore structure, whether it be in the form of a company or trust/foundation or a combination of the two. However, the creation and ownership of any such arrangement will invariably have a tax consequence at the outset and throughout its existence. Taxpayers are, however, able to legally minimize their tax burden, in order to avoid paying high taxes. Taxpayers often take advantage of the mobility of capital and of intangibles, as these commodities can be easily moved from country to country through the use of planned licensing structures.

To address this, most developed jurisdictions around the world have complex anti-avoidance rules which seek to prevent individuals from sheltering income and gains through the use of offshore structures. These anti-avoidance rules work by attributing the income and gains of the offshore company or trust to the person who has initiated the creation of the structure, often referred to as the ultimate beneficial owner.

The importance of protecting taxpayer rights resonates through case law. For example, in the South African Supreme Court of Appeal case *Chairman, State Tender Board v Supersonic Tours (Pty) Ltd*[1346] the court was required to adjudicate whether a decision of the State Tender Board to restrict the company and its directors from getting business from the government. Though the court case dealt with issues of procedural fairness under the provisions of the Promotion of Administrative Justice Act,[1347] a reference was made to the protection of taxpayer information and the conduct of attorneys who were instructed by the Department of Defence to investigate

[1344] (2014) 4.
[1345] Ring (2014) 4.
[1346] (389/07) [2008] ZASCA 56.
[1347] Act 3 of 2000.

the correctness of the information supplied by the respondent (Supersonic Tours). A record of the attorneys reflected the following with regard to their instruction:

> "A more meaningful way would be to obtain access to the records of the South African Revenue Services and the Unemployment Insurance Fund ('U.I.F.') in order to determine the number of, and identity of each employee, from whose salaries income tax and contributions to the U.I.F. are deducted monthly and paid over. However, the South African Revenue Services, by virtue of the provisions of Section 4 of the Income Tax Act 58 of 1962, is prohibited from disclosing any information at its disposal, and therefore such information should be collected in an "unofficial" manner" and "as indicated, we are employing 'unofficial' means of obtaining the information from the South African Revenue Services…"[1348]

The court recommended that in view of the contents of the memorandum, it requested the Registrar of the Court to send a copy of the memorandum and of its judgment to the Commissioner of the South African Revenue Services, in order to alert him to the fact that there may have been a contravention of Section 4 of the Income Tax Act and to "enable him to take such steps as he may deem expedient including, if he considers such a step to be warranted, a referral to the appropriate law society, which has jurisdiction over the firm of attorneys concerned." [1349]

The rationale for protecting information disclosed by taxpayers to the revenue authority is to encourage full disclosure by taxpayers to the revenue authority. In this regard, it was pointed out in a defamation case,[1350] that authorities could face disruption if anyone who desired financial information concerning a party to litigation could subpoena an official to produce the necessary records. As a result, a court will not readily entertain a taxpayer's request that the revenue authority divulge information held by it, regarding information on a taxpayer for purposes of commercial or other litigation. In as far as South Africa is concerned, the revenue authority's service charter clearly states that it (SARS) will protect taxpayers' constitutional rights, by keeping taxpayers' affairs strictly confidential and secret in compliance with the secrecy provisions of the act and in line with the right to privacy contained in Section 13 of the Constitution.[1351]

[1348] [2008] ZASCA 56 9.
[1349] [2008] ZASCA 56 9.
[1350] Welz & Another v Hall & Others, (1996) (SA) 1073, (59 SATC 49) 75.
[1351] Constitution of the Republic of South Africa of 1996.

12.3 Income tax transparency legislation

The introduction of income tax transparency laws in Australia is a significant departure from the established framework for the protection of sensitive taxpayer information. Under the provisions of Section 3C of the TAA 1953, disclosure of protected taxpayer information is authorised by imposing a duty on the Commissioner to publish certain tax information: for every corporate tax entity that reports AUD 100 million or more in total income, the Commissioner is required to publish the entity's reported name and Australian business number; total income; taxable income or net income (if any); and income tax payable.[1352] The laws are to apply in circumstances where the public benefits of disclosure outweigh taxpayer privacy concerns. On the introduction of these laws, the following justification was provided:

> " the base erosion and profit shifting by multi-national entities is a concern for the Group of Twenty (G20) and the Organisation for Economic Cooperation and Development (OECD); the laws would discourage aggressive tax practices; and the laws would inform public debate about corporate tax policy."[1353]

Recent industry transparency initiatives in the extractive sector such as the EITI Standard also promote the idea that certain taxpayer information should be published.[1354]

12.4 Disclosure of taxpayer information in the public interest

In recent times, a number of mass "public interest" disclosures by whistle-blowers highlighted tax and corporate practices which are characterised by aggressive tax avoidance and use of corporate structures to hide profits. The "Luxembourg Leaks" (Luxleaks) and the "Panama Papers" are probably the best known and relevant for purposes of this study. The effect of the scandals was a re-ignition of the debate on international tax reform, to counter practices contributing to IFFs. These scandals also resulted in renewed emphasis of the human rights concerns raised by lost tax revenue and secrecy in financial transactions. It is argued that these funds in particular could have been used to lessen inequality and to advance the realization of economic, social, and cultural rights in countries around the world.[1355]

The Luxleaks[1356] scandal exposed how Luxembourg authorities had reportedly been "secretly sanctioning, on an industrial scale, aggressive cross-border tax avoidance by some of the world's

[1352] ATO (2015) 4.
[1353] ATO (2015) 5.
[1354] Supra 7.6.1.1.
[1355] IJRC (2016).
[1356] According to *Forbes*, on every Wednesday of the week, PwC prepared 30-40 ruling requests, placed on a memory stick, and delivered the stick to the head of the Luxembourg tax office responsible for issuing tax rulings.

largest businesses.” According to press releases at the time, some world leaders expressed that the LuxLeaks revelations meant that the boundaries of permissible tax competition between countries had shifted.”[1357]

In many instances, the Luxembourg authorities were shown to have approved complex, aggressive and artificial tax avoidance structures, which eroded the tax base of other countries. The leak to the media entailed roughly 28000 tax rulings and other return information from a leading accounting firm. The documents disclosed that the Luxembourg authorities had helped 340 big firms to minimise their tax payments, in some cases to one per cent or less. In 2015 the European Parliament awarded one of the whistle-blowers the Citizens’ Prize for his contribution to the promotion of common values. However, at the same time, they were charged with complicity in the violation of professional secrecy laws,[1358] as well as possession and dissemination of confidential papers.[1359]

Short on the heels of the Luxleaks, the Panama Papers disclosures followed. The Panama Papers is described as “a global investigation into the sprawling, secretive industry of offshore jurisdictions which the world’s rich and powerful use to hide assets and skirt rules by setting up front companies in far-flung jurisdictions.”[1360] The content of the Panama Papers is based on more than 11 million leaked files, wherein the investigation reportedly exposed the use of corporate vehicles in offshore jurisdictions, for purposes of facilitating bribery, conducting arms deals, committing tax evasion, financial fraud and drug trafficking.[1361] In a similar manner, in 2016, the Gupta Leaks revealed high levels of corruption amongst senior government officials, including the South African president, in their generous treatment of benefactors of the president.[1362]

According to Christians, the LuxLeaks documents draw a picture of international tax practice, sometimes literally. She describes it as a world of elaborate Escher-like structures, wherein back-to-back fund transfers through layers of similarly named entities are standard features of business

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The tax office approved most of the ruling requests by 5 p.m. that same day. It can be inferred that the tax office rubber stamped the rulings, because it would be impossible to read, let alone digest, analyse, and grant, 30 ruling requests in the course of a day, which in effect meant that multi-nationals were writing their own tax rulings.

1357 Bowers S (2016).

1358 Luxembourg is one of few European countries with a dedicated law on whistle-blowing, but it is considered too narrow. In this instance the whistle-blower is not considered as such, because the law in Luxembourg is limited to corruption offences and the information he revealed did not show blatant corruption. In addition, the law only protects whistle-blowers against dismissal, not against prosecution.

1359 Bowers S (2016).

1360 ICIJ.

1361 ICIJ.

1362 Daily Maverick (2016); Mail & Guardian (2016). The leaks consist of a few hundred gigabytes of information containing between 100,000 and 200,000 unique e-mails and a host of other documents. The e-mails portray members of government, a substantial number of ministers and senior state employees illegally sharing confidential state information with members and associates of the Gupta family. Crucially, they also appear to show the involvement of the security establishment in illegally spying on government for the Guptas.

in a globally interlinked world. In this world, she continues, no simple transfers of funds from A to B seem possible, but instead, the rule seems to be that transfers must always be done in tranches, with different instruments of conveyance, in different packages and through a series of steps, all of which require a constantly growing volume of new company spinoffs.[1363] According to Christians, the Panama Papers identify the architects of this world as a public/private partnership of tax authorities and tax advisers for multi-national corporations.[1364] This reality is also reflected in the diamond value chain as illustrated through the dealings of Barry Steinmetz of the Steinmetz Group who, according to media reports, is "De Beers' most prolific diamond buyer, a supplier to the luxury jewellery brand Tiffany & Co., and an alleged criminal, accused of bribing the wife of a former Guinean president to land a multibillion-dollar iron deal."[1365] The Panama Papers reveal that, in order to protect the company's reputation, Barry Steinmetz sold his share of the company to his brother, whilst retaining a diamond business entity in Sierra Leone through the British Virgin Islands-based entity OCTEA.[1366] The company, which is reportedly run through BSG Resources (BSGR), counts the Steinmetz family as beneficiaries. OCTEA is reportedly wholly owned by Guernsey-based BSGR Resources, and in turn BSGR is owned by several foundations based in Liechtenstein and Switzerland such as Nysco[1367] and Balda.[1368]

Sierra Leone is one of Africa's leading diamond producers by value, and Steinmetz, who reportedly had a personal fortune of USD 6 billion in 2012, is its biggest private investor. The fortunes of the country are reportedly intertwined with those of Steinmetz, as the national government calculated its forecast of national growth closely tied to the success of two of his companies, the BSGR and African Mineral Limited.[1369]

Incomplete diamond export data, obtained by the African Network of Centres for Investigative Reporting (ANCIR), show that during some months from 2012 to 2015, OCTEA exported more

[1363] Christians (2014) 2.
[1364] Christians (2014) 2. She describes the relationship as "this partnership, and the byzantine legal structures it produces, are systemically hidden from public view behind taxpayer confidentiality laws. These laws exist to protect taxpayers' financial privacy, but they also serve to protect governments' political autonomy and flexibility in administering their own tax laws. Lawmakers must constantly balance the protection of their own policy space, the rights of specific taxpayers, and the need to preserve the public's trust in the system which they have created. Preserving trust generally requires that all taxpayers be subject to the same set of rules, while confidentiality leaves room for differential treatment that won't be seen - and possibly protested - by the public
[1365] ANCIR.
[1366] OCTEA Group Limited is not a registered company in Sierra Leone and does not own a mining license to operate in the country, and therefore is not liable to pay property tax.
[1367] ICIJ.
[1368] For ownership and shareholding details, the International Consortium for Investigative Journalists (ICIJ) provide an inter-active analysis available at:
https://offshoreleaks.icij.org/search?utf8=%E2%9C%93&q=octea&e=&commit=Search. See also: https://offshoreleaks.icij.org/nodes/12123583.
[1369] Sharife & Gbandia (2016).

than USD 330 million in rough diamonds. Yet, although OCTEA's rough diamonds average USD 350 per carat, the company is alleged to be more than USD 150 million in the red. [1370]

In 2016, the Sierra Leone Commercial Court ruled that the OCTEA Group Limited is not a registered company in Sierra Leone and does not own a mining license to operate in the country, and therefore is not liable to pay property tax to Koidu City.[1371] According to the court statement "OCTEA has not established a place of business in the country and the 84 Wilkinson Road office in Freetown is the office address of Koidu Limited and not OCTEA." To emphasize that OCTEA has no presence in the country, the judge noted that the Environmental Protection Agency (EPA) did not issue a license to OCTEA, but rather to Koidu Limited. The judge found that OCTEA is a separate legal entity from Koidu Limited, and that no evidence was presented which indicated that OCTEA owns a mining licence. These findings are reported as quite ironic in the face of government having ordered OCTEA in December of 2015 to scale down operations of its Koidu mine for 90 days in order government could assess the payment differences with the entity.[1372]

The mining lease agreement called Koidu Kimberlite Agreement was signed in 2005.[1373] It was subsequently amended and ratified by Parliament in October 2010. This agreement gives Koidu Limited various tax exemptions including exempt payment of property tax to Koidu City. The newspaper article concludes that the Local Government Act of 2004 stated that companies should pay property tax in the area of operation, but this was overlooked by Parliament when it wholly ratified Koidu's agreement. Also, this was the second time that the High Court of Sierra Leone ruled that OCTEA is not a registered company in the country and therefore cannot be sued for payment of taxes.[1374]

12.4.1 Taxpayer obligations

The Foreign Account Tax Compliance Act (FATCA) is a US initiative to improve tax compliance, where foreign financial assets and offshore accounts are involved.[1375] Under FATCA, United States taxpayers (individuals and companies) with specified foreign financial assets above certain

[1370] Sharife & Gbandia (2016).
[1371] Awoko (2016). The company is registered in the British Virgin Islands (BVI) and offshore haven and operates three subsidiary companies registered in the country. The three subsidiaries, according to Justice Alhadi, are Koidu Limited, Tonguma Limited and Boroma Limited.
[1372] Koroma (2015).
[1373] The agreement has not obligated Koidu Limited to pay property tax to the Koidu City Council. The agreement is valid until the 22nd July 2030, she said. OCTEA is not the owner or occupier of any building in Koidu. The companies are exempted from paying all forms of taxes to Koidu City.
[1374] Awoko (2016).
[1375] The Foreign Account Tax Compliance Act, referred to as FATCA, is contained in Chapter 1471–1474 of the Internal Revenue Code of 1986, as enacted into law by Section 501(a) of the Hiring Incentives to Restore Employments (HIRE) Act 2010. Its main purpose was to act as an additional tax revenue source to offset additional spending.

thresholds must report those assets to the Internal Revenue Service (IRS).[1376] Failure to report will result in an initial penalty of USD 10 000, and up to USD 50 000 for continued failure following IRS notification.[1377] In addition, FATCA requires foreign financial institutions to report information directly to the IRS about financial accounts held by US taxpayers, or held by foreign entities in which US taxpayers hold a substantial ownership interest. Foreign financial institutions will also have to withhold and pay to the IRS 30 per cent of any payments of income from US sources, or proceeds from the sale of securities generating US source income that were made to non-participating foreign financial institutions, individuals who fail to provide information on whether they are US persons, or foreign entity (companies, trusts, etc.) account holders who fail to provide information about the identity of their US owners.[1378] The FATCA is described as a response to the difficulties experienced in obtaining such financial information through other methods, including standard EOI agreements.[1379] Unlike a conventional withholding tax, FATCA is described as "an interim measure intended as a highly coercive penalty regime to force foreign financial institutions to disclose private financial information to the IRS unilaterally and submit to governmental control."[1380]

Under the BEPS reforms, country by country reporting (CBCR) is a proposed international tax reform which would require MNEs to, on an annual basis, report financial and business information which includes revenue, profit before income tax, and income tax paid in respect of each country in which the MNE is operating.[1381] CBCR thus simply mandates the disclosure of additional financial and business information to tax authorities and, potentially, the public.[1382] The passage of the US Dodd-Frank Act of 2010 called for mandatory reporting of geographic earnings for all listed companies involved in the extractive sector (apart from the logging industry).[1383]

In 2012, the US Securities and Exchange Commission (SEC) adopted implementing rules to ensure that public companies followed the new regime, however, these rules were struck down in a court ruling on the basis that the law never required disclosures to the public.[1384] In 2013, the European Parliament adopted a directive whereby national laws will mandate the disclosure of tax payments in every country by listed and large unlisted companies registered in the European Union, with operations in the oil, gas, mining and logging sectors. In addition, these companies are to disclose tax payments (such as taxes on profits, royalties, dividends, and licence fees)

[1376] IRS (not dated).
[1377] IRS (not dated).
[1378] IRS (not dated).
[1379] OECD (2014a) 65.
[1380] Byrnes & Munro (2016) Par 1.01.
[1381] Cockfield & MacArthur (2015) 633.
[1382] Cockfield & MacArthur (2015) 633.
[1383] Supra 4.2.1.4.
[1384] *National Association of Manufacturers, et al v Securities & Exchange Commission et al.*

which are attributable to specific projects. The MNE reports on payments to governments are to be made publicly available on an annual basis. These disclosure requirements are meant to complement the EITI efforts by requiring companies to disclose payments to governments along the lines set out by the EITI.

In 2013, the European Commission introduced the Capital Requirements Directive IV, which requires credit institutions and certain investment firms to publicly disclose the name and nature of activities undertaken, as well as the turnover and the average number of employees for each country in which the corporate group has a subsidiary or branch. The corporate group has also been required to disclose, in respect of each subsidiary or branch, the profits and losses, taxes paid and subsidies received.[1385]

12.5 The impact of developments in exchange of information on taxpayer rights

Recently the EOI standard on exchange of taxpayer information has shifted from EOI on request to automatic exchange of information. The latter implies that more systematic exchanges of taxpayer information between tax administrations will take place, but also that the mandatory bulk processing of data will require personal data protection. This raises the question of whether growing social and political acceptance of imposing measures against under-reporting of tax can be effectively counter-balanced by the protection of private rights of taxpayers.[1386]

Within the EU the exchange of information on request and spontaneous exchange of information are allowed, if the data is "foreseeably relevant to the administration and enforcement of domestic laws" of the recipient state.[1387] The Court of Justice of the EU also ruled that the fundamental right to be heard does not require that a tax administration of a member country notifies a taxpayer when it exchanges information with another member state – the reasoning being that EOI takes place in the investigative stage of applying tax procedures.[1388] The European Court of Human Rights found that EOI was in accordance with the aims of the law and that it pursues a legitimate aim, namely the economic wellbeing of the country.[1389] Nevertheless, under the EU data protection directives, protection of tax data relating to natural persons is covered in principle.

[1385] Cockfield & MacArthur (2015) 635.
[1386] Schaper (2016) 514.
[1387] Schaper (2016) 515.
[1388] Schaper (2016) 515-518.
[1389] Schaper (2016) 518.

From a sub-Saharan African perspective, AEOI raises two concerns: (a) whether data protection rights are enshrined in law and (b) whether institutions will, in responding to information requests from other law enforcement agencies, ensure that such data is not used for purposes other than what is allowed in law.

12.6 Taxpayer's right to commercial confidentiality

Corporations have a clear interest in protecting the confidential information of their customers due to their own interest in protecting trade secrets and in maintaining good relations which assures profit making.[1390] The constitutional right to privacy for corporations rests on three premises, namely (i) corporates are legal persons and are entitled to bear legal rights; (ii) corporates have distinct privacy interests and property interests which are protected by a right to privacy and (iii) corporate rights relate to the rights of individuals involved in those corporates.[1391] Robinson argues that privacy is as important to corporates as it is to individuals, because the ability to shield certain actions and information from the public makes it possible for legal entities to carry out the functions for which they were formed.[1392] Furthermore, in the operating context of businesses, there is a correlation between privacy and profits and this correlation is acknowledged through trade secrecy laws.[1393]

Case law from around the globe confirms that courts are less accepting of government invasions that do not involve administrative searches. *GM Leasing Corp. v United States*[1394] dealt with warrantless entry into a corporate building and the seizure of corporate documents and records. In this particular case, the IRS was pursuing an employee of GM and, in the process of doing so, it seized vehicles and records of the company. The court found that the seizure of vehicles was not unconstitutional, because it took place in a public place, but found that the seizure of documents involved intrusion into the privacy of GM's offices.

In *Investigating Directorate: Serious Economic Offences and Others v Hyundai Motor Distributors,*[1395] the court held that the protection of the right to privacy may be claimed by any person. The right to privacy is applicable, where appropriate, to a juristic person, and such applicability of the Bill of Rights to a juristic person is set out in Section 8(4) of the Constitution which states that a juristic person is entitled to the rights in the Bill of Rights to the extent required

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[1390]Robinson (2015) 2287.
[1391] Robinson (2015) 2287-2288.
[1392] Robinson (2015) 2296.
[1393] Robinson (2015) 2296.
[1394] 429 US 338 (1977).
[1395] SA 545 (CC) (25 August 2000) para 17, 18.

by the nature of the rights and the nature of that juristic person.[1396] This position was confirmed in the constitutional case of *Gaertner v Minister of Finance,*[1397] which relates to search and seizure operations conducted by SARS, which were outside the scope of the warrant.[1398]

From the perspective of government agencies, privacy rights for corporate actors may be used to inhibit effective audits of MNEs or to promote offshore tax evasion. In this regard, corporate ownership rules in some jurisdictions prevent access to the identity of shareholders who may be facilitating offshore tax evasion.[1399] Cockfield and MacArthur argue that corporate taxpayer privacy concerns are more concrete in relation to the tax information of small closely held private corporations.[1400]

A valid concern for MNEs revolves around commercial and trade secrets, because the revelation thereof may harm the ability of the MNE to compete effectively in the market place, with potential negative consequences on both a national and global scale. For that reason, commercial and trade information are protected by domestic and treaty rules:[1401]

Domestic tax laws provide for the maintenance of confidentiality with respect to any non-public tax information, including commercial and trade secrets. Tax treaties generally contain a provision which allows the tax authorities of one country to request tax information from another, mainly to assist with audits. Under the general rule in the OECD model tax treaty, a government can deny an information request on the basis that the request violates the taxpayer's right to maintain commercial and trade secrecy. A trade or business secret is generally understood to mean "facts and circumstances that are of considerable economic importance and that can be exploited practically and the unauthorised use of which may lead to severe financial hardship."[1402] The

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[1396] The court argues that [par 19- 20] "juristic persons are not the bearers of human dignity. Their privacy rights, therefore, can never be as intense as those of human beings. However, this does not mean that juristic persons are not protected by the right to privacy. Exclusion of juristic persons would lead to the possibility of grave violations of privacy in our society, with serious implications for the conduct of affairs. The state might, for instance, have free licence to search and seize material from any non-profit organisation or corporate entity at will. This would obviously lead to grave disruptions and would undermine the very fabric of our democratic state. Juristic persons therefore do enjoy the right to privacy, although not to the same extent as natural persons. The level of justification for any particular limitation of the right will have to be judged in the light of the circumstances of each case. Relevant circumstances would include whether the subject of the limitation is a natural person or a juristic person, as well as the nature and effect of the invasion of privacy."

[1397] *Gaertner v Minister of Finance* 2013 ZACC (38) 14 Paragraph 35.

[1398] *Gaertner v Minister of Finance* 2013 ZACC (38) 14 Paragraph 35. The court, in its *obiter dictum* stated that the right to privacy extended beyond a person's home. The elucidation of the contents of the right to privacy was discussed only with reference to the application of the right to the powers of search and seizures. The court did not discuss this right to privacy in the context of the disclosure of the taxpayers' information. However, this case still provides valuable insights, as it affirms the perception that the right to privacy is not an absolute right and may be subject to limitations, where such limitations are justifiable in light of Section 36 of the Constitution.

[1399] Cockfield & MacArthur (2015) 654.

[1400] (2015) 654. The concern here is that the corporation is merely acting as alter ego for the individual shareholders, and therefore public disclosure of corporate tax information would harm the individual shareholder to the same extent as the disclosure of his personal tax information.

[1401] Cockfield & MacArthur (2015) 655.

[1402] OECD (2010) 406 (par 19.2). An example provided in the Commentary is that of a bank that might hold a pending patent application for safe keeping or a secret trade process, or formula that might be described in a loan application

OECD clarifies in the commentary that secret information "should not be taken in too wide a sense," otherwise an overly broad interpretation would render ineffective the exchange of information.[1403] Moreover, any transferred information must be kept confidential by the recipient tax authority and cannot be used for any unauthorized purposes.[1404]

Within this context, it is important to note that none of the information mandated by CBCR would constitute a trade or business secret. CBCR information such as data on revenues earned and taxes paid in every country in which the MNE operates, may encourage a certain amount of public accountability, in that attempts at profit shifting from high to low tax jurisdictions can be readily identifiable.[1405]

12.7 Conclusion

This chapter highlights the importance of the protection of taxpayer information as a cornerstone of a well-functioning tax system. A basic taxpayer right is that the information held by the tax authorities on the affairs of a taxpayer is confidential and will only be used for the purposes as specified in tax legislation. However, with basic taxpayer rights come taxpayer obligations, such as to be honest about tax affairs and to cooperate with the tax authorities.

The lessons from public disclosures such as the Luxleaks, the Panama Papers and the Gupta Leaks are that reform in international tax law cannot only target specific laws, but that it must target the actions of government officials on an operational and policy level. From a tax perspective, the public disclosures demonstrate that tax law involves multi-directional confidences, both between taxpayers and their own governments, as well as in governments' dealings with one another. It is thus a balancing act amongst taxpayer rights, political autonomy and flexibility and the public trust. As seen in the Lux Leaks disclosures, excessive protection of confidentiality of MNEs "have traded on an ideal of public trust to achieve uncertain benefits for a few at potentially high cost for many."[1406] In the case of the Gupta Leaks benefits, taxpayer money accrued to the benefactors of the president through purported acts of bribery, corruption, nepotism and money laundering. The Panama Papers in turn, show how transparency can benefit the identification of hidden wealth of corrupt officials and the opaque structures used in offshore jurisdictions. The era of increased information exchange will challenge governments, and especially tax administrations, in ensuring that taxpayer obligations and taxpayer rights are

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or in a contract held by a bank. In such circumstances, details of the trade, business or other secret should be excised from the documents and the remaining financial information exchanged accordingly.

[1403] OECD (2010) 406.

[1404] Cockfield & MacArthur (2015) 655.

[1405] Cockfield & MacArthur (2015) 655.

[1406] Christians (2014) 8.

managed with the necessary confidentiality. Also, that institutional integrity of such administrations is beyond reproach in as far as its dealings with taxpayers are concerned.

CHAPTER 13:
CONCLUSIONS AND RECOMMENDATIONS

In evaluating tax policy measures required to stem IFFs from sub-Saharan Africa, the key research questions posed were firstly, to determine what constitutes IFFs and where these are encountered, secondly, which policy handles are available to address IFFs and thirdly, what actions can be taken to reduce IFFs. The primary research objectives set, were firstly, to determine what constitutes IFFs and its underlying drivers. Secondly to determine how IFFs manifest in the extractives, with specific reference to the diamond value chain. Thirdly, to determine the policy handles available to governments to identify and mitigate IFFs. Fourthly, to develop guidelines which can assist government agencies to develop a holistic approach to address IFFs as a common objective. In formulating a holistic approach to address IFFs, I set out to approach IFFs as a wicked problem and to identify its main drivers and inter-dependencies, as well as corresponding policy and action strategies which can mitigate the origin and impact of IFFs.

In this concluding chapter, overall conclusions are drawn in relation to the stated research objectives. The latter is followed by policy recommendations based on the results of the study, whereafter I discuss the contribution of this study, as well as areas of future research related to the research in this study. The chapter and study conclude with some final remarks.

13.1 Overall conclusions

The concept IFFs is ill defined in that for some, it includes only acts that are illegal, whilst others view the concept as inclusive of both legal and immoral conduct. In the former view, action strategies to address IFFs will have a narrow focus, whereas a wider view is implicit in the latter view. The definitional challenge posed by IFFs is, however, not unique and is reminiscent of similar definitional problems associated with broadly defined concepts such as “transnational organised crime”. In this sense IFFs is a wicked problem, as it defies definitive formulation because the problem is not understood until a solution is developed, or, “since there is no definitive problem,” there can be no “definitive solution.”

Despite a lack of accurate data of the scale of IFFs, the sizeable estimates which advocacy groups came up with on potential losses that sub-Saharan African countries incur as a result of IFFs, raised the issue as an important policy imperative for many countries to address. Consequently, the importance of measuring a country’s or administration’s success in mitigating IFFs, requires some tangible evidence. To obtain such evidence, one needs to focus on the underlying drivers of IFFs, in order to better understand the scale, challenges and mitigating actions to determine how a country is performing in addressing IFFs.

The main underlying drivers of IFFs identified are corruption, money laundering and tax evasion, if a narrow definitional approach is followed. Under a wide definitional approach, abusive transfer pricing (a form of tax avoidance) can be included. For tax administrations, their performance (as a measure of collections against the tax or compliance gap) is an essential determinant as to where resources should be directed. In the same vein, a measure of the magnitude of money laundering is required to determine the overall effectiveness of the AML regime and to determine whether any reduction of money laundering has taken place in targeted areas. Anti-corruption success is dependent on the levels of accountability, integrity and transparency within government institutions, which in turn is reflected in how well legal and policy frameworks are implemented and in how effectively high profile prosecutions are conducted.

The second objective of this study was to determine how IFFs manifest in the extractives, with specific reference to the diamond value chain. In this regard, it is shown that the diamond value chain is vulnerable to IFFs throughout its six major phases, and to a variety of risks. These risks impact on, *inter alia*, the levels of FDI and infrastructure development, administration and governance, controls and enforcement, as well as tax administration and tax policy. The high-level value chain illustrations below show the types of risks corresponding with each of the steps associated with the extraction, production and sale of the commodity. In addition, each step has implications for industry and government – as indicated in Figures 3 and 4 below:

Figure 13.1: Diamond Value Chain

VALUE CHAIN	IMPACT	RISKS
PRE-DEVELOPMENT	• FDI Policies • Infra-structure • Tax Regime: capture recourse rent realized by exploration of diamonds. Maximise the rents to the benefit of the country whilst keeping incentives to invest	Corruption; lack of transparency **Industry:** Beneficiation requirements; volatile market conditions **Government:**
DEVELOPMENT & EXTRACTION	• Tax regime (selection of mining taxes) • Tax administration	**Government:** Dutch disease; avoidance strategies and transfer pricing; cross border structuring (location in tax havens) base erosion and profit shifting; tax arbitrage **Industry:** Foreign exchange controls; depletion allowances; increases/decreases in cut off grade
ROUGH DIAMOND SALES	• Mining administration (official recording of transactions and property rights to assist in tax collections and to prevent fraud) • Customs control • Financial institutions (first line of defence; due diligence)	**Government and Industry:** Non-adherence to KP Incomplete or non-transparent public record of rights held Sales by means of long-term contracts and auctions Smuggling & ML: the diamond trade is linked to predicate offences trafficking illegal weapons trade, tax and ML offences

Phase 1: Diamond Value Chain from Pre-development to Sales

Source: Author compilation

Figure 13.2: Diamond Value Chain (2)

VALUE CHAIN	IMPACT	RISKS
CUTTING AND POLISHING	• FDI Policies (beneficiation requirements) • Infra-structure • Socio-political environment • Tax Regime: capture recourse rent realized by exploration of diamonds. Maximise the rents to the benefit of the country whilst keeping incentives to invest	Corruption; lack of transparency Taxation choice undermines state building and governance (e.g. exemption) **Industry:** Rising mining and exploration costs; governments of the countries where many of their mines are located are stepping up beneficiation requirements; volatile market conditions **Government:** Uncertainty on how to tax resource base in conditions of uncertainty
POLISHED DIAMOND SALES	• Financial sector (The trade in diamonds is transnational and complex. Significant amount of business is transacted through financial institution) • Tax & Customs regime (valuations) • Law enforcement, FIUs, tax administration and customs	**Government:** Avoidance strategies and transfer pricing; Cross border structuring (location in tax havens) base erosion and profit shifting; tax arbitrage. AML: convenient for ML/TF transactions; difficulties for national law enforcement to conduct investigations and necessitates internation cooperation between law enforcement agencies across countries in which the trade is taking place. Smuggling & ML: the diamond trade is linked to predicate offences trafficking illegal weapons trade, tax and ML offences. **Industry:** Foreign exchange controls; compliance burden under AML regulations.
JEWELLERY MANUFACTURING & SALES	• Structurally, organisationally and operationally the jewellery sector is quite distinct from the diamond sector. The jewellery sector also deals in gold, other precious stones, silver, platinum and a range of raw materials. The financing and capital structure are also entirely different. • Customs control • Financial institutions (first line of defence; due diligence)	**Government and Industry:** Non-adherence to KP Incomplete or non-transparent public record of rights held Sales by means of long-term contracts and auctions Smuggling

Phase 2: Diamond Value Chain from Cutting and Polishing to Jewellery Manufacturing and Sales

Source: Author compilation

Faced with these challenges, a proper risk management framework is required which allows responsible government agencies to identify how, by whom and with which resources the risks in the value chain will be addressed. Risk management is a formal process by which government can assess a variety of risks faced and, based on its risk appetite, its agencies can be mobilised on a common line sight[1407] and through shared resources. The risk management process has the necessary components to allow for an understanding of risk posed by IFFs, and it provides mechanisms to manage and mitigate those risks. Risk management is a strategy enabler, and it can serve as a valuable tool to underpin a whole of government approach as a strategy to address and reduce IFFs.

In addressing the underlying components of IFFs, those agencies which implement strategies to address IFFs within their area of responsibility, often encounter tensions or even contradictions between their objectives and those of other responsible agencies. There is a need for a common shared strategy, and mutually supporting objectives amongst all departments responsible to address the underlying drivers of IFFs. This requires that action strategies and the rationale thereof, are visible to all. Tables 13.1 to 13.8 illustrate how such strategies can be formulated into actions.

Table 13.1: Action Strategies to Address IFFs: Corruption

RISK AREAS AND REMEDIAL ACTIONS ("HOW TO ACTION STRATEGIES")			
	ILLICIT FINANCIAL FLOW SUB-AREA	**POTENTIAL ACTIONS**	**RATIONALE**
1.	Corruption	1.1 Determine the extent to which the legislative framework is consolidated; Ascension to Protocols against Corruption as well as the United Nations Convention against Corruption; 1.2 Determine institutional capacity to prevent and combat corruption; 1.3 Determine level of access to report wrongdoing; 1.4 Determine level of protection of whistle-blowers and witnesses;	1.1 Within the extractive sector, revenue losses at the expense of society are most often due to corrupt acts within all parts of the extractive value chain. Proceeds of corruption are then hidden through money laundering and tax evasion. 1.2 Bribes result in capital outflows to tax havens which are useful for hiding embezzled payments or to syphon off revenue intended for the fiscus.

[1407] I use the term "common line sight" because cooperation goes further than having shared objectives – there should also be a shared view on how those objectives are to be achieved, in other words, an inter-departmental alignment of both goals and objectives in furtherance of a commonly understood strategic imperative, is required.

RISK AREAS AND REMEDIAL ACTIONS ("HOW TO ACTION STRATEGIES")			
	ILLICIT FINANCIAL FLOW SUB-AREA	**POTENTIAL ACTIONS**	**RATIONALE**
		1.5 Determine whether prohibitions exist to exclude corrupt individuals and businesses from transacting (blacklisting); 1.6 Determine quality of management policies and practices; 1.7 Determine level of awareness, training and education; 1.8 Determine effectiveness of Sectoral Coordinating Structures (broadly classified as Public Sector, Civil Society and Business).	1.3 Guarantees of anonymity promote reporting; 1.4. Level of protection promotes reporting; 1.5 Addressing corruption requires strong sanctions. 1.6 Promotes integrity of system. 1.7 Supports transparency in governance and promotes reporting of suspicious activity reporting. 1.8 See 1.7 above.

In articulating the underlying issues to IFFs, UNECA concludes that an estimated 5 per cent of IFFs are driven by corruption with the proviso that the figure could be much higher because corruption is cross-cutting. In assessing corruption risk in the diamond value chain, it is evident that no matter how well institutions are functioning, their objectives will be undermined by any act of corruption. It can therefore be argued that because of the cross-cutting nature of corruption, it is potentially the greatest contributor to IFFs. Anti-corruption initiatives should therefore be the first to be prioritized in a concerted effort to mitigate IFFs.

Table 13.2 Action Strategies to Address IFFs: Money Laundering

	ILLICIT FINANCIAL FLOW SUB-AREA	**POTENTIAL ACTIONS**	**RATIONALE**
2.	Money laundering	2.1 Determine country compliance to FATF 40 +9 Recommendations; 2.2 Determine position regarding treatment of beneficial ownership; 2.3 Determine position regarding PEPs;	2.1 Global standard to align AML regimes, are aimed at protection of the integrity of the financial system by giving government powerful instruments to take action against all types of financial crimes.[1409] 2.2 Corporate vehicles are used as

[1409] FATF (2012).

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
		2.4 Determine extent of ML prosecution; 2.5 Determine nature of predicate crimes; 2.6 Determine quality and volume of reporting between local FIU and Tax Administration; 2.7 Assess presence of risk indicators.[1408]	a means to hide/conceal ownership and "to provide a veneer of legitimacy for illicit activities."[1410] Several features of corporate vehicles make them ideal for separating the origin of funds from the real beneficial owner. Benefits from signing up to Global Forum and implementing 5 stepped approach. 2.3 See 1.1. and 1.2 above. 2.5 AML is a major element in the standard list of interventions available to countries with the potential to reduce IFFs both into and out of developing countries. AML interventions are also powerful tools to address other elements of IFFs such as corruption and tax evasion (which are predicate crimes). However, this potential is largely dependent on the implementation of the relevant FATF Recommendations.

Money laundering is a component of a larger wicked problem of IFFs, and an immediate solution can be framed as follows: if the necessary capacity is in place and the number of successful AML prosecutions increases dramatically, then a component of illicit financial flows can be resolved. We know, however, that "every wicked problem is a symptom of another problem." Money laundering has numerous underlying predicate offences which need to be established before a charge of money laundering can be pursued – thus the removal of the predicate offence (e.g. tax evasion or corruption) may provide a better long-term solution. In turn, the latter could be considered the symptom of still another higher-level problem, for instance tax evasion and corruption can be viewed as outcomes of a weak compliance culture.

[1408] *Supra:* 9.3.2.1 Money Laundering Risk in the Diamond Value Chain.
[1410] OECD (2014) 38.

Table 13.3 Action Strategies to Address IFFs: Harmful Tax Avoidance Practices

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
3.	Harmful Tax Avoidance	3.1 Determine MNE activity; 3.1.1 Identify high net worth (HNW) individuals; 3.2 Determine if legislation contains up to date anti-avoidance and TP legislation; Explore the assigning of the burden of proof in transfer pricing cases to the taxpayer instead of the tax administration; 3.3 Determine scope, nature and number of treaties; 3.3.1 Determine treaty partners; 3.4 Determine if Exchange of Information agreements are in place; 3.5 Determine state of IIAs- particularly with respect to the extent that public interest rights of the host country are protected; 3.6 Assess presence of risk indicators.[1411]	3.1 Corporate structuring can entail securing tax-based advantages. Where this is done through jurisdictions that do not warrant business justification, profits may be moved illicitly. 3.3.1 Economic rationale needs to exist for selection of trade partner. 3.4 Benefits of signing up to Global Forum and implementing 5-step approach allow for pro-active approach in identifying avoidance. 3.5 Sovereign countries may constrain their fiscal sovereignty through bilateral treaties that limit their tax jurisdiction in return for corresponding limitations undertaken by a treaty partner; "The role of investment in building the corporate structures that enable tax avoidance is fundamental. Therefore, investment policy should form an integral part of any solution to tax avoidance."[1412]

Coherent international tax and investment policies which protect the government revenue base whilst promoting investment are essential to mitigate harmful tax avoidance practices. In the context of the global rough diamond trade, transfer pricing can be linked to both over and under valuation. Risk mitigation should start with review of the level of mining activity and the extent to which it is driven by MNEs, whether risk indicators are present, whether legislation contains anti-avoidance provisions and whether an appropriate treaty network is in place.

Table 13.4 Action Strategies to Address IFFs: Tax Evasion

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
4.	Tax Evasion	4.1 Implement compliance model & conduct compliance risk management assessment;	4.1 A tax administration forms part of the broader society wherein citizens, businesses, organisations

[1411] *Supra*: 9.3.2.3 Tax and Customs Risks relevant to the diamond value chain.
[1412] UNCTAD (2015).

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
		4.2 Determine whether taxpayer education and service programmes are in place/working; 4.3 Determine level of administrative and compliance costs; 4.4 Determine the degree of detection and prosecution of tax violators; 4.5 Assess quality of data holdings, data availability and data quality; 4.6 Determine level and quality of information sharing between government agencies; 4.7 Determine robustness of compliance risk management function/establish function if not in place; 4.8 Assess presence of risk indicators.[1413]	and public bodies react to each other's actions. Certain actions on the part of a tax administration lead to a reaction from the taxpayer and vice versa. In order to influence taxpayer behaviour a tax administration needs to be aware of its own behaviour but also of behaviour within society. It is important too to know what causes non-compliant behaviour by citizens and businesses.[1414] 4.2; 4.3: This understanding is created through a compliance risk management approach "that is a systematic process through which a tax administration makes deliberate choices on the available treatment instruments which could be used to effectively stimulate compliance and prevent non-compliance, based on the knowledge of all taxpayers (behaviour) and related to the available capacity of the revenue authority."[1415] 4.4 Use of third party data is useful to verify risks; institutional knowledge should be available to authorities to make monitoring of compliance levels possible. Benefits of signing up to Global Forum and implementing 5-step approach allow for pro-active approach in identifying evasion. 4.5 EoI and AEOI can provide valuable information together with implementation of beneficial ownership provisions to uncover hidden wealth.
4.1.	Informal/cash economy	4.1.1 Conduct compliance risk management assessment; 4.2.1 Prioritize high risk segments/sectors;	From a tax perspective, the inability to effectively tax the cash economy raises aspects such as the fairness of the tax system and the risk of reduced public goods available to

[1413] *Supra*: 9.3.2.3 Tax and Customs Risks relevant to the diamond value chain.
[1414] EU (2010) 5.
[1415] EU (2010) 5.

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
		4.2.3 Determine appropriate compliance strategy per segment/taxpayer type.	society. Per Braithwaite *et al* "the concern that governments express over the cash economy is based not so much on the fact that it exists, but on the percentage of Gross Domestic Product (GDP) it represents. If the cash economy increases substantially as a percentage of official GDP, governments are likely to see an erosion of their tax base, and a reduction in the revenue that they can expect to collect."[1416] 4.1 Policy responses will differ and depending on sector, activity and entities involved therein. 4.2; 4.3 The type of non-compliance involved (i.e. level of seriousness) and the type of treatment warranted. In this regard, cognisance must be taken of the fact that in some developing countries the weakness of legal institutions causes growth of the cash economy.

"Bad governance manifests itself through an unjust tax system and rampant tax evasion," where the latter then becomes or remains a trigger for or indicator of political instability.[1417] Tax evasion, corruption and criminality as the main drivers of illicit capital flows, are at the same time "both causes and effects of the fragility of state institutions" and in this sense, are challenges to state legitimacy.[1418] Everest-Phillips contends that "tax evasion undermines the funding of the state and therefore the legitimacy associated with the state through the delivery of public services," whilst "corruption weakens the moral legitimacy of the state and criminality challenges the legitimacy of state authority."[1419] As shown in Chapter 8, the different regulatory frameworks aimed at fighting corruption, evasion and money laundering are complementary and provide diverse options to enforcement agencies.[1420]

1416 (2017) 93-94.
1417 Everest-Phillips (2012) 70.
1418 Everest-Phillips (2012) 72.
1419 (2012) 72.
1420 *Supra* 8.7.

Informality hampers tax collections, but its consequences do not end there – informality has costs to the economy and society which go beyond the loss of tax revenue, for example, businesses that operate in the informal economy mostly do so on a small scale, which minimizes the risk of detection, but it also means that productivity gains are sacrificed and access to productive resources (e.g. credit and technology) is limited.

Some good practices have emerged in the diamond industry to enhance conditions in the informal sector and increase the productivity of operators. An example thereof occurs in Botswana where the forward linkages in raw diamond production created 21 businesses in cutting and polishing stones with about 3,000 new jobs.

Table 13.5 Action Strategies to Address IFFs: Illicit Trade/Organised Crime

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
5.	Illicit trade/organised crime	5.1 Conduct customs risk assessment; 5.1.1 Create risk profiles; 5.1.2 Determine areas for coordinated action (domestic and international) these could relate to smuggling trends, money flows, etc.; 5.2 Improve/build capacity in valuation.	Illicit trade involves money, goods or value gained from illegal and otherwise unethical activity, and encompasses a number of illegal trading activities, including environmental crime, human trafficking, illegal trade in natural resources, intellectual property infringements, trade in substances that cause health or safety risks, smuggling of excisable goods, drug trafficking, and a variety of illicit financial flows. These activities are damaging to the economic, social, environmental and political landscape and contribute to IFFs.

Illicit trade is mainly fuelled by organised criminal activity in all types of commodities across international borders and it remains a threat to the security and economic development of all countries. Those involved in criminal activities seek to remove the taint of crime from the proceeds thereof, thus they will seek to integrate such into the formal economy through money laundering activity. It is therefore important for governments to have proper customs controls in place to uncover smuggling and false declarations, as well as money laundering schemes in the trade area. To this end, inter-agency cooperation should be fundamental in all initiatives aimed at addressing illicit trade. Examples thereof are provided in this study.[1421] In addition, international

[1421] *Supra* 10.3.

cooperation in the form of mutual assistance agreements and the exchange of financial account information in pursuit of AML and tax investigations objectives, provide a platform to address illicit trade across multiple jurisdictions.

Table 13.6 Action Strategies to Address IFFs: Trade Mispricing

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
6	Trade Mispricing	6.1 Determine quality of statistical data; 6.2 Determine level of fraudulent transactions; 6.3 Determine level of unreported trade; 6.4 Misreported trade – use of fraudulent documents.	6.1 Probability of data captured incorrectly or not at all by the relevant administration may result in commodities not being accounted for. 6.2 Hiding transactions in under-reported trade or in mispriced invoices may be indicative of tax evasion, ML and profit shifting. 6.3 Unreported trade activities typically refer to smuggling of commodities that can affect asymmetries in partner country trade statistics because the transactions have to be recorded by one of the partners. 6.4 Includes capital flight (e.g. if exchange restrictions are in place, over invoicing of imports and under invoicing of exports are popular methods for the unrecorded movement of capital out of the country); underreporting of exports (allows companies to acquire foreign exchange that is not disclosed to national authorities which can be used by exporters without complying with controls and regulations) and hiding output and exports (authorities may use information on the export activities of companies to infer the production output of such companies).

Trade mispricing is the practice wherein export or import documents carry false prices, which may be important both as a source of tax evasion and as a channel for movement of illicit funds. To address trade mispricing, aggregate data (indicative of trade mispricing) needs to be interrogated on a micro level, in order to determine whether discrepancies are due to statistical reasons, fraud, or under or misreported trade. This is an area which is abused for purposes of tax evasion and avoidance, criminal activity, money laundering and violation of exchange controls. It is also here where some of the biggest risks to the diamond value chain occur, for example smuggling, profit shifting, undermining of regulatory controls through the issuing of false KP certificates, as well as tax evasion.

Table 13.7 Action Strategies to Address IFFs: Investment Policy

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
7.	Investment Policy	Synchronize IIA reform actions at all levels (national, bilateral, regional and multi-lateral). Include reform actions steps (e.g. take stock of IIA and underlying economic reasons; identify problem areas in IIAs; develop strategic approach toward reform and list remedial actions and desired outcomes.	Safeguarding the “right to regulate in the public interest” to ensure that IIAs' limits on the sovereignty of States do not unduly constrain public policymaking Because investment plays a fundamental role in establishing the corporate structures that enable tax avoidance, “investment policy should form an integral part of any solution to tax avoidance.”[1422]

UN Resolution 1803 stresses that nations have permanent sovereignty over natural resources and this right must be exercised responsibly to the benefit of all people of the nation.[1423] The reality for Africa is that the tax base in several African mining jurisdictions has been eroded through often badly designed dispensations to attract FDI. A vast amount in revenue generated mainly through extractive industries, leaves the continent or is harnessed to serve the elite. Investment policy, tax policy and anti-corruption policy therefore require close coordination, in order to ensure that taxing rights are not signed away. As shown in this study, many FDI structures involve more than two countries with the tax objectives of such structuring, in order to extract income from the original host country at the least possible costs, to avoid or mitigate tax on that income in the home country and to pay little or no tax on the income in the intermediate country.

Table 13.8 Action Strategies to Address IFFs: Improved Governance

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
8.	Governance	8.1 Implement anti-corruption measures; 8.2 Mandatory rotation of audit firms;	8.1.1 Poor governance leads to ineffective institutions. 8.1.2 The oversight role of audit firms is diminished when they are reappointed over long terms.

[1422] UNCTAD (2015).
[1423] United Nations Resolution 1803 of 1962.

	ILLICIT FINANCIAL FLOW SUB-AREA	POTENTIAL ACTIONS	RATIONALE
		8.3 Improve tax administration; 8.4 Tax policy should drive economic growth.	8.1.3 By improving the tax administration a ripple effect can be created through improvement in connected entities such as business registries, property registries and agencies responsible for promotion of FDI. 8.4.1 Where governments depend on taxes, it serves as a strong incentive to promote growth and the reliance on taxes serves as an incentive to improve governance so that tax compliance levels become/remain high.

Throughout this study reference is made to the need for good governance. The best designed public investments cannot fill urgent infrastructure gaps, or improve the overall business climate, or act as catalyst for increased private investment in the face of poor governance. Poor governance leads to ineffective institutions, unjust tax systems and rampant tax evasion. Good governance is a measure to prevent and combat corruption, and good governance, together with aspects such as information sharing and cooperation on tax and financial crime matters, contributes toward ensuring that globalisation brings about equal benefits to countries.

The above listed action strategies are generic and apply to all the selected countries. There are also very specific tax policy actions that countries can take to address IFFs in the diamond value chain as reflected in the table below:

Table 13.9 Country Specific Tax Policy Action Strategies to Address IFFs in the Diamond Value Chain

	ACTION STRATEGY	COUNTRY
1.	Enhance fit and proper tests for entrants to economically strategic sectors such as the diamond industry. Complement with compliance risk management practice.	All.
2.	Improve transparency through joining initiatives such as EITI	Botswana, Namibia, South Africa
3.	Introduce transfer pricing regulations in the Income Tax Act.	Sierra Leone, Liberia, Namibia
4.	Establish a dedicated transfer pricing unit	Sierra Leone
5.	Review excessive incentives in the mining sector, e.g. deduction of expenditure	Liberia, Sierra Leone

	ACTION STRATEGY	COUNTRY
6.	Introduce rules to make it mandatory to draft and file transfer pricing documentation	Namibia
7.	Integrate artisanal diamond sector into the rest of the economy	Ghana, Liberia, Sierra Leone, Zimbabwe
8.	Improve beneficial ownership data and exchange of information to identify tax evasion and avoidance	All.

13.2 Policy Recommendations

Broad consensus exists that IFFs are ill defined, and that in turn implies that different policy handles may be available to address the problem. Tax policy is a key component to addressing IFFs: aside from its revenue mobilization properties, it is an important tool for good governance, democracy and the basis for the social fiscal contract between governments and their citizens and corporations. However, IFFs, inclusive of related tax crimes, money laundering and other financial crimes such as bribery and corruption, threaten the strategic, political and economic interests of both developed and developing countries. Such activities erode confidence in government and negatively affect tax compliance, which ultimately deprives countries of revenue required to implement legitimate government policies.

Developing countries are pressed to spend more on public services and infrastructure if they want their economies to grow and to achieve the Sustainable Development Goals (SDG). As such, they need to increase their tax effort by increasing tax revenue as a percentage of GDP. The OECD points out that a significant share of the tax revenue increase in Africa stems from natural resource taxes, while non-resource-related revenue has increased by less than one per cent of GDP over 25 years.[1424] In this context, IFFs constitute a good focus for policy. It is a subject that resonates well with heads of state in Africa, especially after the issuance of the UNECA Report. It also has the attention of international institutions such as the World Bank, the IMF, the OECD and the FATF. In addition, various non-governmental organisations are actively sponsoring work in this area. IFFs have also featured prominently on the G20 agenda, together with initiatives to address tax evasion and aggressive tax avoidance. This creates an ideal platform for countries and their government agencies to seize the initiative to get agencies to “start thinking about aligning different objectives to outcomes supporting SGDs or national interest.”[1425]

IFFs as a policy focus also provide the benefit that the developed world can play a direct role in assisting developing countries on the African continent and elsewhere, due to the cross-cutting properties of IFFs. Although there is a role to play for governments of developed countries which

[1424]OECD (2009).
[1425] Reuter (2012).

serve as domicile for many of the recipient banks of IFFs –such as implementing legislation that pushes financial institutions to ensure that they are not taking in illicit flows, the underlying causes of IFFs remain domestic and action strategies must be identified and implemented amongst relevant agencies.

By looking at the issues through the lens of wicked problems, various causal factors were identified in this study, and it is evident that no single solution, no singular agency, nor any country by itself, can sufficiently address the multi-faceted nature and scope of IFFs. Consequently, the action strategies listed in this study,[1426] require two additional dimensions. These are (a) "observing the wickedness of problems" and (b) "enabling the conditions"[1427] of the governance system in which different government agencies operate to deal with IFFs. Tax policy drafters are to a degree both action strategists and observers of wicked problems, as they need to continuously identify enabling conditions which may or may not assist in achieving planned policy outcomes. As Fjeldstad and Moore point out, "tax reform can be seen as a continuous stream of small technical modifications to law and procedure which are a reflection of specific national circumstances, the interests of diverse lobbyist groups, and the continual efforts of public finance specialists to reconcile the competing objectives of governments' fiscal activities."[1428] However, tax policy outcomes can be limited by the same factors mentioned above, as well as by an inability to recognize overlaps in tax policy objectives with those of other government departments. This is so because strategies for solving wicked problems are informed by the way in which one views them, and in this regard, people tend to ignore those aspects of problems which fall outside their scope or, for which they might not have an action repertoire. For these reasons, a whole of government approach is required to ensure that all aspects of the problem are identified, considered and addressed by the appropriate authority/authorities.

The reasons for a whole of government approach are driven by both internal and external factors.[1429] Due to these factors, the whole of government approach can be seen as an efficiency measure to address budgetary and resource pressures. Any collaboration will, however, require a lead agency, as well as an overriding policy direction that is best positioned to address some of the underlying causes of IFFs. If the tax agency, for example, plays a leading role, there are various risks – as illustrated through the diamond value chain - which, if not addressed, will negate or skew the objectives of the tax regime. For example:

[1426] *Supra;* Tables 13.1-13.7.
[1427] Termeer *et al* (2012) 1-5.
[1428] Fjeldstad & Moore (2008) 235-237.
[1429] For example, the strength of internal controls, capacity considerations (internal) and globalization and increased threats of terrorism (external).

- Corrupt politicians may approve contracts that allow for unreasonable exemptions, thus affecting the taxation of profits;
- The environment may be uncontrolled to the extent that smuggling of the commodity deprives the state of revenue;
- The collection of taxes may resort under different ministries where the collected revenue does not find its way to the treasury;[1430] and
- Weak institutions can furthermore fail to detect outflows which escape taxation - either through tax evasion or avoidance strategies.

The concept IFFs has elevated the importance of taxation in the state building debate, as is evidenced by African countries' increased interest to improve domestic laws (e.g. by putting in place transfer pricing legislation) and also by signing of tax information agreements and multi-lateral treaties.[1431]

13.3 Summary of contributions of the study

This study makes several contributions. In Chapter 2 the definitional challenges surrounding IFFs are outlined, and it is proposed that a wide definition and interpretation – similar to that of the concept "organised transnational criminal activity" – is adopted in the IFF discourse. This approach is informed by the finding that IFFs is an outcome of various actions which can have either an illegal basis or an immoral basis. The actions resulting in outflows can have several causes. For instance, badly designed IIAs will create opportunities for aggressive tax avoidance, whilst poor governance will lead to ineffective institutions.

For sub-Saharan Africa to achieve the Sustainable Development Goals,[1432] it requires that countries are able to identify internal enablers and constraints and the levels of inter-connectedness which exist on a regional and international basis. IFFs is a phenomenon that diminishes the potential of countries and regions to achieve the SDGs, because the underlying causes of IFFs wreak havoc on a country's institutional ability to identify or neutralise the risks posed to its institutions and, ultimately, its ability to govern. This study proposes a whole of

[1430] In Zimbabwe, for example, the collection of revenue in the diamond fields are controlled by the minerals department. Production in the Marange fields started in 2006, and estimates of its potential ranged from 25 to 36 million carats per year, with total gross revenue of USD 1-2 billion, which could be sustained for 14 years. However, the 2013 national budget for Zimbabwe shows that Treasury only received USD 41 million from diamond mining in 2012.
[1431] Botswana has exchange of information relationships with 26 jurisdictions through 18 DTCs and 8 TIEAs; Ghana has exchange of information relationships with 18 jurisdictions through 17 DTCs and 1 TIEAs; South Africa has exchange of information relationships with 101 jurisdictions through 83 DTCs and 20 TIEAs. Sierra Leone joined the Global Forum in 2009 and has signed 15 TIEAs.
[1432] On September 25th 2015, countries adopted a set of goals to end poverty, protect the planet, and ensure prosperity for all as part of a new sustainable development agenda. Each goal has specific targets to be achieved over the next 15 years (UN).

government approach underpinned by sound risk management practices as strategy and enabler, in order to identify and mitigate the impact of IFFs. The basis for this proposal is that IFFs meet the criteria of wicked problems as set by Rittel and Webber, and that the concept “IFFs” qualifies as a newly identified wicked problem. By identifying some of the prominent inter-connected subsets of problems which cut across multiple policy domains and levels of government, I propose that the best framed solution to the problem of IFFs lies in taking a collaborative approach on the components of IFFs identified. The most appropriate collaborative approach identified is the whole of government approach and is supported by the findings herein, which culminate into guidelines for government agencies to identify and address cross functional policy and operational areas.

13.4 Future research

This study highlights a number of areas for further research. First, aggregate data estimates dominate the IFF discourse, and areas such as trade mispricing and transfer pricing are singled out as the main sources of IFFs. However, to better inform policy and action strategies to address IFFs, research on a micro level (dealing with specific trade and customs transactional data) aimed at identifying and understanding trade anomalies, is required. Such research will allow government agencies to respond to specific risks in a meaningful manner and through the optimal deployment of resources. Second, tax administrations are reliant on quality information to assess risks and to conduct audits, which promote compliance and which yield revenue. In this regard data of ownership, of assets and of wealth is key and the implementation of beneficial ownership requirements in sub-Saharan African countries should be closely followed to determine how its effective implementation can address revenue leakage in the diamond value chain. After all, from the Panama Papers it is known that some 200 000 transactions are related to the diamond industry.

Third, there are a variety of approaches in the economics fields which can possibly be helpful to address IFFs as a wicked problem. Addressing wicked problems in a policy context requires approaches based on disciplines such as ecological economics, complexity economics and sustainability science. Applied economics can play a role in addressing wicked problems such as IFFs, because it is a wicked problem of high consequence to society.

An area which is evolving quite rapidly is that of digital technologies. Two perspectives are relevant thereto. The first relates to data disclosures and the potential impact thereof on taxpayer rights (for example, through the implementation of beneficial ownership and Common Reporting Standard registers) ; the second relates to the role of digital technologies in facilitating IFFs and how the impact of such transactions, especially in the financial services area, can be offset by mechanisms such as a Tobin tax.

Lastly, studies with an in-depth focus on country experience in applying a whole of government approach to address IFFs or elements thereof, would be beneficial to the African region in several ways. This can include primary data collection to assess how individual countries are positioned to respond to various components of IFFs such as transfer pricing, trade mispricing, corruption, money laundering and customs fraud. Such data can also contribute toward developing standard risk management methodologies to support information exchange and cooperation in cross border enforcement actions, or to set common policy objectives supportive of improving governance in general or in specific areas such as the value chains of specific commodities. It can also include the use of technological developments that make closer collaboration through information technology infrastructure possible.

ANNEXURE A
DIAMOND MINING: COUNTRY OVERVIEW

1. Botswana

Botswana is the host to the world's largest, most profitable and longest life kimberlite diamonds.[1433] With sound macro-economic policies and prudent use of diamond revenues, Botswana became one of the fastest growing economies over a 25-year period. Mining represents ninety per cent of the country's total export earnings, accounts for fifty per cent of government revenue and close to one third of Botswana's GDP. Botswana is a good example of successful government policy implementation ensuring localised beneficiation. It also underscores the argument that economic development and political stability are primary conditions for natural resource extraction.[1434] Since 2011, the country became the world's largest sorting and distribution centre of rough diamonds and a major diamond and diamond jewelry manufacturing centre employing some three thousand workers.

Botswana's success is ascribed to factors such as limited colonial influence, good laws, working government institutions, visionary leadership[1435] and prudent economic policy.[1436] Also added to these characteristics is the "elite's positive motivation" and the perception of the country as being the least corrupt in Africa.[1437] Diamond wealth has not resulted in a resource curse, as the country already had strong institutions and governance structures in place and, unlike in many other African countries, diamonds have enabled the maintenance of a stable, democratic and peaceful environment.

A private-public sector agreement (creating Debswana) between De Beers and the government of Botswana, is a hallmark of successful diamond mining in Botswana. In addition, the diamond sorting business of De Beers was migrated from London to Botswana, the government gets access to sell 10 per cent of Debswana's production independently, the first state diamond trading company, the Okavango Diamond Trading Company, was formed and the De Beers Global

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[1433] Even-Zohar (2007) 233.

[1434] According to published Census Bureau statistics, rough diamond imports for 2013 from South Africa were USD 80 million. Re-exports from the United States in 2013 totalled USD315.9 million. Of these USD 28.7 million were re-exported to South Africa. The latter makes a strong case for SA to follow the Botswana example in terms of downstream beneficiation.

[1435] The BDP Election Manifesto of 1965 made it clear that "…leaving mineral rights vested in tribal authorities and private companies must necessarily result in uneven growth of the country's economy, as well as deprive the Central Government of an important source of revenue for developing the country. …It will be the policy of the BDP Government to negotiate with all parties concerning the takeover of the country's mineral rights by the Central Government, and subsequently expand the present mining operations and step up prospecting activities throughout the territory."

[1436] CNRG (2013) 4.

[1437] Even-Zohar (2007) 252.

Sightholder Sales was formed to aggregate global De Beers diamond production in Botswana for the first time.1438

1.1 Taxation

Taxable income from mining operations is determined in accordance with special rules contained in the main provisions and the Twelfth Schedule of the Income Tax Act,[1439] whereas companies engaged in diamond mining are taxed in accordance with the terms of agreements negotiated between the government and the company concerned. The annual tax rate imposed on mining profits (other than profits from diamond mining) is determined according to a specified formula, but may in no case be less than the current rate of 22 per cent applicable to companies. The maximum rate is 55 per cent. Royalties are charged at 10 per cent of turnover. Currently Botswana does not have a transfer pricing regime. The tax authority (Botswana Unified Revenue Service) conducts transfer pricing audits under the general anti-avoidance provisions of the Income Tax Act. The Ministry is considering proposals from the Taxation Review Committee which include: introduction of Transfer Pricing rules in the Income Tax Act that would curb any undesirable tax avoidance as well as underscore the alignment of this country's tax system to international best practice.[1440]

2. Ghana

The mineral sector is a significant contributor to Ghana's economy, through an average of 43 per cent contribution in total export earnings, a 37 per cent contribution to corporate tax earnings, and investment flows of USD 1 billion.[1441] Ghana is amongst the world's top ten producers of gold and amongst the world's twenty leading producers of diamonds, by volume.[1442] In 2014 the mineral sector accounted for 16.06 per cent of revenue receipts.[1443]

In the past, the majority of Ghana's diamond production came from small-scale and artisanal miners who operated in the Bonsa River valley and the Birim River valley. Diamond production was mainly from secondary deposits and there were no known diamondiferous kimberlites in the country.[1444] From a development perspective, artisanal small scale mining (ASM) in Ghana is

[1438] Debswana (not dated).
[1439] Chapter 52:01 Section 31.
[1440] Matambo O.K. (2017) Budget Speech. Available at: http://www.gov.bw/contentassets/95fd057dbf2b4f54801841329125487b/2017-budget-speech_final_-3february_2017.pdf
[1441] Bermúdez-Lugo (2016) 20.1.
[1442] Bermúdez-Lugo (2016) 20.1.
[1443] GEITI (2015) 1.
[1444] Bermúdez-Lugo (2016) 20.1

viewed as a largely informal and unstructured economic sector with many complexities (and elsewhere in Africa). ASM gold and diamond exports In 2014, diamond and gold exports from this sector amounted to approximately USD 2 billion and its total contribution to exports stood at 14.7 per cent.[1445] ASM is regulated through Sections 81 to 99 of the Minerals and Mining Act and its accompanying regulations.[1446] GEITI estimates that 30,000 people are employed "within the legalized segment of the Ghanaian small-scale mining sector."[1447] In 2011 production reached 301 937 carats and planned investments for the industry were estimated at USD 100 million, with annual production of 1 million carats per annum.[1448] However, by 2016, production was limited to 141,530 carats.[1449]

The Ministry of Lands and Natural Resources (MLNR) - through its Geological Survey Department (GSD)[1450] - together with the Minerals Commission (which sets policy on use and regulation) and the Precious Minerals Marketing Co. Ltd. (PMMC), oversees all matters pertaining to the mineral sector. An inspectorate division enforces health and safety and environmental regulations.[1451]

The government has a 10 per cent shareholding in nine large scale mines, 20 per cent in one and 0 per cent in another four.[1452] The Minerals and Mining General Regulation 2012, LI 2173, effective since 2012, requires extractive companies to provide localization plans to the Minerals Commission that detail how they intend to grow employment of Ghanaian personnel.[1453] The Ghana Extractive Industries Transparency Initiative (GHEITI) Bill was expected to have been laid before Parliament in 2016, in order to institutionalise the GHEITI. Until it is passed as law, collection of data for GHEITI can only be voluntary for stakeholders.[1454]

2.1 Taxation

The Minerals and Mining Act[1455] provides the legislative framework for the mineral sector in Ghana. According to the legislation, "any transaction, contract or undertaking involving the

[1445] GEITI (2015) 31.
[1446] Mineral Right Licenses for small scale operations are granted to Ghanaian nationals only for a limited period and for a limited area not exceeding 25 acres; all small-scale miners are liable for payment of taxes 35% income tax), royalties (5% on gross income) and other local imposts levied by MMDAs and other government agencies. Import duty exemptions for plant and machinery are allowed. Ground rent is payable to the land owner.
[1447] GEITI (2015) 41.
[1448] Bermúdez-Lugo (2016); The Mineral Industry of Ghana. USGS. 20.1.
[1449] Kimberley Process (not dated).
[1450] Responsible for geology data and reports.
[1451] GEITI (2015) 53.
[1452] GEITI (2015) 53.
[1453] GEITI (2015) 29.
[1454] http://www.graphic.com.gh/business/business-news/passage-of-extractive-industries-bill-delays.html (Accessed on 22 June 2016).
[1455] 703 of 2006.

exploitation of minerals or mining leases, requires ratification by Parliament." In 2012 corporate tax rates for mining companies were increased to 35 per cent from 25 per cent, a windfall profits tax of 10 per cent was introduced, a capital allowance rate of 20 per cent (on a straight line basis, from the previous 80 per cent deduction) was introduced, as well as a fixed mineral royalty rate of 5 per cent.[1456] In 2012 a National Renegotiation Team was established to look into mining issues such as the manner in which stability agreements are granted. Royalty/natural resource payment incomes are subject to withholding tax at a rate of 15 per cent, and income from payment for unprocessed precious minerals at a 10 per cent rate.[1457]

In July 2013 the National Fiscal Stabilisation Levy (NFSL) was reinstated for a period of 18 months. This special levy imposes a 5 per cent tax on the profits of certain companies, including those in the mining sector.[1458] In the Budget Speech of 2016, an extension of the National Fiscal Stabilization Levy of 5 per cent and a special import levy of between 1 and 2 per cent for 2017 was announced, as well as an increase in the withholding tax on directors' remuneration from 10 per cent to 20 per cent.[1459]

3. Liberia

All major mines were closed during the 14-year civil war, and the mineral sector's contribution to the economy was negligible. In 2010, Liberia made significant progress in reviving the mining sector, which before 1990 had contributed more than 65 per cent of the country's export earnings and represented approximately 25 per cent of GDP. Government revenue from the extractive sector increased by more than 68 per cent to USD 186 million in the 2012/2013 financial year, and the value of total commodity exports grew by 126 per cent to USD 352 million.[1460] KPCS public statistics on Liberia's rough diamond production reveal a consistent growth pattern in both production and value. In 2014, output rose to 65,822.49 carats (from 44,334 in 2013), with a value of USD 28,175,134.04[1461] and over a four-year period (since 2011), consistent growth of more than 5 per cent in production is shown. The increase in diamond production is attributed to a rise in the number of diamond fields in operation.[1462]

[1456] GEITI (2015:59) indicates that: "For the purposes of computing capital allowances for mining entities, the following are considered as assets: i) Mineral Exploration rights; ii) Building, structures and works of a permanent nature which are likely to be of little or no value when the rights are exhausted or the prospecting, exploration, or development ends; iii) Plant and machinery used in mining operations; (iv) Costs incurred in respect of mineral prospecting, exploration and development (are treated as if they were incurred in securing the acquisition of assets). Mining companies are allowed to carry forward losses arising in any year to the next year for offset against the profit. The loss must however be deducted within five years."
[1457] Bermúdez-Lugo (2016) USGS; EY (2013).
[1458] EY (2013).
[1459] The 2016 Budget Statement and Economic Policy of the Government of Ghana. 21.
[1460] LEITI (2015) 3.
[1461] Kimberley Process (not dated).
[1462] USGS (2014) 26.1.

The mineral sector accounts for roughly 10.8 per cent of GDP and experienced tremendous growth since 2013. In 2013 alone, the sector expanded by 40 per cent, driven largely by increased output in diamond, cement and iron ore production. Export earnings from the mineral sector increased by 125 per cent to USD 351.2 million in 2013, from USD 155.8 million in 2012. Liberia participates in the EITI (boasting compliance with EITI standards since 2009) and is a member of the Kimberley Process Certification Scheme (KPCS).[1463]

Administration of the mineral sector, including the granting of mining licenses, is the responsibility of the Ministry of Lands, Mines and Energy (MLME). The ministry also has statutory oversight over the energy, land, mineral, and water sectors – which can lead to conflict of interest. The mineral sector is regulated by the Mining and Minerals Law of 2000.[1464]

3.1 Taxation

Mining and petroleum companies are taxed at a 30 per cent rate, and a twenty per cent additional surtax is applicable to high-yield mining projects. Import and export of rough diamonds is overseen by the Government Diamond Office (GDO) within the MLME, and by the Bureau of Customs. The fiscal regime specifically for mining companies is set out in the Liberia Revenue Code (LRC), as amended from Section 701 to Section 739. The main taxes paid by a mining company are: tax on taxable income, royalties and surface rent. Under Section 702 (a) the rate of tax on taxable income from a mining project is 30 per cent. Under Section 702 (b) a surtax on income from high-yield projects (as defined under Section 730) is provided for.[1465] Section 703 provides for "valuation at fair market value f.o.b. Liberia without reduction for claims, counterclaims, discounts, commissions, or any other asserted offset or deduction." The fair market value f.o.b. Liberia is determined for the day of shipment.

Royalties are due and payable to the Government of Liberia at the time of each shipment, and in the amount of the stated per cent of the value of commercially shipped minerals, regardless of whether the shipment is a sale or other disposition. The rate for iron ore is 4.5 per cent; for gold and other base metals, three per cent, and five per cent for commercial diamonds.[1466] Certain categories of licences may result in the payment of annual surface rents.

[1463] Bermúdez-Lugo (2014). 26.1.
[1464] LEITI (2015) 30.
[1465] Under Section 730(b) the definition of a high yield project: the project's pre-tax rate of return on total investment is greater than 22.5 per cent.
[1466] Section 704 (a)(1)(2)(3).

Under Section 17, provision is made for stability clauses for mining projects, whereby the Government of Liberia is permitted to accept a clause stabilizing various aspects of taxation to the terms under code provisions for a period not to exceed fifteen years from the effective date of the agreement.[1467]

There is no specific regulation on transfer pricing in the RCL. However, the Minister of Finance has the power to adjust non-arm's length transactions between related parties, to reflect the actual tax payable, had the transactions between them been at arm's length.[1468] If a person who has entered into an APA complies fully with its terms and conditions, the Ministry of Finance will not contest the application of the TPM to the subject matter of the APA. Section 18 (4) provides that:

> "… while an APA request is pending and after an APA is executed, a person who has entered into an APA is under a continuing duty to supplement material facts and information submitted in connection with the person's request for the APA. If, after an APA is executed, the person discovers that information provided in connection with the APA request was false, incorrect, or incomplete in some material respect, the person must disclose the error or omission in its next-filed tax return or other scheduled report (or sooner as specified in the regulations)."

According to GIZ, Liberia is setting up a unit within its tax authority specifically to inspect mining operations. Initial inspections led to payment notices for over USD 10 million in additional taxes and duties.[1469]

4. Namibia

Unlike Botswana and South Africa, the entire Namibian diamond production is alluvial in nature (which is associated with labour intensive extraction) in both on and offshore mining; the latter is reflected in high quality marine/seabed production. The Namibian economy was estimated to have grown by 5.1 per cent in 2013. This was partly attributed to an increase in construction projects in the mineral sector led by private industry, and to an increase in diamond output, although improved performance in non-mineral-related sectors of the economy was also reported

[1467] (1) The income tax rate; (2) The rate of royalty; (3) The special rule for extended net operating loss carry forward; (4) The special rule for depreciation and other cost recovery; (5) The rate for withholding of tax on payments; (6) The exemption provided in Section 1001(e)(6) and Section 1001(g)(5); (7) The exemption provided in Section 1708(b); and (8) The exemption provided in Section 2009(i).
[1468] Section 18(a) provides for "advance pricing agreements (APAs) with the general rule that it means an agreement with the Government of Liberia whereby a transfer pricing methodology (TPM) is established, with the intention to reflect transactions between related parties as they would be if they had been between unrelated parties dealing at arm's length."
[1469]GIZ (not dated).

as a contributing factor. Namibia's mineral sector contribution to gross domestic product was, at the time, estimated at 13 per cent. In terms of real value added, the mineral sector as a whole increased by an estimated 0.6 per cent, compared with 25.1 per cent in 2012. Diamond production, as reported by the Kimberley Process Certification Scheme, increased by about 4 per cent to nearly 1.7 million carats. In 2015, the trend reversed through a 4 per cent contraction in production.[1470]

The diamond sector nevertheless continues to be a significant contributor to Namibia's economy. In 2013, although Namibia accounted for less than 2 per cent of global rough diamond production by weight (carats), it ranked number one in terms of the value per unit weight in dollars per carat. The average value of Namibia's diamonds was approximately USD 805 per carat; this value was nearly USD 220 more than the value per unit weight of diamonds from Lesotho, which was the world's second-ranked diamond producer by value per unit weight in 2013. Namibia's total diamond exports were valued at USD 1 billion in 2013.[1471]

Similar to Botswana's arrangement with De Beers, a new 10-year sales agreement with the Namibian government was agreed to in 2016, which is aimed at downstream beneficiation. Under the accord, Namdeb Holdings, a fifty-fifty joint venture between De Beers and the Namibia government, was assigned the rights to sort, value and sell diamonds. On an annual basis, an estimated USD 430 million worth of rough diamonds will be made available for sale to the Namibia Diamond Trading Company (another fifty-fifty joint venture between the parties). In addition, all of Namdeb Holdings' special stones, which are typically large, very large or unusual stones, will be made available to sell domestically.[1472]

Socio-economic policies aimed at increasing the number of underrepresented or previously disadvantaged black populations in Africa were revised in Namibia, and new legislation was put in place to replace the country's Black Economic Empowerment policy with the New Equitable Economic Empowerment Framework (NEEEF). The policy is aimed at promoting the participation of previously disadvantaged Namibians in the country's economic activities. The government announced plans to introduce new legislation which would allow an increase in state participation with respect to the mining of strategic minerals. Under the proposed law, coal, copper, diamond, gold, rare-earth minerals and uranium would be designated as strategic minerals.[1473]

[1470] Bermúdez-Lugo (2015) 32.1.
[1471] Bermúdez-Lugo (2015) 32.1, 32.2.
[1472] Mining Journal (2016).
[1473] Bermúdez-Lugo (2015) 32.1, 32.2.

4.1 Taxation

The Minerals (Prospecting and Mining) Act[1474] provides for “the reconnaissance, prospecting and mining for, and disposal of, and the exercise of control over, minerals in Namibia; and provides for matters incidental thereto.” Royalties on mining are payable under Section 114 to the commissioner for the benefit of the State Revenue Fund.[1475] Royalties are levied as a percentage of the market value of the minerals extracted by licence holders in the course of finding or mining any mineral or group of minerals. The Diamond Act[1476] provides for the establishment the Diamond Board of Namibia, the establishment of the Diamond Board Fund and the Diamond Valuation Fund, the management and control of the funds, as well as control measures in respect of the possession, the purchase and sale, the processing and the import and export of diamonds. Section 62 of the act provides for duties payable on exports of unpolished/rough diamonds at a rate of 10 per cent of the value of that diamond (this export duty replaces the royalty provision).[1477] Exports of polished diamonds are exempt from duties, and sales of diamonds to domestic cutters are also exempt from any royalty payment to the producer. The corporate tax rate is 32 per cent, however, the tax rate for diamond mining is set at 55 per cent (whilst non-diamond mining is taxed at 37.5 per cent). Withholding tax rates range from 20 per cent (on dividends paid to non-residents with shareholding of less than 25 per cent), to ten per cent (on dividends paid to non-residents with shareholding of more than 25 per cent; royalties and interests to non-residents as well as management, technical, administration, consulting, entertainment and directors’ fees). The Minerals (Prospecting and Mining) Act levies a royalty on minerals won or mined by a licence holder at 3 per cent of the market value.

Transfer pricing measures were introduced in May 2005 and require that cross-border transactions with connected persons, be entered into on an arm’s-length basis.

5. Sierra Leone

Sierra Leone is rich in both alluvial diamond deposits and kimberlite resources, and its alluvial diamond resources account for 90 per cent of the diamond exports in West Africa, which makes it the leading diamond producer and exporter in West Africa. The third-largest diamond in the world, the near-1000 carat "Star of Sierra Leone", was discovered there in 1972. Most of the

[1474] Act 33 of 1992.
[1475] State Revenue Fund means the State Revenue Fund referred to in Article 125(1) of the Namibian Constitution of 1990.
[1476] Act 13 of 1999.
[1477] The levy is for the benefit of the Diamond Valuation Fund and (under Section 63) it “shall be utilized to defray the cost of valuation of any unpolished diamond pursuant to the provisions of the Act and to defray the expenses incurred in administering the said Fund.”

diamond mining is centred in Koidu-Sefadu in the Kono District in eastern Sierra Leone, near the border with Guinea and Liberia. For many years the Magna Egoli Mine on the Sewa River was Sierra Leone's only large-scale mining operation, but since the mid-1990s foreign mining companies have invested millions in exploring the country's kimberlite resources and in constructing underground kimberlite mines.[1478]

Restructuring of the diamond sector is *sine quo non* to sustained economic development and avoidance of future conflict, and the international community is funding attempts to create a more open, transparent, accessible and less corrupt diamond mining and trading system. In 2006, the Law Reform Commission decided to reform the domestic rough diamond trading structures and to facilitate the establishment of a polished diamond manufacturing and export sector. There are approximately between 300 000 and 400 000 artisanal miners in Sierra Leone, and attempts are underway to finance these and to market their output. Many small licenced miners are creating co-operatives to be able to produce the critical mass needed to facilitate efficient marketing options. *De facto* control of the largest part of production is controlled by Lebanese traders, who reportedly “use the diamond industry as a monetary vehicle to finance other profitable enterprises such as contracting and materials in the building industry and rice imports – ventures in which they also hold monopoly positions.”[1479]

Under British rule the diamond industry was structured in a way to ensure that the rebellious hinterlands were controlled and at the same time, that the colonial government could be funded.[1480] The two-fold solution entailed that indirect rule through the traditional paramount chiefs” was instituted, and a “tributary system” was introduced whereby miners/diggers received a share of any diamonds they recovered in lieu of wages.[1481] Many unemployed were willing to work for below sustenance wages in the diamond field, hoping to one day find a significant stone. The system of pleasing the chiefs and promising diggers a share of the profits “progressively degraded state control and thwarted the development of a strong legitimate government institution which could prevent corruption.”[1482] The effort to control the production of both diamonds and gold led over time to the creation of a shadow state, with no accountability to the public, ultimately dominating the minerals sector. The colonial administration granted the chiefs control of settlement and local migration, in order to placate the local population. As local chiefs obtained

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[1478] Evan-Zohar (2007) 460-463.
[1479] Evan-Zohar (2007) 463-464.
[1480] In 1934 the British colonial rulers gave an exclusive licence to explore, mine and market diamonds for a period of 99 years to a single company*, Consolidated African Selection Trust (CAST)*.[1480] *CAST* operated in Sierra Leone through a wholly owned subsidiary, *Sierra Leone Selection Trust (SLST),* and the country became one of the world’s richest diamond producers yielding an extraordinary high proportion of gem quality goods. After assuming a nationwide monopoly, the SLST generated dissatisfaction when it demanded that outsiders be removed from mining areas and that illicit mining be stopped (Evan-Zohar 2007: 463).
[1481] Evan-Zohar (2007) 460-463.
[1482] Evan-Zohar (2007) 460-463.

the power to decide who could stay in the Kono concession area, illicit mining grew apace in the 1940 – 1950's, as those with money found ways to circumvent the SLST.[1483] Diamond revenue and control of the region became inter-laced with broader political agendas of the day, where the informal illicit diamond market and those who benefited from it, became the major players in the rivalry between political parties.[1484] In 1955, the administration was forced to yield some of the SLST's monopoly after local diggers stormed the company's offices. The government reduced the SLST's exploration and mining territory and granted local miners the right to engage in small scale mining operations. At the time the government tried to remove all foreigners (mainly from Guinea and Lebanon) from the Kono concession areas. The massive number of local people going into the mining sector had harmful consequences for the agricultural sector, and in the process, the economic and social rural infrastructure of the country was destroyed. In addition, the unexpected inflow of migrants further undermined the capacity of the chronically under-financed local administration. After independence, government policy saw diamonds as state property and a nationalistic approach to mineral resource development was adopted. Macroeconomic policies were restrictive to foreign private investment and foreign owned operations were expropriated, access to land for mining was restricted, mineral resources were generally exploited by state owned entities and diamond sales were done by or on behalf of government.[1485]

While in most diamond mining countries the role of government is one of being owner and operator of mining and/or marketing, in Sierra Leone it is one of lessor – regulator, i.e. the role of government is to lease mining and exploration concessions to the private sector. (In Botswana, Namibia, Angola and Tanzania the governments are partners in both selling and mining mechanisms for diamonds – a trend typical for developing countries). Artisanal mining licences can only be held by Sierra Leone citizens, but mechanical and industrial operations can be owned by foreigners, though a local partner is needed (who is typically a straw person for a politician or someone high in government). These are unknown silent partners, which is not a desirable situation and it would be more straightforward to have government as partner.

The mineral sector was the country's principal income earner accounting for 93.4 per cent of export revenues in 2013. Sierra Leone was amongst the world's top 10 ranked producers of diamonds and rutile by carat and tonnage, respectively. The increase in diamond production (12.5 per cent) was largely driven by improved performance from the Koidu Mine. Export revenues, as reported by the Bank of Sierra Leone, totalled USD 1.92 billion in 2013; an increase of 70.9 per cent from total export revenues in 2012. The mineral sector accounted for the majority of these

[1483] Evan-Zohar (2007) 462.
[1484] Evan-Zohar (2007) 460-463.
[1485] Evan-Zohar (2007) 463-464.

revenues, most of which came from increased earnings from the iron ore industry. Diamond exports, which were mainly gem-quality diamonds, increased by 13.6 per cent to approximately 605,000 carats, and were valued at USD186 million; industrial-quality diamond exports increased by approximately 16 per cent in terms of weight, but decreased by approximately 5.2 per cent in terms of value.[1486]

In 2014, the Kimberley Process Certification Scheme reported[1487] Sierra Leone's total rough diamond production to be 620,181.11 carats. The average value per carat increased from 302 per carat to USD 357. This represented a 12.5 per cent increase from production in 2012. The average value per carat remained more or less the same as that of 2012 or USD 302.95 per carat). According to a 2016 case study,[1488] the contribution of the mining sector to the domestic tax base has been limited, accounting for 60 per cent of exports in 2010, but only 8 per cent of government revenue. The variation is ascribed to the generous tax incentives afforded to mining companies, often reinforced by political corruption and possible tax avoidance.

6.1 Taxation

The Mines and Mineral Act of 2009 (MMA) governs the mining sector. The fiscal regimes for the extractive sectors are incorporated into the Income Tax Act (2000) and its amendments, as well as the Finance Act of 2015. The main fiscal tools in the mining sector are corporate income tax and mineral royalty tax. Royalties are payable in accordance with percentages of market value and are set at 15 per cent for special stones, defined as those precious stones whose market value is above five-hundred thousand USD, and 6.5 per cent for precious stones.[1489] Section 150 provides for provisional royalties to be paid, where for any reason it is impracticable to assess the amount of any royalty due. Company diamond exporters are liable to standard assessment of a minimum tax at a rate of 2 per cent of export value.

Besides stipulating thresholds for diamond dealers, diamond dealers' agents and alluvial diamond miners, the small and micro taxpayer regime provides for a diamond exporter's (percentage of the export value) levy of 3 per cent.[1490] Since the introduction of the Income Tax Act (ITA) of 2000, the commissioner general of the National Revenue Authority (NRA) has had the power to re-characterize transactions between associated persons deemed not at arm's length. This provision

1486 USGS (2014).
1487 Kimberley Process Rough Diamond Statistics, 2014.
1488 Readhead (2016a) 1.
1489 Section 148 (1) MMA. Under Section 148(3) the term "market value" shall for the purposes of calculation of royalty be the sale value receivable in an arm's length transaction without discount, commissions or deductions for the mineral or mineral products on disposal as defined in regulations.
1490 Income Tax Act of 2000 as amended; Part IV Section 4(2).

was strengthened in 2013 when the Finance Act repealed and replaced Section 95 of the Income Tax Act with more comprehensive rules; in particular, confirming that the onus is on the taxpayer to calculate their chargeable income as per the arm's length standard.[1491]

Transfer pricing regulations still need to be developed, but the Mines and Minerals Act (MMA) of 2009 reinforces the transfer pricing provision in the ITA. Section 154 stipulates that where mineral rights holders sell mineral products to affiliates, this must be done according to the arm's length price. This requirement only applies to holders of large-scale mining licenses having a capital expenditure of no less than USD 5 million.[1492]

6. South Africa

South Africa remains as a global leader in mining and mineral-processing. The mineral industry accounted for 8.3 per cent of the gross domestic product (GDP) in 2012, whilst diamond production was 7.25 million carats (compared with a revised 7.11 million carats in 2011). The De Beers Group accounts for the bulk of the country's rough diamond production. Its Venetia Mine produced nearly 3.07 million carats in 2012; the Kimberley Surface Mining Operations 755,000 carats; and the Voorspoed Mine[1493] 611,000 carats (projected to increase to 800 000 carats per annum). De Beers commenced with an underground mine at Venetia, thereby extending the mine's life from 2021 to 2042.

In September 2010, the government introduced its new Mining Charter,[1494] which allows companies to use the value of their domestic beneficiation activities as credit for up to 11 per cent of their black ownership requirements. The charter required mining companies to purchase 70 per cent of their services, 50 per cent of their consumable goods, and 40 per cent of their capital goods from BEE entities. With the charter currently under review,[1495] government has proposed further contributions toward what it describes as "supplier development and enterprise development".[1496] In line with the government's Black Economic Empowerment (BEE) programme, it was required that black ownership of mining companies reach 26 per cent by 2014. In 2016 a legal dispute arose on whether mining companies must perpetually top up their black

1491 Readhead (2016a) 3.
1492 Readhead (2016a) 3.
1493 Yager (2016). 38.8.
1494 The original Mining Charter was published on 13 August 2004 in terms of Section 100(2)(a) of the Mineral and Petroleum Resources Development Act.
1495 Press Release (June 2016) South Africa: Deputy Director General Joel Raphela - Youth in Mining Summit. Available at: http://allafrica.com/stories/201606141221.html.
1496 The proposals are that a mining right-holder must procure a minimum of 60% locally manufactured capital goods from BEE compliant manufacturing companies. Right-holders are also required to procure 70% of locally manufactured consumables and 80% of services from such companies. It also entails a revision of the contribution by multi-national suppliers of capital goods to a minimum of 1% of their annual income to a social development fund.

ownership levels to 26 per cent when black shareholders sell out (the interpretation favoured by government), or whether it is sufficient to sell 26 per cent to black shareholders once.[1497] The government also holds the view that the Mining Charter can no longer be part of the Mineral Petroleum Resources Development Act (MPRDA), but that it forms part of the legislation's regulations.

Attempts at downstream beneficiation resulted in the formation of the South African Young Diamond Beneficiators Guild in 2015. This is a collective of predominantly black-owned South African small and emerging diamond producers, that are involved in cutting and polishing of rough stones.[1498]

5.1 Taxation

The Mineral and Petroleum Resources Development Act (MPRDA)[1499] provides the regulatory framework for mining in South Africa. Under Section 3(4) of the act, the finance ministry must make a determination on the levy payable to the state as royalty, which was done through the promulgation of the Mineral and Petroleum Resources Royalty Act,[1500] and the Mineral and Petroleum Resources Royalty (Administration) Act,[1501] 2008. Both acts are administered by SARS. The royalty is triggered on the transfer of a mineral royalty extracted from within the republic. As is the case for all other taxes, duties, levies, fees or money collected by SARS, the royalty collected is paid to the National Revenue Fund.[1502] A diamond export levy on unpolished diamonds exported from South Africa was introduced, effective from 1 November 2008, at a rate of 5% of the value of such diamonds.[1503] In its review of the mining taxation regime in South Africa, the Davis Tax Committee (DTC) observes that the success of export taxes as a means for promoting beneficiation is not promising; it also notes that the IMF highlights the diamond levy on exports as an example of a thus far unsuccessful government initiative designed to promote the domestic cutting and polishing industry; and that only countries with market power (South Africa does not have price making power in this industry) can impose export taxes and record any

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[1497]CCE News(2017).

[1498] Press Release (June 2016) South Africa: Deputy Director General Joel Raphela - Youth in Mining Summit.

[1499] Act 28 of 2002. The purpose of the Act is to "amend the Mineral and Petroleum Resources Development Act, 2002, so as to make the Minister the responsible authority for implementing environmental matters in terms of the National Environmental Management Act, 1998, and specific environmental legislation as it relates to prospecting, mining, exploration, production and related activities or activities incidental thereto on a prospecting, mining, exploration or production area; to align the Mineral and Petroleum Resources Development Act with the National Environmental Management Act, 1998, in order to provide for one environmental management system; to remove ambiguities in certain definitions; to add functions to the Regional Mining Development and Environmental Committee; to amend the transitional arrangements so as to further afford statutory protection to certain existing old order rights; and to provide for matters connected therewith."

[1500] Act 28 of 2008.

[1501] Act 29 of 2008.

[1502] SARS (not dated).

[1503] Through the Diamond Export Levy Act, 15 of 2007.

measure of success and, furthermore, price taking countries tend to lose export market share as a consequence of the imposition of such taxes, with negligible additional tax revenue. Thus, even if government beneficiation objectives were achieved by this means, it would most likely cause hardship to upstream industries wishing to export their produce. A further point made in relation to levies is that even "if export levies could theoretically assist with beneficiation, there is some doubt concerning the effectiveness of South African export levies which can be bypassed by channelling exports through treaty exempt countries.[1504]

A key recommendation for reform by the DTC is that clear valuation guidelines publish reference prices, simplify collections and coordinate between the DMR and the State Diamond and Precious Metals Regulator, regarding mineral volume and value verification.[1505].

South Africa's tax regime has been described as generous in that (i) companies are allowed to write off against tax all their capital expenditures in the year of acquisition and can carry forward any losses indefinitely, also offsetting them against tax liability; (ii) mining companies pay no VAT on their exports and are entitled to a refund for all the input taxes paid by them, which is a major gain for diamond companies which export virtually all of their production.[1506]

Sharife and Bracking[1507] suggest that the disparity between import and export values of diamonds, is indicative transfer pricing manipulation of the value of rough stones. They find that that diamond valuation in South Africa largely escapes regulation and that it "works heavily in favour of capital holders who, by means of their control over marketization, can then condition prices and taxes more broadly."[1508]The authors find that by controlling valuation, industry players such as De Beers, can then choose to make profits in low tax jurisdictions instead of the country of primary economic activity.

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7. Zimbabwe

Zimbabwe has a brief but turbulent diamond mining history. In 2006 a major diamond field was discovered in Marange, and since then several private mining companies have operated in partnership with the state-owned Zimbabwe Mining Development Corporation (ZMDC). This arrangement began after thousands of artisanal miners were violently evicted from the newly

1504 Davis Tax Committee (2015) 90.
1505 DTC (2015) 96.
1506 Curtis (not dated) 2.
1507 (2016) 557.
1508 (2016) 558.

discovered alluvial deposits. The government holds a 51 per cent stake in diamond mining operations through the ZMDC.[1509]

In 2013, GDP was approximately USD 13.5 billion, of which mining and quarrying accounted for 8.8 per cent. Zimbabwe's diverse mineral output included approximately 9 per cent of the world's diamond production (by volume). The Ministry of Mines and Mining Development manages the mineral sector in accordance with the Mines and Minerals Act (Chapter 21:05); the Mining (General) Regulations, 1977; and their amendments. Mining operations are also regulated by numerous other acts, amendments, regulations, statutory instruments and general notices.[1510] Because of the various sources of regulation, policy uncertainty is prevalent with little investment in the sector.[1511]

The state-owned Minerals Marketing Corporation of Zimbabwe (MMCZ) officially markets much of the mineral production of Zimbabwe, excluding platinum group metals, in accordance with the Minerals Marketing Corp. of Zimbabwe Act (PGMs). Mining companies which produce PGMs, ship their concentrates and smelter matter directly to processing facilities in South Africa. Mining royalties, which are based on the value of minerals or mineral-bearing products that are shipped from the mine site, are payable to the Zimbabwe Revenue Authority.[1512]

Several companies are active in the production of industrial diamonds from unconsolidated surface sediments in the Marange diamond field in the Chiadzwe area of eastern Zimbabwe, including Anjin Investments (Private) Ltd., the Diamond Mining Corporation (Private) Ltd., Gye Nyame Resources, Marange Resources (Private) Ltd. and Mbada Mining (Private) Ltd. In 2013, Kusena Diamonds started mining operations at Marange, and Rera Diamonds initiated diamond exploration. DTZ-OZGEO (Private) Ltd. started diamond mining operations in Chimanimani.[1513]

In 2013, many of the diamond companies that worked the Marange diamond field were adversely affected by the depletion of alluvial diamonds in the surface and near-surface material that was being processed, reducing production. The companies were not equipped to process the underlying diamond-containing conglomerate. Reduced output resulted in increased labour disputes over non-payment of salaries, reductions in the operational staff of the mines, non-payment of required government fees and taxes, and the failure to start payments on a USD 50-million pledge to the Marange-Zimunya Community Share Ownership Trust.[1514]

[1509] The Zimbabwean (2016).
[1510] Mobbs (2016) 47.1.
[1511] CNRG (2013) 10.
[1512] Mobbs (2016) 47.2; 47.3.
[1513] Mobbs (2016) 47.2; 47.3.
[1514] Mobbs (2016) 47.2; 47.3.

Murowa Diamonds (Private) Ltd., which was a subsidiary of the joint venture of Rio Tinto plc of the United Kingdom and RioZim Ltd., recovered 410,096 carats of diamonds from the Murowa Mine in 2013. Rio Tinto was unable to find a suitable buyer for its interest in the mine and subsequently suspended plans to divest its interest in the Murowa Mine.[1515]

2014 saw the establishment of the Zimbabwe Consolidated Diamond Company - which is described as a “merger” of private firms wherein government is a 51 per cent shareholder.[1516] It has since March of 2016 sold approximately 513 000 carats valued at USD 21.5 million from two of the diamond operations it took over in the same month of 2016.[1517] The ZCDC reportedly made total profits of USD 6,7 million from the USD 21 549,008. The company made USD 3,5 million profit in March from the sale of 218 278 carats; USD 2,2 million from 222 528 carats in April and USD 900 000 from the sale of 72 563 carats in May from the two operations. Of this, estimates are that USD one million went to the treasury, with the rest being re-employed to capitalize the company.[1518]

7.1 Taxation

Mining royalties are charged in terms of the Mines and Minerals Act (Chapter 21:05). The royalties are collectable from all the minerals or mineral bearing products obtained from any mining location and disposed of by a miner or on his behalf. The royalties are chargeable whether the disposal is made within or outside Zimbabwe. Mining royalties are charged based on the face value of the invoice and the rate is 15 per cent.[1519] In 2015 the government of Zimbabwe eliminated the fifteen per cent royalties on diamond sales to stimulate production and attract investment into the sector, amid low international prices.[1520]

[1515] Mobbs (2016) 47.2; 47.3.
[1516] Reportedly Mines and Mining Development Minister Walter Chidhakwa said that the firms were operating illegally after the expiry of their joint-venture permits with the state.
[1517] All Africa.com: the ZCDC “has taken over diamond concessions that were previously owned by eight companies that were operating in Chiadzwa, which included Marange Resources; Mbada Diamonds; Diamond Mining Corporation; Anjin Investments; Jinan Mining; Kusena Diamonds; Rera Diamonds and Gye-Nyame Resources. The consolidation of diamond mining companies was informed by government's attempt to ensure transparency in the mining and trade in diamonds.”
[1518] All Africa.com website: http://allafrica.com/stories/201606210413.html.
[1519] ZIMRA (not dated).
[1520] The Herald (2016).

The corporate tax rate is 25 per cent for a general mining operation, or 15 per cent for those with Special Mining Leases.[1521] Taxes on additional profits are charged to the holder of special mining leases.[1522]

Several tax and customs incentives exist in the form of tax holidays, reduced tax rates, and accelerated depreciation. The incentives are given by sector, type of activity, form of organization, and geographical location of investment. For mining companies, all capital expenditure on exploration, development, and operating, incurred wholly and exclusively for mining operations is allowed in full.[1523] There is no restriction on carryover of tax losses; these can be carried forward for an indefinite period. Taxable income of a holder of a special mining lease is taxed at a special rate of 15 per cent.[1524] A transfer pricing framework which broadly follows the OECD transfer pricing guidelines was introduced effective from 1 January 2016.

Under Chapter 23:06 (Part III) of the Income Tax Act, provision is made for a presumptive tax on small scale miners. Section 7(1) stipulates the collection agents and Section 7(2) provides that every agent who buys any precious metals or precious stones from a small-scale miner must notify the Commissioner in writing of the name, home address and address of the mining location of the small-scale miner concerned. Section 7(3) provides for a record keeping obligation by agents of any small-scale miner from whom purchases are made. Withholding or presumptive tax from amounts payable to small-scale miners is provided for under Section 8, which stipulates that "the agent shall withhold from the gross amount payable to the small-scale miner for the sale of the precious metals or precious stones in question, an amount equal to such percentage of the amount so paid as is fixed from time to time in the charging act, and shall remit each amount so withheld to the Commissioner."[1525]

[1521] Section 22 and the 22nd Schedule of the Income Tax Act.
[1522] Section 22.
[1523] ZIMRA (not dated).
[1524] ZIMRA (not dated).
[1525] Income Tax Act.

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