

# Note

## Countering Complexity’s Corporate Bias: Tax Simplification as a Strategy to Reduce Profit Shifting in the African Extractive Sector

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### INTRODUCTION

Sierra Leone’s struggles to benefit from its immense resource wealth would sound familiar to many African governments. Although diamonds account for sixty percent of the country’s exports, they provide just eight percent of the government’s revenue.<sup>1</sup> A major reason for this revenue shortfall is that

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1. Alexandra Readhead, *Transfer Pricing in the Extractive Sector in Sierra Leone*, NAT. RES.

the multinational companies that conduct mining in Sierra Leone exploit weaknesses in the global tax system in order to shift profits to low-tax jurisdictions. For example, leaked documents revealed that one of the country's largest diamond mines undervalued sales to its subsidiaries in tax havens by as much as thirty-five percent, illicitly reducing the tax owed to Sierra Leone.<sup>2</sup> Sierra Leone's tax authorities have few tools to prevent these losses. None of the country's auditors have been trained on these profit-shifting strategies,<sup>3</sup> the country's regulations to address them are ambiguous or inadequate,<sup>4</sup> and the tax authority operates on a shoestring budget.<sup>5</sup> Sierra Leone's Deputy Minister of Mines puts it bluntly: "We do not have capacity to get involved with legal issues. Companies have the best lawyers; as a ministry we don't have the best lawyers."<sup>6</sup> Sierra Leone's ability to provide services to its population—forty-three percent of whom live under \$1.90 per day—is severely hampered without this revenue.<sup>7</sup> The estimated amount of revenue Sierra Leone loses to global tax abuse is nearly 1.5 times larger than its entire health budget.<sup>8</sup>

Improving African governments' ability to collect revenue from the extractive sector—meaning minerals, oil, and gas—would greatly increase the ability of those governments to serve their populations. Although resource wealth is unevenly distributed among African countries, many of those countries have among the world's richest reserves of valuable natural resources. And because the populations of African countries tend to make up a small tax base, the revenue extractive industries can provide is particularly important to governments.<sup>9</sup> The profit-shifting strategies used by multinational corporations deprive African governments of significant portions of this revenue. Profit-shifting strategies serve to reduce the companies' allocations of profits to the African countries in which they extract resources and increase their allocations of profits to subsidiaries in low-tax jurisdictions in which they conduct little real economic activity. This profit shifting happens almost entirely on paper, and it

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GOVERNANCE INST. 1 (2016), [https://resourcegovernance.org/sites/default/files/documents/nrgi\\_sierra\\_leone\\_transfer-pricing-study.pdf](https://resourcegovernance.org/sites/default/files/documents/nrgi_sierra_leone_transfer-pricing-study.pdf).

2. *Africa Probes the Panama Connection*, 57 AFR. CONFIDENTIAL 8 (2016), <https://www.africa-confidential.com/index.aspx?pageid=7&articleid=11619>. ("'Koidu is one of the highest revenue per carat diamond mines in the world,' said the Standard Chartered note. It contained a graph entitled 'Koidu Historic Sales Profile', which showed that diamond values from the mine surpassed an average of \$450 per carat in 2011.... Industry insiders say the diamonds are sometimes being valued in Sierra Leone at up to \$140 a carat less than that, leaving a potentially mammoth profit margin for the exporters.'").

3. Readhead, *supra* note 1, at 10.

4. *Id.* at 19.

5. Thomas Lassourd & Alexandra Readhead, *Securing Mining Revenues: Good Practice from Zambia, Tanzania, and South Africa*, NAT. RES. GOVERNANCE INST. (Apr. 17, 2017), <https://resourcegovernance.org/blog/securing-mining-revenues-good-practice-zambia-tanzania-south-africa>.

6. *Id.*

7. *Poverty Headcount Ratio at \$1.90 a day (2011 PPP) (% of population) – Sierra Leone* (2018), WORLD BANK, <https://data.worldbank.org/indicator/SI.POV.DDAY?locations=SL>

8. *Illicit Financial Flows Vulnerability Index – Sierra Leone*, TAX JUST. NETWORK, <https://iff.taxjustice.net/#/profile/SLE> (last visited Dec. 12, 2020).

9. See Annet Wanyana Oguttu, *Tax Base Erosion and Profit Shifting in Africa – Part 1: Africa's Response to the OECD BEPS Action Plan*, INT'L CTR. FOR TAX AND DEV. 11 (2016).

tends to exist in a legal gray area.<sup>10</sup> Profit shifting is not unique to Africa. The issue is a broad global concern, and the Organization for Economic Cooperation and Development (OECD) is currently overseeing the biggest changes to international corporate taxation in a century through its Base Erosion and Profit Shifting (BEPS) Project.<sup>11</sup> African countries have had little say in these negotiations, however, and the reforms will leave significant amounts of profit shifting in the African extractive sector untouched.

This Note argues that African tax authorities could increase tax revenue and achieve significant reductions in profit shifting by implementing legal reforms that simplify tax administration. The capacities of African tax authorities are typically far outmatched by the corporations from which they seek to collect taxes, and building the capacity of African tax authorities is a long and arduous process. However, different tax frameworks demand different levels of capacity, and the tax rules used by wealthy countries often will not be the best rules for African countries.<sup>12</sup> African governments can take advantage of various reforms that simplify tax administration and reduce the potential for abuse, such as placing hard limits on interest deductions, benchmarking transfer prices to commodities' internationally traded prices, and increasing the use of production-based royalties relative to corporate income tax. These reforms can stray from the arm's length principle and fail to account for the nuances of particular transactions, but they remain preferable to the status quo of rampant profit shifting.<sup>13</sup>

In addition to providing practical legal reforms to secure much-needed revenue for African governments, this Note advances a broader argument that complexity in international tax rules systematically favors multinational corporations over most tax authorities. When there are capacity asymmetries between tax authorities and the companies from which they seek to collect revenue, complex tax rules increase the likelihood that well-resourced multinational corporations will find opportunities to reduce their tax liabilities and decrease the likelihood that under-resourced tax authorities will be able to identify and challenge tax avoidance.<sup>14</sup> In contrast, simpler tax rules rely on easily verifiable standards and reduce administrative burdens, putting tax authorities and multinational corporations on a more level playing field. The African extractive sector is an ideal setting for simplifying the taxation of multinational corporations. African tax authorities typically have limited

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10. *Id.* at 13.

11. See generally *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy*, OECD (July 1, 2021), <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf>.

12. See Luis Calderon Gomez, *Transcending "Tax" Sovereignty and Tax Standardization: Three Questions*, 45 *YALE J. INT'L L.* 191 (2020).

13. See generally Thomas R. Torslov, Ludvig S. Weir & Gabriel Zucman, *The Missing Profits of Nations* (Nat'l Bureau of Econ. Research Working Paper 24701, 2018), [https://www.nber.org/system/files/working\\_papers/w24701/w24701.pdf](https://www.nber.org/system/files/working_papers/w24701/w24701.pdf).

14. See Fernando C. Saldívar, *Africa in the Economy of Francesco: Rethinking the Ethics of the International Financial Order at the Intersection of Tax Justice and Catholic Social Teaching*, 1 *AFR. J. INT'L ECON. L.* 160, 172 (2020).

resources and low administrative capacities, the tangible and geographically fixed nature of natural resources facilitates simplified tax rules, and the sector will remain vulnerable to profit shifting despite the forthcoming global corporate tax reforms.

Part I of this Note describes existing methods of profit shifting, argues that the goal of reducing profit shifting deserves more focus than formalistic distinctions between tax evasion and tax avoidance, and explains OECD-led tax reforms. Part II describes the enormous scale of profit shifting in the African extractive sector and analyzes the causes of vulnerability to profit shifting, particularly the mismatch between the capacities of African tax authorities and the companies from which they collect revenue. Finally, Part III argues for tax simplification as a goal of international corporate tax law and policy, and it presents a number of legal reforms that would simplify tax administration and reduce profit shifting in the African extractive sector.

## I. PROFIT SHIFTING

Part I provides a general overview of profit shifting. Section A describes three primary profit-shifting strategies that multinational enterprises (MNEs) use to reduce their overall tax liabilities. These strategies all shift profits from companies in countries where economic activity takes place to affiliated companies in low-tax jurisdictions. First, companies issue unnecessary loans and require repayment to affiliates in low-tax jurisdictions. Second, companies artificially increase or decrease transfer prices to increase profits in low-tax jurisdictions. And third, companies attribute intangible assets to low-tax jurisdictions and charge affiliated companies for their use. Section B notes that it can be difficult to determine whether profit-shifting strategies qualify as illegal tax evasion or legal tax avoidance. Because these distinctions are based on legal fictions, Section B argues that the more relevant question is whether MNEs are shifting profits away from the country in which economic activity actually takes place. Section C examines the most prominent international effort to reduce profit shifting: the OECD BEPS Project. Although the forthcoming changes to the international system are of huge importance, they will not address significant amounts of profit shifting in the African extractive sector. Extractive industries are excluded from Pillar One. Pillar Two's global minimum corporate tax will not apply to many companies in the African extractive sector, and it sets its minimum tax below the statutory rates of most African countries.

### A. *Forms of Profit Shifting*

Multinational tax activity often takes place in a legal gray area, and how to draw the line between licit and illicit activity is a matter of significant debate.<sup>15</sup> Although tax evasion and avoidance can take place on a domestic scale as well,

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15. See *Equity in Extractives: Stewarding Africa's Natural Resources for All*, AFR. PROGRESS PANEL 65 (2013), <https://reliefweb.int/sites/reliefweb.int/files/resources/relatorio-africa-progress-report-2013-pdf-20130511-125153.pdf>.

the transnational nature of MNEs produces distinct challenges for international corporate taxation. An MNE headquartered in one country may extract minerals in a second country, process them in a third, and sell them in a fourth, while managers in a fifth country provide oversight. These international economic relations produce a question that does not emerge in purely domestic economic activity: What share of the profits is taxable in each of the countries involved? In international trade between distinct companies, revenues and costs are relatively clearly attributable to specific countries. But transactions between subsidiaries of the same multinational company do not take place in a normal market setting, and profits are spread across the company's global network. This challenge is becoming increasingly prevalent, and most global trade is now conducted between affiliates of the same company.<sup>16</sup>

MNEs may attempt to shift profits to low-tax jurisdictions in an effort to minimize the total amount of tax they pay. Profit shifting refers to the process of allocating profits and assets in a way that minimizes effective tax rates. Consider this simplified example: A South African company generates \$100 million in profits. If South Africa has a tax rate of twenty-eight percent, the company should pay \$28 million in tax. However, if the company uses profit-shifting strategies to attribute half its profits to a subsidiary in a different jurisdiction with no corporate tax, then only \$50 million would be taxable in South Africa. Given the South African tax rate of twenty-eight percent, the company would then owe \$14 million. Because the company pays no tax in the other jurisdiction, its global effective tax rate would be fourteen percent.

Jansky and Palansky identify three primary methods of profit shifting: debt shifting, strategic transfer pricing, and the location of intangible assets.<sup>17</sup> For all three channels, the low-tax jurisdiction to which profits are shifted may serve little or no meaningful economic purpose. These channels of profit shifting can be utilized in all sectors of the global economy, but this description will focus primarily on their relevance to the extractive sector.

### *i. Debt Shifting*

Jansky and Palansky describe debt shifting as the implementation of “unnecessary loans at high interest rates from one MNE affiliate located in a low-tax jurisdiction to another profitable unit located elsewhere.”<sup>18</sup> In the African extractive context, debt shifting strategies would create debts for the subsidiary in the country in which extraction takes place, with the repayment of the loans and the significant profit accrued through interest assigned to the affiliate in a low-tax jurisdiction. As a result, the MNE would owe less tax to the African government and face a smaller overall tax bill. While there are many legitimate reasons for an extractive company to seek loans, a loan is likely a method of profit shifting if it would lack commercial logic if conducted with an unrelated

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16. *Id.*

17. Petr Jansky & Miroslav Palansky, *Estimating the Scale of Profit Shifting and Tax Revenue Losses Related to Foreign Direct Investment*, 26 INT'L TAX AND PUB. FIN. 1051 (2019).

18. *Id.*

party. For example, a loan lacking a clear obligation to repay is most likely a profit-shifting strategy.<sup>19</sup> Interest rates that are much higher than standard market rates can also provide evidence of profit shifting. Still, determining a typical market interest rate can be complicated, and there is often a risk premium associated with loans for economic activity in African countries.<sup>20</sup>

*ii. Transfer Pricing*

Transfer pricing is not inherently a method of profit shifting but rather a fundamental part of the global tax regime. Transfer pricing derives from two principles of global tax law: the separate entity principle and the arm's length principle.<sup>21</sup> According to the separate entity principle, different affiliates of a multinational corporation must be treated as distinct entities for tax purposes. These entities are of course not truly distinct, and transactions between these related parties—known as controlled transactions—do not follow a normal market process. Therefore, the arm's length principle establishes that the prices of controlled transactions reported for tax purposes should correspond to the price that would have been used for a market transaction between unrelated parties. For example, if a Zambian mining company would sell a given quantity of copper to an unrelated German company for \$50,000, it should use a transfer price of \$50,000 for tax purposes even if the copper was transferred to a German subsidiary of the same company. In this situation, the company is not pursuing a strategy of profit shifting but merely following the applicable transfer pricing law.

Transfer pricing becomes a strategy of profit shifting when MNEs alter prices in order to reduce taxable income.<sup>22</sup> A company may artificially increase or decrease the price of a transaction between subsidiaries in order to allocate profits to a low-tax jurisdiction and reduce taxable income. If the transfer price does not comply with the arm's length principle, tax authorities are authorized to make a transfer pricing adjustment so that the transaction can be taxed at the arm's length price.<sup>23</sup>

Applying the arm's length principle creates significant practical challenges. MNEs can cite a wide range of factors that influence the price of a transaction beyond the quantity of the commodity being transferred. Prices can differ based on the risk involved in the transaction, the contractual terms of the

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19. See Alexandra Readhead, *New Toolkit Aims to Curb Transfer Mispricing in African Mining*, AFR. TAX ADMIN. FORUM (Sep. 28, 2017), <https://medium.com/african-tax-administration-forum/new-toolkit-aims-to-curb-transfer-mispricing-in-african-mining-86af2cf15850>.

20. See Pietro Guj, Stephanie Martin & Alexandra Readhead, *Transfer Pricing in Mining with a Focus on Africa: A Briefing Note*, WORLD BANK 28 (2017), <http://documents1.worldbank.org/curated/en/213881485941701316/pdf/112344-REVISED-Transfer-pricing-in-mining-with-a-focus-on-Africa-a-briefing-note-Web.pdf>.

21. See, e.g., Dick Bryan, Michael Rafferty & Duncan Wigan, *Capital Unchained: Finance, Intangible Assets and the Double Life of Capital in the Offshore World*, 24 REV. INT'L POL. ECON. 1, 74.

22. See Jansky & Palansky, *supra* note 17, at 1051.

23. See, e.g., *Transfer Pricing in the Mining Sector: Preventing Loss of Income in Tax Revenue*, NAT. RES. GOVERNANCE INST. 4 (2016), [https://resourcegovernance.org/sites/default/files/documents/nrgi\\_primer\\_transfer-pricing.pdf](https://resourcegovernance.org/sites/default/files/documents/nrgi_primer_transfer-pricing.pdf).

transaction, the quality or specific characteristics of the goods, the services provided in the transaction, and the companies' economic circumstances and business strategies.<sup>24</sup> Because the analysis used to determine whether to apply a transfer pricing adjustment is based on comparing identical controlled and uncontrolled transactions, a company might claim that any of these factors represents a material difference justifying a different price from a similar but not identical uncontrolled transaction.

Guj, Martin, and Readhead write that "the key question is whether the arrangement entered into possesses commercial rationality."<sup>25</sup> Acting independently, companies "would not enter into arrangements involving conditions that could reasonably be expected to lead to them trading at an unacceptable rate of return or even at a long-term loss."<sup>26</sup> Therefore, if a company is selling a resource at significantly below market rates, purchasing goods and services from a related entity in a low-tax jurisdiction at prices significantly higher than market rates, or divesting assets to a related entity at a below market rate and then paying fees to use the assets, the company is likely engaging in profit shifting.<sup>27</sup>

### iii. Intangible Assets

While tax authorities already face challenges in countering profit shifting involving commerce in material goods, they encounter even more difficulties in valuating intangible assets. Extractive industries rely on the use of intangible assets including intellectual property related to industrial methods and processes, computer programs and databases, specialized expertise, and management services.<sup>28</sup> Unlike the resources themselves, which at any one time are present in a specific geographic location, intangible assets lack a fixed location. By assigning the intangible assets to a subsidiary in a low-tax jurisdiction and charging the African subsidiary for the use of the intangible assets, multinational corporations can reduce the tax they owe to African governments. The location to which intangible assets are assigned is often removed from the economic activity that produced the intangible assets, such as the research and development of intellectual property or the specific employees who provide expertise or management services.<sup>29</sup>

Much like the location of intangible assets, the transfer prices of intangible assets are prone to manipulation. Although there are a number of challenges in applying the arm's length principle to the transfer of natural resources, there is at least a concrete good with a price that can be compared to uncontrolled transactions of that good. When considering a patent for a process used in mining

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24. See, e.g., Alexander Ezenagu, *Safe Harbour Regimes in Transfer Pricing: An African Perspective*, INT'L CTR. FOR TAX AND DEV. 8-9 (2019), [https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/14620/ICTD\\_WP100.pdf?sequence=1&isAllowed=y](https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/14620/ICTD_WP100.pdf?sequence=1&isAllowed=y).

25. Guj, Martin & Readhead, *supra* note 20, at 32.

26. *Id.* at 20.

27. *Id.*

28. *Id.* at 12.

29. *Id.* at 18.

or corporate management services provided for oil production, it is extremely difficult to determine the true economic value of those added services. Although comparisons to uncontrolled transactions for similar intellectual property or services can provide a guide, tax authorities struggle to rebut companies' assertions that differences in the quality or importance of the intangible asset in question justify a different price.

*B. Focus on Profit Shifting, not Distinguishing Evasion and Avoidance*

Due to this wide range of ambiguities, the line between licit and illicit activity is extremely fine. Distinctions between tax evasion and tax avoidance often depend on legality. Readhead defines tax avoidance as "the use of legal methods to minimize the amount of income tax owed by multinational enterprises."<sup>30</sup> This tax avoidance may be undesirable and exploit weaknesses in the global tax system, but it does not violate any nation's laws. In contrast, Readhead defines multinational corporate tax evasion as the use of "illegal ways to reduce [firms'] taxable income, by knowingly and illegally misrepresenting their transactions."<sup>31</sup>

However, profit shifting often does not fit neatly into categories of legality.<sup>32</sup> The vast majority of knowing and illegal misrepresentation will never be detected by tax authorities. In uncontrolled transactions, identifying illicit activity depends on a concrete reality with which the tax on the transaction should correspond. If the price or quantity of minerals a company reports to the tax authority differs from the actual details of its transaction with an unrelated party, there is little question that the company engaged in tax evasion even if the tax authorities never identify the company's misrepresentation. In contrast, a controlled transaction never actually took place in an arm's length manner.<sup>33</sup>

The transaction a company reports to the tax authority cannot be compared to the reality of the transaction but only to a counterfactual identical but uncontrolled transaction. Unless a tax authority identifies a suspect transaction and an appropriate arm's length price that differs from the MNE's reported price, it is unclear that a true arm's length price ever existed. All the while, MNEs can claim that they reported the fair arm's length price and did not seek to deceive tax authorities. Determining a taxpayer's intent or knowledge of misrepresentation is not the focus of transfer pricing analysis. Bryan, Rafferty, and Wigan challenge the very concept of arm's length pricing. They note that companies choose to operate as multinational corporations because they are able to obtain economic benefits that they would not be able to achieve as unrelated entities interacting through market transactions. They write that "if there is by

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30. Alexandra Readhead, *Preventing Tax Base Erosion in Africa: A Regional Study of Transfer Pricing Challenges in the Mining Sector*, NAT. RES. GOVERNANCE INST. 1 (2016), [https://resourcegovernance.org/sites/default/files/documents/nrgi\\_transfer-pricing-study.pdf](https://resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf).

31. *Id.*

32. See Wanyana Oguttu, *supra* note 9, at 13.

33. See, e.g., Lee Sheppard, *Transfer Pricing as Tax Avoidance*, FORBES (Jun. 25, 2010), <https://www.forbes.com/2010/06/24/tax-finance-multinational-economics-opinions-columnists-lee-sheppard.html?sh=5fe57da66346>.

definition no market price, a stipulation that intrafirm pricing should mirror market pricing . . . collapses under the weight of its own logical inconsistencies.”<sup>34</sup>

Governments around the world are increasingly focusing on reducing tax avoidance rather than just tax evasion, and African governments should not be any different. Distinguishing between illegal tax evasion and legal tax avoidance is extremely difficult, but the key issue for African governments is how much revenue they collect. A significant amount of tax avoidance is arguably legal under existing legal frameworks because it exploits weaknesses in existing laws, not because African governments intended for the behavior to be legal. Tax authorities will of course have to comply with applicable laws, but in crafting those laws and processes to implement them, the relationship between where economic activity takes place and where tax is paid should be the central question for African governments. This perspective is now widely shared: For example, the OECD has described the focus of the BEPS Project as “ensuring that profits are taxed where economic activities generating the profits are performed and where value is created.”<sup>35</sup>

Meaningfully addressing profit shifting may require deviating from the arm’s length principle. The arm’s length principle allows great nuance when considering controlled transactions, but this nuance also produces significant legal ambiguity that MNEs can exploit to shift profits.<sup>36</sup> As described below, the OECD BEPS reforms sometimes stray from the arm’s length principle.<sup>37</sup> Rather than emphasizing formalistic distinctions that even the world’s most powerful governments are abandoning, a more direct focus on profit shifting can both produce greater legal certainty and achieve more logical outcomes than the status quo: a situation in which tax revenues can be allocated to low-tax jurisdictions where MNEs conduct hardly any true economic activity rather than the African countries possessing the natural resources at the heart of economic activity in the extractive sector.

### C. *The OECD’s Base Erosion and Profit Shifting Project*

The OECD, an organization made up of thirty-eight wealthy countries, launched its BEPS Project in 2013 amid growing concern about corporate profit shifting. Governments had come to recognize that many major companies were using tax planning strategies that could greatly reduce their tax liabilities even in wealthy countries.<sup>38</sup> The growth of the digital economy—and in turn, increased prevalence of intangible assets—posed problems for a system based on the arm’s

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34. Bryan, Rafferty & Wigan, *supra* note 21, at 74.

35. *BEPS Actions*, OECD (last visited Sept. 14, 2021), <https://www.oecd.org/tax/beps/beps-actions/>.

36. See Kimberly Clausing, *Taxing Multinational Companies in the 21<sup>st</sup> Century*, BROOKINGS INST. 258 (2020), [https://www.brookings.edu/wp-content/uploads/2020/01/Clausing\\_Book\\_LO\\_FINAL.pdf](https://www.brookings.edu/wp-content/uploads/2020/01/Clausing_Book_LO_FINAL.pdf).

37. See OECD, *supra* note 11, at 2.

38. See, e.g., Megan Cerullo, *60 of America’s Biggest Companies Paid No Federal Income Tax in 2018*, CBS (Apr. 12, 2019), <https://www.cbsnews.com/news/2018-taxes-some-of-americas-biggest-companies-paid-little-to-no-federal-income-tax-last-year/>.

length principle.<sup>39</sup> Further, as countries competed to attract investment, they felt pressure to lower tax rates and exacerbate a race to the bottom. In 2016 the OECD and G20 created an Inclusive Framework to involve developing countries, but developing countries still have significantly less ability to influence the negotiations.<sup>40</sup> The negotiations began to progress rapidly in 2021, and countries are nearing an agreement that would constitute the largest change in international corporation taxation in a century.<sup>41</sup> The BEPS Project focuses on two pillars: Pillar One is primarily motivated by the digital economy and would redirect corporate taxes towards countries in which major companies sell their products, while Pillar Two would institute a global minimum effective tax rate for major companies.<sup>42</sup>

Extractive industries are exempt from Pillar One.<sup>43</sup> Pillar One is limited to companies with global turnover exceeding €20 billion—with that threshold falling to €10 billion after seven years—and global profits exceeding ten percent.<sup>44</sup> Some companies in the extractive sector meet these requirements, but the OECD specifically exempts extractives from Pillar One.<sup>45</sup> The companies that are subject to Pillar One will have to allocate twenty to thirty percent of their profits exceeding ten percent to the countries where they sell their products. Although Pillar One is limited to few companies and only a small proportion of their revenue, it represents a notable break with the separate entity and arm's length principles. Rather than attempting to replicate uncontrolled transactions between unrelated parties, Pillar One is effectively a form of unitary taxation and formulary apportionment. Under unitary taxation, all affiliates of an MNE are considered to be a single corporation. Formulary apportionment uses a formula to determine what share of the MNE's profits is taxable in different jurisdictions. Pillar One's formula is based on sales. While companies like Apple can currently declare most of their profits in low-tax jurisdictions like Ireland, and thus avoid taxes, Pillar One will redirect tax revenue towards the countries in which their products are used and consumed.

Pillar Two's global minimum tax will have more consequential effects on the African extractive sector. Pillar Two applies to MNEs with global revenues

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39. *Secretariat Proposal for a "Unified Approach" under Pillar One*, OECD 6 (2019), <https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf> ("Moreover, there seems to be agreement that the arm's length principle is becoming an increasing source of complexity and that simplification would be desirable to contain the increasing administration and compliance costs of trying to apply it.").

40. See, e.g., Irene Burgers & Irma Mosquera, *Corporate Taxation and BEPS: A Fair Slice for Developing Countries?*, 1 ERASMUS L. REV. (2017) ("Although the OECD refers to the participation as being on 'equal footing', given developing countries are late-comers in the discussion, they have little capacity and probably also less knowledge on the topic than developed countries that this gives a too optimistic view of reality. Moreover, the participation in the discussion of the multilateral instrument and in the inclusive framework will not solve the problem of the lack of participation of developing countries in the setting of the agenda and the content of the BEPS Actions.").

41. Liz Alderman, Jim Tankersley & Eshe Nelson, *U.S. Proposal for 15% Global Minimum Tax Wins Support From 130 Countries*, N.Y. TIMES (July 1, 2021), <https://www.nytimes.com/2021/07/01/business/global-minimum-tax.html>.

42. OECD, *supra* note 11.

43. *Id.* at 1.

44. *Id.*

45. *Id.*

exceeding €750 million.<sup>46</sup> For these MNEs, Pillar Two imposes a global minimum effective tax rate of fifteen percent.<sup>47</sup> If an MNE's global effective tax rate is below fifteen percent, Pillar Two will allow the MNE's country of residence to collect additional tax revenue in order to bring the MNE's global effective tax rate up to fifteen percent. Pillar Two will not eliminate key portions of the international tax system—like the arm's length principle and transfer pricing—but it reduces their ability to be exploited for profit shifting. And by focusing on an MNE's global effective tax rate, the global minimum tax moves away from the conceptual logic of the separate entity principle.

The distribution of revenues under the current version of Pillar Two is unfavorable to developing countries, but it will reduce profit shifting and competitive pressure to reduce tax rates. Under Pillar Two, the country in which an MNE is headquartered is granted the right to apply the top-up tax to fill the gap between a company's effective tax rate and the global minimum effective tax rate of fifteen percent. Because MNEs are typically headquartered in wealthy countries, Pillar Two would distribute little revenue to developing countries directly.<sup>48</sup> In addition, some African countries have given over-generous tax incentives in attempts to attract investment, sometimes pushing the effective tax rate below fifteen percent. These incentives will be rendered ineffective, but African countries will not be able to collect the additional tax revenues generated by the global minimum tax because those will be transferred to headquarter countries.<sup>49</sup>

It is not the case that Pillar Two will bring no benefits to developing countries, however. The expectation is that headquarter countries will not indefinitely apply top-up taxes at the same scale but rather that the implementation of a minimum tax will reduce profit shifting, and effective tax rates will trend toward fifteen percent. Because the top-up tax brings MNEs' global effective tax rates up to fifteen percent, any country with an effective tax rate below fifteen percent would simply be forfeiting revenue for headquarter countries to collect. It is expected that low-tax countries will raise their rates to fifteen percent. Even if they do not, MNEs subject to the global minimum tax would have little incentive to shift profits in a way that pushes their effective take rate below fifteen percent.<sup>50</sup>

Still, there are a number of important ways in which Pillar Two will not impact revenue collection in the African extractive sector. First, because Pillar

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46. *Id.* at 4.

47. *Id.*

48. See Alex Cobham, *A Corporate Tax Reset by the G7 Will Only Work if it Delivers for Poorer Nations too*, *GUARDIAN* (June 3, 2021), <https://www.theguardian.com/commentisfree/2021/jun/03/corporate-tax-reset-g7-poorer-nations>.

49. See Alexandra Readhead, Thomas Lassourd & Howard Mann, *The End of Tax Incentives: How Will a Global Minimum Tax Affect Tax Incentives Regimes in Developing Countries?*, *INT'L INST. FOR SUSTAINABLE DEV.* (June 24, 2021), <https://www.iisd.org/itn/en/2021/06/24/the-end-of-tax-incentives-how-will-a-global-minimum-tax-affect-tax-incentives-regimes-in-developing-countries/>.

50. See Didier Jacobs, *Are the Global Tax Proposals in the Interests of Low- and Middle-Income Countries?*, *OXFAM AMERICA* (Aug. 16, 2021), [https://webassets.oxfamamerica.org/media/documents/Global\\_Tax\\_Proposals\\_Oxfam.pdf?\\_gl=1\\*60vjnq\\*\\_ga\\*MTY5NzY3Nzk1Mi4xNjI4MjU4MTY2\\*\\_ga\\_R58YETD6XK\\*MTYyOTg1MDU0MC4zLjAuMTYyOTg1MDU0MC4w\\_](https://webassets.oxfamamerica.org/media/documents/Global_Tax_Proposals_Oxfam.pdf?_gl=1*60vjnq*_ga*MTY5NzY3Nzk1Mi4xNjI4MjU4MTY2*_ga_R58YETD6XK*MTYyOTg1MDU0MC4zLjAuMTYyOTg1MDU0MC4w_)

Two only applies to MNEs with global revenues exceeding €750 million, many important companies in the African extractive sector will not be subject to the global minimum tax.<sup>51</sup> Although a company with global revenues of €500 million may not be particularly important on the global stage, it could still be one of the largest sources of potential revenue for an African government. And despite Pillar Two, this company would still be able to push its global minimum effective tax rate below fifteen percent. Second, African countries typically have statutory corporate tax rates much higher than the fairly low rate of fifteen percent enforced by the global minimum tax.<sup>52</sup> If a profit-shifting strategy pushed the effective tax rate of a company subject to the global minimum tax from fifteen percent to ten percent, it would no longer make sense. But if a country had a corporate tax rate of thirty percent and profit shifting could reduce the MNE's effective tax rate to fifteen percent, the incentive to shift profits would remain. Third, Pillar Two is limited to forms of revenue collection that are based on MNE profits. Some important means of revenue collection in the African extractive sector—such as revenue-based royalties or production sharing agreements—are not based on profit and thus are outside the scope of Pillar Two.<sup>53</sup>

## II. EXTRACTIVES AND REVENUE COLLECTION IN AFRICA

Part II examines revenue collection in the African extractive sector. Section A notes that although African countries have among the richest natural resource endowments in the world, these same countries often experience widespread poverty. Profit shifting is one major reason that many African countries struggle to benefit from this resource wealth, and Section A presents evidence suggesting that profit shifting is taking place on an enormous scale. Section B analyzes the causes of vulnerability to profit shifting in the African extractive sector. Due to their tangible and geographically fixed nature, extractive industries are less inherently vulnerable to profit shifting than other sectors. But other causes—including unfavorable contractual terms, reliance on methods of revenue collection vulnerable to profit shifting, and corruption—all contribute to profit shifting in the African extractive sector. Arguably the most significant cause of vulnerability to profit shifting, however, is that African tax authorities are

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51. See, e.g., Mukasiri Sibanda, *Civil Society Perspectives on the Implications of Global Digital Tax Reforms for African Mining Countries*, INTERGOVERNMENTAL F. ON MINING, MINERALS, METALS, & SUSTAINABLE DEV. (Feb. 23, 2021), <https://www.igfmining.org/beps/commentaries/civil-society-perspectives-on-the-implications-of-global-digital-tax-reforms-for-african-mining-countries/>. (“This does not take into consideration the economic reality of mineral-dependent countries in Africa. Medium- and small-sized mining companies have a material economic impact on mining at the domestic level, and many of these will be left out by the reform process.”); Alexandra Readhead & Thomas Lassourd, *Global Digital Tax Reforms: Highlighting Potential Impact for Mining Countries*, INTERGOVERNMENTAL F. ON MINING, MINERALS, METALS, AND SUSTAINABLE DEV. (March 2021), <https://www.iisd.org/system/files/2021-03/digital-tax-reforms-mining-en.pdf> (“The threshold for companies to be included in Pillar Two is set at EUR 750 million of global consolidated annual gross revenue, which is likely to exclude many smaller but significant companies operating in developing countries.”).

52. See Jose Antonio Ocampo & Tommaso Faccio, *A Global Tax Deal for the Rich, Not the Poor*, PROJECT SYNDICATE (June 11, 2021), <https://www.project-syndicate.org/commentary/g7-corporate-tax-agreement-unfair-to-developing-countries-by-jose-antonio-ocampo-and-tommaso-faccio-2021-06>.

53. See Readhead, Lassourd & Mann, *supra* note 49.

understaffed and undertrained. Section B presents evidence showing that most African tax authorities are unable to carry out key functions—such as conducting transfer pricing audits, comparing MNE tax data with arm's length transactions, and litigating tax disputes—on a meaningful scale.

#### A. *The Scale and Consequences of Profit Shifting in the African Extractive Sector*

Profit shifting is one significant reason that African countries have struggled to translate enormous resource wealth into economic success and quality standards of living. While there is significant diversity in the extent of different countries' resource endowments, the IMF considers twenty of fifty-four African countries to be rich in natural resources.<sup>54</sup> Extractives constitute the most economically valuable resources: of those twenty countries, thirteen export primarily minerals while seven export mainly oil and gas. For many of these resources, particularly minerals, African countries are the primary suppliers of globally valued commodities. Africa supplies 70.9% of cobalt, 63.5% of platinum, and 53.8% of diamonds. African countries also provide significant portions of the world's gold, copper, and uranium: 18.9%, 17.2%, and 10.5%, respectively.<sup>55</sup>

This wealth should provide significant benefits to countries' populations, but resource wealth and extreme poverty often coexist. Even before the pandemic caused severe economic distress, one in three Africans—or 422 million people—lived below the extreme poverty line of \$1.90 per day.<sup>56</sup> Eighty-five percent of Africans live on less than \$5.50 per day.<sup>57</sup> These rates of poverty are unmatched by any other continent: Africa has seventeen percent of the world's population<sup>58</sup> and seventy percent of the people living in extreme poverty.<sup>59</sup> Poverty is by no means restricted to African countries lacking natural resource wealth. For example, Nigeria both produces more oil and has larger natural gas reserves than any other African country<sup>60</sup> and has more people living in extreme poverty than any country in the world.<sup>61</sup>

Profit shifting is not the only source of lost revenue in the African

54. The IMF defines a country rich in natural resources as a country for which natural resources constitute more than twenty-five percent of exports. Yannick Bouterige, Celine de Quatrebarbes & Bertrand Laporte, *Mining Taxation in Africa: What Recent Evolution in 2018*, INT'L CTR. FOR TAX & DEV.1 (2020), [https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/15184/ICTD\\_SummaryBrief\\_21\\_Online.pdf](https://opendocs.ids.ac.uk/opendocs/bitstream/handle/20.500.12413/15184/ICTD_SummaryBrief_21_Online.pdf).

55. Guj, Martin & Readhead, *supra* note 20, at 1.

56. Kristofer Hamel, Baldwin Tong & Martin Hofer, *Poverty in Africa Is Now Falling—But Not Fast Enough*, BROOKINGS INST. (Mar. 28, 2019), <https://www.brookings.edu/blog/future-development/2019/03/28/poverty-in-africa-is-now-falling-but-not-fast-enough/#:~:text=Africa%20is%20the%20world's%20last,of%20the%20world's%20poorest%20people>.

57. R. Andres Castaneda Aguilar et al., *85% of Africans Live on Less than \$5.50 per Day*, WORLD BANK (Oct. 3, 2019), <https://blogs.worldbank.org/opendata/85-africans-live-less-550-day>.

58. *Population*, UNITED NATIONS, <https://www.un.org/en/global-issues/population>.

59. Hamel, Tong & Hofer, *supra* note 56.

60. *Nigeria*, U.S. ENERGY INFO. ADMIN. (2020), <https://www.eia.gov/international/analysis/country/NGA>.

61. Yomi Kazeem, *Nigeria Has Become the Poverty Capital of the World*, QUARTZ (Jun. 25, 2018), <https://qz.com/africa/1313380/nigerias-has-the-highest-rate-of-extreme-poverty-globally/>.

extractive sector, but it is a prevalent phenomenon that significantly harms African governments' abilities to provide services to their populations.<sup>62</sup> Due to widespread poverty in most African countries, African governments tend to have small domestic tax bases.<sup>63</sup> Therefore, corporate taxation plays a particularly important role in African revenue collection, and losing corporate tax revenue to profit shifting is particularly costly.<sup>64</sup> African governments' reliance on corporate income taxation (CIT) is unusually high even as compared to other developing countries, and the thirty percent of tax revenue African governments receive from CIT is nearly three times greater than the proportion of tax revenue that developed countries derive from CIT.<sup>65</sup> A significant portion of African taxation comes from extractive industries: Extractive industries are the largest driver of foreign investment in Africa<sup>66</sup> and extractive industries provide one-third of all tax taken in Africa.<sup>67</sup> Multinational tax abuse in the extractive sector deserves particular note because foreign companies—often from formal colonial powers—are directly involved in transferring wealth out of resource-rich countries, at the expense of public services in those countries. Indeed, African leaders, scholars, and activists have long criticized the exploitation of Africa's natural resources, arguing that it contributes to poverty and underdevelopment; sovereignty over natural resources was a primary demand of post-colonial leaders.<sup>68</sup>

Tax revenues from extractive industries would be significantly higher without MNE profit shifting. The Africa Progress Panel notes that the revenue African governments collect from the extractive sector “appear[s] to be very low in relation to the value of exports, and compared with international standards.”<sup>69</sup> For example, the IMF estimates that globally the effective tax rate on mining is typically between forty-five and sixty-five percent.<sup>70</sup> However, in 2011, Zambia collected only 2.4% of copper export value and Guinea collected just 3.3% of mining export value.<sup>71</sup> Profit shifting is not the only cause of these low rates of revenue—due to a lack of bargaining power and a desire to attract investment, African governments often agree to contractual terms that favor foreign corporations and drive down effective tax rates—but profit shifting is a major

62. Le Billon identifies tax evasion as one of three sources of illicit financial flows in the extractive sector, along with corruption and illegal exploitation. Philippe Le Billon, *Extractive Sectors and Illicit Financial Flows: What Role for Revenue Governance Initiatives?*, CHR. MICHELSEN INST. 4 (2011), <https://www.cmi.no/publications/file/4248-extractive-sectors-and-illicit-financial-flows.pdf>.

63. Wanyana Oguttu, *supra* note 9, at 11.

64. Ernesto Crivelli, Ruud De Mooij & Michael Keen, *Base Erosion, Profit Shifting, and Developing Countries*, 72 PUB. FIN. ANALYSIS 269 (2016).

65. NAT. RES. GOVERNANCE INST., *supra* note 23, at 2.

66. *Foreign Direct Investment to Africa Increases, Defying Global Trend for 2012*, UNCTAD (June 26, 2013), <https://unctad.org/press-material/foreign-direct-investment-africa-increases-defying-global-trend-2012>.

67. *From Aspiration to Reality: Unpacking the African Mining Vision*, OXFAM 6 (2017), <https://www-cdn.oxfam.org/s3fs-public/bp-africa-mining-vision-090317-en.pdf>.

68. See, e.g., Permanent Sovereignty Over Natural Resources, G.A. Res. 1803 (XVII) (1962).

69. AFR. PROGRESS PANEL, *supra* note 15, at 64.

70. *Fiscal Regimes for Extractive Industries: Design and Implementation*, INT'L MONETARY FUND 35 (2012), <https://www.imf.org/external/np/pp/eng/2012/081512.pdf>.

71. AFR. PROGRESS PANEL, *supra* note 15, at 64.

cause of the enormous gap between African resource extraction and standard government revenues.

These revenues could be used for education, health, infrastructure, and other services crucial to poverty alleviation and economic development. Using country-by-country data released by the OECD, the 2020 State of Tax Justice report sought to provide more precise estimates of the impacts of global corporate tax abuse.<sup>72</sup> The report found that Africa loses \$23 billion each year to global corporate tax abuse, significantly higher than the \$2.5 billion it loses to individual tax abuse. Put together, this tax abuse constitutes 6.96% of the region's average tax revenue, equivalent to 52.5% of African public health spending or 28.7% of combined education spending. Though developed countries lose more tax revenue in absolute terms, the proportion of African tax revenue lost to tax abuse is significantly higher than the global average of 2.61%.<sup>73</sup> These rates also vary among African countries, and resource-rich countries tend to have much higher rates of lost revenue than the African average.

Other estimates also identify corporate tax abuse as a central source of revenue loss for African governments. Yeboah estimates that twenty-four percent of Nigeria's crude oil exports to the U.S. were under-invoiced between 1996 and 2014,<sup>74</sup> while a 2008 World Bank study in Tanzania estimated that businesses did not report thirty-one percent of sales for tax purposes.<sup>75</sup> Tax Justice Network estimates that Zambia—which faces a \$12 billion external debt load and was forced to default in 2020<sup>76</sup>—loses about \$2 billion per year to tax avoidance and abusive transfer pricing by foreign companies.<sup>77</sup> Globally, Torslov, Wier, and Zucman estimate that MNEs artificially shift forty percent of profits to tax havens.<sup>78</sup> The methodological challenges inherent to these studies give reason to question their precision, but the full body of evidence leaves little doubt that profit shifting in the extractive sector deprives African governments of significant amounts of revenue. And as discussed in Part I, the forthcoming global tax reforms will leave much of this profit shifting untouched.

72. The report notes that it only measures direct tax abuse. Indirect tax abuse includes spillovers, such as when governments reduce tax rates in an attempt to avoid multinational tax abuse. Because the report does not include indirect abuse, its estimates are smaller than some studies that include both direct and indirect abuse. However, the report defines tax abuse to include both unlawful tax evasion and avoidance as well as tax avoidance that misaligns profits with economic activity, meaning that its estimates are larger than studies that take a narrow view of illegal tax evasion. *The State of Tax Justice 2020*, TAX JUST. NETWORK (2020), [https://taxjustice.net/wp-content/uploads/2020/11/The\\_State\\_of\\_Tax\\_Justice\\_2020\\_ENGLISH.pdf](https://taxjustice.net/wp-content/uploads/2020/11/The_State_of_Tax_Justice_2020_ENGLISH.pdf).

73. *Id.* at 74.

74. Stephen Yeboah, *Down the Drain? The Economic Costs of Illicit Financial Flows in Africa's Extractive Sector*, AFRICAN DEV. BANK 67 (2017).

75. Tanzania Episcopal Conference et al., *The One Billion Dollar Question: How Can Tanzania Stop Losing So Much Tax Revenue?*, CURTIS RES. 21 (2012), <https://curtisresearch.org/wp-content/uploads/ONE-BILLION-DOLLAR-QUESTION.Final-text.-June-2012.pdf>.

76. *Zambia on Brink of Defaulting on Foreign Debt*, BBC (Nov. 13, 2020), <https://www.bbc.com/news/world-africa-54928836>.

77. *Where is the Money?: Taxation and the State of Africa Mining Vision Implementation in Ghana (ECOWAS), Tanzania (EAC), and Zambia (SADC)*, TAX JUST. AFR. 38 (2016), <https://taxjusticeafrica.net/wp-content/uploads/2020/04/AMV-Mapping-Analysis-Study-Synthesis-Report.pdf>.

78. Torslov, Weir & Zucman, *supra* note 13, at 3.

*B. Causes of Profit Shifting in the African Extractive Sector*

Extensive profit shifting takes place in the African extractive sector, but in many ways extractive industries are less inherently vulnerable to profit shifting than other sectors. As the IMF has argued, “there is no intrinsic reason for effective and transparent administration of EI [extractive industry] fiscal regimes . . . [to] be harder for EI than other industries. They are simpler than other industries (such as finance and telecoms) in that they involve physical operations with outputs that can be analyzed, weighed, and measured, with prices in most cases quoted on international exchanges.”<sup>79</sup> *The Future of Resource Taxation* also cites the fact that extractive industries are a “location-specific, predominantly brick-and-mortar business” as a factor facilitating the collection of tax revenue.<sup>80</sup> Certain aspects of the extractive sector complicate effort to address profit shifting, but these factors are not unique to the sector. First, extractive industries involve complex technical knowledge that is difficult to understand for tax authorities and others outside the industry,<sup>81</sup> though technical knowledge is important in many other sectors, too. Second, the growing use of intangible assets, particularly as extractive industries increase automation, makes addressing profit shifting more difficult.<sup>82</sup> Still, when compared to sectors that are composed primarily of intangible assets, such as the digital economy, the fact that tangible natural resources will continue to provide the central source of economic value offers reason for optimism that African governments can effectively address profit shifting in the extractive sector.

Similarly, although some methods of revenue collection in the extractive sector are highly vulnerable to profit shifting—particularly corporate income tax—methods of revenue collection vary significantly in their degree of vulnerability to profit shifting. Direct government production is much more common for oil than mining. Globally, governments control fifty-five percent of oil production but just ten percent of metal production.<sup>83</sup> While state-operated production increases the risk of government corruption, it reduces the risk of profit shifting. For private production, African governments typically derive revenue from a combination of royalties and CIT. Royalties are usually levied on gross sales, while CIT only applies to profits.<sup>84</sup> “Royalty payments are intended to deliver proportionally less than CIT over the life of a mining project” and rates typically vary from two to six percent as opposed to twenty percent to forty percent for CIT.<sup>85</sup> Royalties offer the benefit of providing earlier and more stable revenues, whereas CIT is more volatile. Mining projects require a significant amount of investment before they can become profitable, and profits

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79. INT’L MONETARY FUND, *supra* note 70, at 29.

80. Isaac Agyiri Danso et. al, *The Future of Resource Taxation: A Roadmap*, INT’L INST. FOR SUSTAINABLE DEV. 6 (2020), <https://www.iisd.org/system/files/2020-10/future-resource-taxation-roadmap.pdf>.

81. *See* Le Billon, *supra* note 62, at 3.

82. *See* Danso et al., *supra* note 80, at 6.

83. *Id.* at 2.

84. *See* INT’L MONETARY FUND, *supra* note 70, at 5.

85. Danso et al., *supra* note 80, at 3.

may be concentrated in short periods when commodity prices are favorable.

CIT is much more prone to profit shifting than royalties are. Although companies could still reduce the royalties owed to the government through strategic transfer pricing or mis-invoicing the quantity of minerals sold, debt shifting and the use of intangible assets are only applicable to profits, not revenues. The relative ease of reducing CIT through profit shifting bears out in government revenues: Though royalty rates are significantly lower than CIT, countries rely heavily on royalty payments and tend to collect far less CIT than planned. Some resource-rich countries, including Zambia and Ghana, ultimately receive more than half of all declared payments from mining companies through royalties.<sup>86</sup>

African governments' abilities to collect CIT is also harmed by unfavorable terms in agreements that they have signed. In an effort to attract investment, governments often offer low tax rates or agree to terms that MNEs can exploit to reduce taxable profits. For example, Zambia and Ghana allow companies to deduct pre-production capital expenditures from taxable profit and to carry forward losses from mineral prospecting and exploration. As a result, companies can go five years or more without declaring taxable profit.<sup>87</sup> The double taxation agreements that African governments have signed with other countries can also increase vulnerability to profit shifting. Although governments believe these agreements will increase investment by reducing the risk of double taxation, they also contain many loopholes and constrain governments' abilities to alter tax policy.<sup>88</sup>

Although government officials do not profit directly from profit shifting, government corruption can increase vulnerability to profit shifting. Le Billon notes that the extractive sector is often "controlled by the president's office and a small cadre of technocrats and [is] particularly prone to secrecy."<sup>89</sup> Bribery of government officials is not uncommon in the extractives sector. As a result, government officials may accept agreements that leave their government vulnerable to profit shifting, or they may decline to provide adequate resources to tax authorities.<sup>90</sup> Despite the potential impacts of corruption on revenue collection in the extractive sector, the relevant government officials face little oversight because "civil society organizations and members of parliaments often lack sufficient understanding of transfer pricing and mineral taxation to demand systemic improvements and accountability."<sup>91</sup>

Arguably the most significant cause of African governments' vulnerability to profit shifting in the extractive sector, however, is that African tax authorities

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86. David Manley & Thomas Lassourd, *As Mining Enters the Renewables Era, Taxation Challenges Persist*, NAT. RES. GOVERNANCE INST. (Oct. 22, 2019), <https://resourcegovernance.org/blog/mining-renewables-taxation-IGF>.

87. See TAX JUST. AFR., *supra* note 77, at 34.

88. *Id.* at 6.

89. Le Billon, *supra* note 62, at 3.

90. Le Billon, *supra* note 62, at 6 (demonstrating that companies often seek favorable terms that allow them to route profits through subsidiaries in low-tax jurisdictions, and that officials may realize favorable terms can allow them to charge higher initial fees that are prone to embezzlement).

91. See Readhead, *supra* note 30, at 4.

are forced to work with few resources, little training, and complex regulations.<sup>92</sup> Most African countries have legislation that implements the arm's length principle and grants tax authorities the power to adjust companies' taxable profits, in line with standard international tax frameworks.<sup>93</sup> But Readhead notes that "introducing the concept of the arm's length principle in the income tax law is only a first step. Few countries have followed up with 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."<sup>94</sup> As a result, tax authorities have little certainty on how to apply the law and MNEs are even more able to exploit ambiguity in order to shift profits.<sup>95</sup>

Further, African tax authorities are extremely understaffed.<sup>96</sup> As of 2015, "only three African countries had transfer pricing units in their internal revenue services."<sup>97</sup> More countries have exchange of information units, another key element of global tax cooperation, but as of 2019, African countries still had an average of only four people in those units. Less than half of those people work full-time.<sup>98</sup> While there have been increases in the number of staff allocated to international tax issues by African tax authorities, the number is still entirely insufficient for the number of taxpayers that they have to monitor. For example, Nigeria has more than 2,900 taxpayers subject to transfer pricing rules and Tanzania has more than 820 such taxpayers.<sup>99</sup>

While methods such as the exchange of information and audits have shown success in increasing tax revenue, most African governments have little ability to carry them out. In 2019, Uganda sent thirty-two exchange of information requests to other countries and as a direct consequence recovered \$9 million, meaning it recovered an average of \$281,000 for each request sent.<sup>100</sup> However, few African countries perform such requests at meaningful rates. Developing countries are typically net senders of requests for information, but African countries are net receivers, and Uganda is one of four countries that have sent seventy-four percent of Africa's outgoing requests for information.<sup>101</sup>

Similarly, tax authorities conduct few transfer pricing audits. A 2017 report

92. See Wanyana Oguttu, *supra* note 9, at 19.

93. See, e.g., Ezenagu, *supra* note 24, at 7-9.

94. Readhead, *supra* note 30, at 2.

95. Readhead notes that tax authorities in Tanzania and Ghana—which have far more developed regulations—have been far more able to conduct transfer pricing audits than Sierra Leone, Zambia, and Guinea, which do not. *Id.* at 12.

96. See, e.g., *id.* at 2. ("Preliminary results from research by the Institute for Mining for Development (IM4DC) suggests that out of 26 countries surveyed in Africa, most do not have the requisite capacity to implement effective transfer pricing rules.")

97. *Report of the High Level Panel on Illicit Financial Flows from Africa*, UNITED NATIONS ECONOMIC COMMISSION FOR AFRICA 27 (2015), <https://repository.uneca.org/bitstream/handle/10855/22695/b11524868.pdf?sequence=3&isAllowed=y>.

98. Global Forum on Transparency and Exchange of Information for Tax Purposes, *Tax Transparency in Africa 2020*, 31-37 (2020).

99. Ezenagu, *supra* note 24, at 9.

100. Global Forum on Transparency and Exchange of Information for Tax Purposes, *supra* note 98, at 36.

101. *Id.* at 35.

contains the results of a survey the World Bank and the International Mining for Development Centre conducted with senior tax and mines officials from 19 African countries.<sup>102</sup> For countries that conducted audits, “audits are considered to be cost-justified in terms of both consequent adjustments and improvements in the taxpayers’ compliance behavior.”<sup>103</sup> However, in 2013, three-quarters of respondents did not conduct any transfer pricing audits.<sup>104</sup> Even beyond audits, most countries do not even have a system for analyzing transfer pricing of minerals. The survey found that “most jurisdictions see the area of mineral transfers/sales as the main transfer pricing risk; however, only a quarter of respondents had systems in place to check the degree to which the prices applied to minerals transferred to related parties comply with the arm’s length principle, and only two or three do so systematically.”<sup>105</sup> Similarly, only one-quarter of respondents systematically analyzed whether marketing and hedging fees followed the arm’s length principle.<sup>106</sup>

Even when African tax authorities can look into potential profit shifting, they often lack the information and expertise to do so effectively. Applying the arm’s length principle requires comparisons to uncontrolled transactions. However, “data specific to Africa’s mining sector does not yet exist,” and oil and gas data are also limited.<sup>107</sup> As a result, African tax authorities must adapt data from other regions to the African context—a time-consuming and complex process that still may not produce actionable results due to material differences between the transactions. African governments also often lack relevant information on the resources in their own countries. MNEs tend to have much better knowledge than tax authorities of resource deposits’ size, quality, and potential profitability.<sup>108</sup>

In addition, African tax authorities frequently receive little training on international tax issues, a sharp contrast to MNEs’ ability to hire a wide range of specialists to reduce their tax bills. The United Nations Economic Commission for Africa notes that “most African countries do not have enough highly trained lawyers, accountants and tax experts to carry out the oversight functions to prevent or punish perpetrators of illicit financial outflows.”<sup>109</sup> Governments also struggle to retain the experts they do have because this expertise makes them

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102. Pietro Guj et al., *Transfer Pricing in Mining with a Focus on Africa: A Reference Guide for Practitioners*, WORLD BANK 28, 95 (2017), <https://documents1.worldbank.org/curated/en/801771485941579048/pdf/112346-REVISED-Dated-Transfer-pricing-in-mining-with-a-focus-on-Africa-a-reference-guide-for-practitioners-Web.pdf>. While the survey provides insight on the state of African tax authorities, its results should not be taken as definitive. Only fifty percent of the countries present at the conference at which the survey was administered completed it, and a number of respondents did not answer all the questions on the survey.

103. *Id.* at 97.

104. *Id.* at 96.

105. *Id.*

106. *Id.*

107. Readhead, *supra* note 30, at 2.

108. UNITED NATIONS ECONOMIC COMMISSION FOR AFRICA, *supra* note 97, at 31 (“Also of concern in this regard is the asymmetry of information between African countries and the multinationals, which often have more information about the quantity and quality of the mineral deposits for which such contracts are being signed.”).

109. *Id.* at 72.

attractive employees for private companies that can offer much better salaries.<sup>110</sup> Even if African tax authorities have the expertise to identify illicit profit shifting, the expense and complexity of tax disputes deters African governments from bringing them. For example, in 2017 Australia won a major judgment against Chevron for shifting profits abroad. While the \$209 million reward justified the Australian government's efforts, African countries are extremely unlikely to be able to afford to litigate a similar dispute: The \$7.5 million the Australian government spent on litigation fees equals forty-five percent of the total operating budget of Sierra Leone's tax authority.<sup>111</sup>

The result of these vulnerabilities is that most African tax authorities currently have little ability to control profit shifting. African tax authorities are tasked with enforcing unfavorable and ambiguous laws without the number of people or knowledge necessary to do so. Even if they manage to identify profit shifting, departments consisting of a few undertrained staff are put up against some of the world's most talented and well-compensated lawyers and accountants. Unsurprisingly, massive amounts of profit shifting go unchallenged, and the forthcoming OECD-led global tax reforms will leave much of this profit shifting untouched.

### III. TAX SIMPLIFICATION

Part III makes the case for tax simplification as a goal of international corporate tax law and policy and presents actionable proposals to simplify MNE taxation in the African extractive sector. Section A first presents alternative strategies for reducing profit shifting, noting both their potential benefits and the challenges that they leave unresolved. Section A argues that the OECD-led BEPS reforms include some measures to simplify international corporate taxation but rely on measures that would partially correct the consequences of tax complexity rather than removing the underlying causes. Increased tax transparency generally serves to simplify tax administration and it is a vital component of efforts to reduce profit shifting, but it does not change the underlying rules of the international corporate tax system. And although capacity building is essential, reforms that would reduce the amount of capacity needed to effectively administer tax systems can be achieved more quickly than building capacity. Section A then calls for the simplification of international corporate tax rules, arguing that complex tax rules favor MNEs over tax authorities. Because MNEs are able to devote more resources to tax issues than governments and thus enjoy stronger tax capabilities, complexity increases MNEs' ability to outmaneuver tax authorities and reduce their tax liabilities. Simplifying tax rules, in contrast, levels the playing field.

Section B presents legal reforms that African governments could undertake to simplify tax administration in the extractive sector: increasing the use of royalties relative to CIT, setting limits on interest deductions and fees for

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110. See Guj, Martin & Readhead, *supra* note 20, at 42.

111. Alexandra Readhead, *How Global Tax Reforms Apply to the Extractive Industries*, INT'L TAX REV. (July 10, 2019).

intangible assets, benchmarking commodity transfer prices to market rates, implementing safe harbor agreements, using advance pricing agreements in limited circumstances, and relying on favorable model treaties when negotiating double taxation agreements. By using clear standards, limiting flexibility, and reducing administrative burdens, these strategies create a tax system that better suits the capacities of African tax authorities and limits opportunities for MNEs to shift profits. These reforms are sometimes blunt instruments, but governments should be mindful that adding nuance can increase MNEs' ability to shift profits.

### A. *The Case For Tax Simplification*

#### i. *Alternative Approaches*

Although numerous scholars have noted the complexity of the international tax system and some existing proposals to address profit shifting would simplify tax administration, tax simplification has rarely been advanced as an explicit goal for international corporate tax law and policy. Instead, efforts to reduce the scale of profit shifting in developing countries have often emphasized capacity building or transparency, while the OECD BEPS Project has largely focused on technical reforms that can be standardized and achieve multilateral support—particularly among wealthy countries. All these initiatives bring important benefits, but they largely leave the complexity of the international tax system in place. Tax complexity should not be thought of as merely burdensome, but rather as a force that interacts with administrative capacity to systematically favor MNEs over tax authorities.

Simplifying the international tax system has not been a priority in the OECD BEPS Project. To be sure, some BEPS reforms would result in simplified tax administration. For example, BEPS Action 4 calls for hard limitations on interest deductions rather than relying on individual assessments of particular transactions.<sup>112</sup> Further, the global minimum tax arguably simplifies tax administration by guaranteeing a fixed effective tax rate. And Pillar One implements a system based on formulary apportionment, which simplifies tax administration relative to reliance on the separate entity and arm's length principles. However, both Pillar One and Pillar Two build new systems on top of the existing global tax system rather than removing complex components of it. For companies subject to Pillar One, profits up to ten percent and seventy to eighty percent of profits in excess of ten percent will still be subject to existing global tax rules. Pillar Two implements a global minimum tax as a corrective to the gaps in the existing tax rules, but it continues to rely on separate entity accounting and its requirement that tax authorities assess individual transactions in comparison to hypothetical uncontrolled transactions.<sup>113</sup> Pillar Two may lead to some simplification by reducing incentives to exploit complexity, but it does

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112. *Action 4 Limitation on Interest Deductions*, OECD, <https://www.oecd.org/tax/beps/beps-actions/action4/>.

113. See Laurens van Apeldoorn, *BEPS, Tax Sovereignty and Global Justice*, 21 CRITICAL REV. INT'L SOC. & POL. PHIL. 478, 484 (2018).

not achieve it in the short-term, and the low rate of fifteen percent limits its efficacy. The fact that BEPS reforms were designed with the tax administrations of wealthy countries in mind may help explain why they do not appear to have seen simplification as a priority.<sup>114</sup>

Another major approach to addressing profit shifting—increasing transparency—tends to encourage tax simplification even if arguments for it have typically been framed in different terms.<sup>115</sup> Tax authorities' efforts to collect revenue are made far more difficult because MNE financial data is extremely opaque.<sup>116</sup> Tax Justice Network calls for the ABCs of tax transparency: automatic exchanges of information; beneficial ownership registries that would track the true owners of companies; and country-by-country reporting that would document corporations' economic activity, divided by the jurisdiction in which it takes place.<sup>117</sup> The OECD has adopted country-by-country reporting for companies with revenues greater than €750 million, and having access to this information grants tax authorities information that would otherwise have to be painstakingly investigated and pieced together.<sup>118</sup> Similarly, the availability of beneficial ownership registries would mean that tax authorities would no longer have to search extensively to determine whether companies are related, while the automatic exchange of information reduces the need for tax authorities to actively request information from other countries. Still, increased transparency measures can require reciprocity and standardized reporting mechanisms that are difficult for under-resourced African tax authorities to keep up with. And simply having access to information does not mean it is easy to sort through, particularly when the arm's length principle demands individualized assessment of an enormous amount of data.<sup>119</sup>

Capacity building is one approach taken by many developing countries to address profit shifting.<sup>120</sup> Although definitions of capacity building vary, these efforts tend to focus on providing training and improving the quality of tax administration.<sup>121</sup> Proponents of capacity building are correct that developing

114. See Allison Christians, *Global Trends and Constraints on Tax Policy in the Least Developed Countries*, 40 U.B.C. L. REV. 3 (2009).

115. See Allison Christians, *Tax Activists and the Global Movement for Development through Transparency*, Legal Studies Research Paper Series Paper No. 1193 (2012), [http://esvc000076.wic060u.server-web.com/ssl/CMS/files\\_cms/298\\_13%2003%2031%20ChristiansTax%20activists%20and%20the%20global%20movement%20for%20development%20through%20transparency1.pdf](http://esvc000076.wic060u.server-web.com/ssl/CMS/files_cms/298_13%2003%2031%20ChristiansTax%20activists%20and%20the%20global%20movement%20for%20development%20through%20transparency1.pdf).

116. *Id.* at 6.

117. *What Are the ABCs of Tax Justice?*, TAX JUST. NETWORK, <https://taxjustice.net/faq/what-are-the-abc-of-tax-justice>; *Country by Country Reporting*, TAX JUST. NETWORK (Nov. 14, 2020), <https://taxjustice.net/topics/country-by-country-reporting>.

118. See Gregory Pun, *Base Erosion and Profit Shifting: How Corporations Use Transfer Pricing to Avoid Taxation*, 40 B.C. INT'L & COMPAR. L. REV. 2, 305 (2017).

119. See Annet Wanyana Oguttu, *A Critique on the Effectiveness of "Exchange of Information on Tax Matters" in Preventing Tax Avoidance and Evasion: A South African Perspective*, 68 BULLETIN FOR INT'L TAXATION (2013), [https://research.ibfd.org/#/doc?url=/collections/bit/html/bit\\_2014\\_01\\_int\\_2.html%23bit\\_2014\\_01\\_int\\_2\\_s\\_9](https://research.ibfd.org/#/doc?url=/collections/bit/html/bit_2014_01_int_2.html%23bit_2014_01_int_2_s_9)

120. See Natalia Quiñones, *The Birth of a New International Tax Framework and the Role of Developing Countries*, in TAX SOVEREIGNTY IN THE BEPS ERA 165, 170 (Sergio André Rocha & Allison Christians eds., 2017).

121. See Diane Ring, *Developing Countries in an Age of Transparency and Disclosure*, 6 BYU L. REV. 1767, 1798 (2017).

country tax authorities often face severe deficits in administrative capacity, as is the case for most African governments.<sup>122</sup> Capacity building approaches tend to frame development assistance programs as the solution to these capacity weaknesses.<sup>123</sup> The OECD has been particularly active in supporting capacity building programs, even as it limits developing countries' power in international tax negotiations.<sup>124</sup> A number of developing country governments have also initiated their own reforms aimed at improving the capacities of tax authorities.<sup>125</sup>

Although capacity building is an essential piece of improving revenue collection, different tax frameworks demand different levels of administrative capacity. Proponents of capacity building correctly note that there is a gap between African tax authorities' administrative capabilities and the complexity of the tax systems they administer, but both of these factors are fluid: Administrative capacity can be increased just as administrative complexity can be decreased. Section B demonstrates that a number of legal reforms could reduce the administrative complexity of African tax systems.

Simplifying tax administration can also be achieved more quickly than building capacity. Even supporters of capacity building note that decades of technical assistance are required to achieve sustainable increases in revenue collection.<sup>126</sup> In contrast, legal reforms that simplify tax administration can be quickly passed and implemented.<sup>127</sup> Capacity building faces another major challenge limiting its ability to quickly increase tax revenue: Companies may hire away tax authorities' best employees. If successful, capacity building gives government officials sophisticated technical skills and a strong understanding of international taxation. These skills are highly transferable between the public and private sectors, and just as they can be used to reduce profit shifting, they can be used to help companies outmaneuver tax authorities. As government officials develop these skills, they become more attractive employees to private sector companies that typically offer far higher salaries. Therefore, "capacity building in international taxation holds the risk that governments will end up subsidizing the private sector."<sup>128</sup>

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122. Saldivar, *supra* note 14, at 176.

123. See, e.g., *About*, TAX INSPECTORS WITHOUT BORDERS (last visited Sept. 14, 2021), <http://www.tiwb.org/about/>; *Building Capacity to Prevent Profit Shifting by Large Companies in Zambia*, OECD (2020), <https://www.oecd.org/tax/tax-global/building-capacity-to-prevent-profit-shifting-by-large-companies-in-zambia.pdf>; *Enhancing the Effectiveness of External Support in Building Tax Capacity in Developing Countries*, WORLD BANK (2016), <https://pubdocs.worldbank.org/en/858011469113510187/Enhancing-the-Effectiveness-of-External-Support-in-Building-Tax-Capacity.pdf>.

124. See Quiñones, *supra* note 120, at 170.

125. See, e.g., Wanyana Oguttu, *supra* note 9, at 20.

126. See, e.g., *Strengthening Tax Transparency to Combat Tax Evasion, Illicit Financial Flows and Profit Shifting in Uganda*, OECD 7 (2021), <https://www.oecd.org/tax/tax-global/strengthening-tax-transparency-to-combat-tax-evasion-illicit-financial-flows-and-profit-shifting-in-uganda.pdf>.

127. However, it should be noted that in some cases governments face legal constraints limiting their ability to change tax rules affecting MNEs, particularly if their contracts with MNEs contain restrictive stabilization clauses.

128. *Capacity Building for International Taxation in African Revenue Authorities*, INT'L CTR. FOR TAX & DEV. (May 18, 2015), <https://www.ictd.ac/news/capacity-building-for-international-taxation-in-african-revenue-authorities>.

*ii. Simplification as a Goal*

Identifying simplification as a goal of international corporate tax law and policy can reduce profit shifting in ways that the BEPS reforms, increased transparency, and capacity building cannot. Tax simplification can be difficult to define.<sup>129</sup> When this Note calls for tax simplification, it emphasizes reducing administrative burdens and prioritizing clear standards and certainty of outcomes over flexibility and individualized assessment. This Note also stresses the importance of relaxing fidelity to the arm's length principle and the enormous complexities it produces.<sup>130</sup> Although rarely named as an explicit goal in efforts to reduce profit shifting, calls for tax simplification are not entirely novel in this domain.<sup>131</sup> In particular, Alexandra Readhead has written prolifically on taxation in the African extractive sector and has repeatedly called for reduced reliance on profit-based taxes and a move towards tax rules that suit African countries' administrative capabilities.<sup>132</sup> Tax simplification has received more attention in discussions of domestic tax systems. However, these calls are often framed in terms of reducing burdens on taxpayers and increasing the efficiency of the tax system, rather than focusing on how simplification affects total tax revenue and who pays it.<sup>133</sup>

Instead, tax simplification should be seen as a strategy to reduce systematic bias towards multinational corporations. Revenue collection is in many ways a competition: Tax authorities seek to maximize the amount of revenue they collect while MNEs seek to reduce their tax liabilities. But in this competition, MNEs can almost always afford to employ more players and players who are more skilled.<sup>134</sup> For example, Zambian tax authorities collect taxes from Glencore, a company with revenues nearly ten times greater than Zambia's GDP. And while capacity asymmetries between tax authorities and MNEs can be reduced, they are nearly impossible to overcome. As noted above, developing country governments will always struggle to offer salaries that are competitive with the private sector, increasing the ability of MNEs to hire away the most

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129. See J.B. Ruhl & Daniel Martin Katz, *Measuring, Monitoring, and Managing Legal Complexity*, 101 IOWA L. REV. 191 (2015).

130. See Van Apeldoorn, *supra* note 113, at 484.

131. See, e.g., Saldívar, *supra* note 14, at 72; Zachée Pougá Tinhaga, *From Avoiding Double Taxation 'Yesterday' to Avoiding Double Non-Taxation 'Today': The Urgent Need for an International Tax Regime Based on Unitary Tax Principles* 63 (2016) (S.J.D. dissertation, University of Michigan).

132. See, e.g., Lassourd & Readhead, *supra* note 5 (noting that "South Africa, Zambia, and Tanzania have decided that they do not have the resources to audit all of the transfer pricing practices of multinational companies. They have therefore tried to avoid getting into unwinnable battles by introducing clear, objectively verifiable and easy to administer tax rules, as well as strong government institutions to oversee the mining sector. Other mineral-rich countries should take note.").

133. See, e.g., Steven A. Dean, *More Cooperation, Less Uniformity: Tax Deharmonization and the Future of the International Tax Regime*, 84 TUL. L. REV. 125, 152 (2009); William G. Gale, *Tax Simplification: Issues and Options*, BROOKINGS INSTITUTION (July 17, 2001), <https://www.brookings.edu/testimonies/tax-simplification-issues-and-options>; Tamer Budak, Simon James & Adrian Sawyer, *The Complexity of Tax Simplification: Experiences from Around the World*, in THE COMPLEXITY OF TAX SIMPLIFICATION: EXPERIENCES FROM AROUND THE WORLD 1, 3 (Tamer Budak, Simon James & Adrian Sawyer eds., 2016).

134. See Pougá Tinhaga, *supra* note 131, at 157.

skilled tax officials.<sup>135</sup> The complexity of the global tax system poses immense problems even to OECD countries: As the Africa Progress Panel notes, “tracking value-added through a maze of interconnected companies linked through shell companies, holding companies and other intermediaries registered in centers from the British Virgin Islands to Switzerland and London is challenging for even the most developed tax bodies in the OECD.”<sup>136</sup>

Complex tax systems produce opportunities for MNEs to outmaneuver tax authorities, and the systematic bias in favor of corporations only grows as capacity gaps between MNEs and tax authorities increase. Large and well-trained corporate tax departments have more time to identify loopholes in complex tax codes than under-resourced tax authorities have to design complex technical fixes to close them. Complex tax codes increase the cost and difficulty of conducting audits and litigating disputes, reducing the likelihood that under-resourced tax authorities will initiate those audits and disputes. And if they do bring these disputes, MNEs are able to afford highly skilled accountants and lawyers to contest them.

Tax simplification will not always be worth the potential cost to other policy goals, but it is an important goal that can reduce profit shifting and increase revenue collection. Tax simplification is often seen as standing in tension to progressivity, and it is true that measures to increase progressivity by creating differentiated rules for different types of taxpayers make the tax system more complex.<sup>137</sup> The relationship is not entirely straightforward, however: The wealthy are far more able than the poor to exploit complexity to avoid taxes.<sup>138</sup> Therefore, while progressivity on paper sometimes translates to progressivity in practice, that will not always be the case, because complex provisions aimed at achieving progressivity may in fact result in tax avoidance by large companies.

In addition, governments may fear that tax simplification could deter investment. Complex tax codes allow for greater nuance for MNEs' individual circumstances, while tax simplification will subject them to more rigid standards. Given the volatility of investments in the extractive sector, extractive MNEs are particularly insistent on the importance of flexible, profit-based tax systems. However, generous tax regimes have been less effective at attracting investment than many countries anticipated,<sup>139</sup> and making the tax environment less favorable to MNEs will not produce dramatic decreases in investment. Further, the purpose of encouraging foreign investment is to produce benefits to countries' citizens: If MNEs are delivering far less tax revenue than intended,

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135. See Saldivar, *supra* note 14, at 177.

136. AFR. PROGRESS PANEL, *supra* note 15, at 65.

137. See, e.g., Budak et al., *supra* note 133, at 3.

138. See Kristina Froberg & Attiya Waris, *Bringing the Billions Back: How Africa and Europe Can End Illicit Capital Flight*, GLOBAL STUDIES 19 (2011), <https://www.hrdi.org.za/publications/iv%20Forum%20Syd%20Report.%20Bringing%20the%20billions%20back.pdf>.

139. *Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment*, OECD 3 (Oct. 15, 2015), <https://www.oecd.org/tax/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment.pdf> (“Tax incentives generally rank low in investment climate surveys in low-income countries, and there are many examples in which they are reported to be redundant—that is, investment would have been undertaken even without them.”).

countries should question whether decreased investment would really be so costly.

*B. Reforms to Achieve Simplification in the African Extractive Sector*

This section presents domestic reforms that could be achieved unilaterally and would both simplify tax administration and increase revenue collection. Increased use of royalties can reduce the reliance on CIT; capping interest deductions and fees for intangibles can reduce profit shifting; using price benchmarks would limit abusive transfer pricing; tax authorities can implement safe harbors; and African governments can reassess the types of agreements they sign with companies and foreign countries. While tax simplification offers promising opportunities to all tax authorities, it is particularly well-suited to addressing the causes of profit shifting in the African extractive sector.

First, the nature of extractive industries facilitates tax simplification.<sup>140</sup> Natural resources are a tangible asset that can be objectively measured. They also have a fixed geographic location, enabling the imposition of clear criteria that limit companies' ability to allocate profits to foreign jurisdictions. Further, natural resources are widely traded on public markets, meaning that the market price is easily ascertainable.

Second, tax simplification creates tax rules that are much better aligned with the capacities of African tax authorities. To be sure, there is significant variability in the training and resources available to different African tax authorities.<sup>141</sup> However, African governments tend to be under-trained and under-resourced, particularly in comparison to the MNEs from which they collect revenue. As described in Part II.B, African governments send few requests for information, conduct few transfer pricing audits, and struggle to litigate disputes. The reforms described below would greatly reduce the administrative complexity of African tax systems. Instead of needing to conduct difficult individualized assessments in order to identify profit shifting, tax simplification would increase the use of clear and easily verifiable standards. Relying on standardized tax treaties and contracts—rather than entering open-ended and highly individualized negotiations—could also reduce the risk that African governments will be outmaneuvered by better-trained negotiators. By reducing the complexity of African tax systems, these reforms would level the playing field between African tax authorities and MNEs seeking to avoid taxation.

Third, tax simplification would reduce the likelihood of corruption. Complex tax codes create ample discretion, flexibility, and ambiguity, all of which can be exploited by corrupt officials. And the extreme complexity and lack of transparency in the existing tax system is “all but impossible for the public to monitor or understand.”<sup>142</sup> The more rigid and easily verifiable standards that tax simplification would impose would limit officials' ability to

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140. See Danso et al., *supra* note 80, at 6.

141. See Wanyana Oguttu, *supra* note 9, at 19.

142. Christians, *supra* note 115, at 6.

engage in corruption. Moreover, tax simplification would increase the ability of supervisors, members of parliament, and civil society organizations to identify corruption.<sup>143</sup> In a 2015 cross-country statistical analysis, Awasthi and Bayraktar found that tax simplification significantly reduced tax corruption, with the effects particularly strong in Sub-Saharan Africa.<sup>144</sup>

Fourth, levels of profit shifting vary significantly among forms of revenue collection in the African extractive sector, and tax simplification would reduce governments' reliance on methods that are vulnerable to profit shifting. Profit-based methods of revenue collection are inherently more complex than production-based methods: Rather than just considering revenue or raw production, profit-based methods also must consider costs. These costs can be easily manipulated to shift profits. Unsurprisingly, African governments are far more successful at collecting revenue from production-based methods,<sup>145</sup> and a strategy aimed at simplification could reduce reliance on profit-based taxes. Further, tax rules that strictly adhere to the arm's length principle demand complex comparability analyses. Tax simplification would increase the use of rules that are less administratively burdensome.

Fifth, the African extractive sector remains ripe for reform despite the forthcoming OECD-led global tax reforms. These global changes will render some popular ideas for domestic reforms redundant, and they have also crowded out alternative proposals for ambitious international tax reforms.<sup>146</sup> But as discussed in Part I.C, the OECD-led reforms will leave significant amounts of profit shifting in the African extractive sector untouched. And after having played a minimal role in the negotiations for the OECD reforms, African governments may be eager to undertake reforms that fit their needs. The reforms below are aimed at African countries with large natural resource endowments and low administrative capacities. They will not be well-suited to every African country,<sup>147</sup> though the underlying motivation of using tax simplification to reduce profit shifting deserves broader consideration.

### *i. Royalties*

Although CIT will remain an important part of revenue collection, African governments can consider increasing their use of royalties. As discussed in Part II, royalties have far lower rates than CIT and are intended to deliver much less revenue to governments. But because CIT is based on profits while royalties are based on companies' revenues, CIT is easier to evade and resource-rich countries tend to end up receiving a disproportionately large share of tax revenue from

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143. See generally Readhead, *supra* note 30.

144. Rajul Awasthi & Nihal Bayraktar, *Can Tax Simplification Help Lower Tax Corruption?*, 5 EURASIAN ECON. REV. 297, 299 (2015), <https://link.springer.com/content/pdf/10.1007/s40822-015-0014-9.pdf>.

145. See Manley & Lassourd, *supra* note 86.

146. See, e.g., TAX JUST. NETWORK, *supra* note 72, at 9.

147. See Annet Wanyana Oguttu, *Tax Base Erosion and Profit Shifting in Africa – Part 2: A Critique of Some Priority OECD Actions from an African Perspective*, INT'L CTR. FOR TAX & DEV. 3 (2016).

royalties.<sup>148</sup> A number of African countries have recognized that royalties are more easily administrable, and the Democratic Republic of the Congo, Senegal, Sierra Leone, and Tanzania all increased royalty rates between 2016 and 2018.<sup>149</sup>

Governments can consider implementing more flexible royalty systems that account for royalties' shortcomings, but they should be mindful that adding layers of complexity to royalties will increase the potential for profit shifting.<sup>150</sup> Royalties create real challenges: Mining profits vary significantly over the lifecycle of a project, and royalties can be more difficult to pay in the early stages of a project before the investment becomes profitable. Standard royalties also do not adjust well to fluctuations in commodity prices,<sup>151</sup> and royalties can be regressive.<sup>152</sup> Royalties with sliding scale rates can increase flexibility and progressivity. For example, in 2019, Zambia implemented a royalty in which the rate increases when mineral prices are high.<sup>153</sup> South Africa and Niger use royalties that take operating profit into account.<sup>154</sup> Sliding scale rates that are based on an easily verifiable factor external to the MNE—like the commodity's market price—will be simpler to administer and less vulnerable to profit shifting than profit-based rates.

#### ii. *Limits on Interest Deductions and Intangible Fees*

For CIT, countries can set limits in order to prevent excessive debt shifting or excessive charges for intangible assets. South Africa was among the first countries in the world to set a limit on the deduction of interest payments to related parties abroad. Rather than using the highly time-intensive process of analyzing loans to see if they possess commercial rationality, South Africa disallowed the deduction of interest payments exceeding forty percent of turnover.<sup>155</sup> The OECD has also endorsed caps on interest deductions in BEPS Action 4.<sup>156</sup> As another means of limiting debt shifting, several African countries have instituted a withholding tax on interest payments. For interest payments to

148. See Manley & Lassourd, *supra* note 86.

149. Bouterige, Quatrebarbes & Laporte, *supra* note 54, at 6.

150. See Alexandra Readhead, *Tax Incentives in Mining: Minimising Risks to Revenue*, OECD 15 (2018), <https://www.oecd.org/tax/beps/tax-incentives-in-mining-minimising-risks-to-revenue-oecd-igf.pdf>.

151. See, e.g., Manley & Lassourd, *supra* note 86 (“But fixed ad valorem royalties lack flexibility: they do not adjust well to the profile of mining investments, nor to booms and busts. They may cause interruptions in mining activity, or require frequent regulatory changes.”)

152. *Fiscal Regime Design: What Revenues the Government Will be Entitled to Collect*, NAT. RES. GOVERNANCE INST. (2015), [https://resourcegovernance.org/sites/default/files/nrgi\\_Fiscal-Regime-Design.pdf](https://resourcegovernance.org/sites/default/files/nrgi_Fiscal-Regime-Design.pdf) (“Most royalties are regressive, because they result in a greater burden for companies in a lower-profit context.”).

153. See Chris Mfula, *Zambia Hikes Mining Taxes in 2019 Budget to Rein in Debt*, REUTERS (Sept. 28, 2018), <https://www.reuters.com/article/zambia-budget/update-3-zambia-hikes-mining-taxes-in-2019-budget-to-rein-in-debt-idUSL8N1WE5RK>.

154. See Manley & Lassourd, *supra* note 86.

155. Alexandra Readhead, *Preventing Base Erosion: South Africa's Interest Limitation Rules*, NAT. RES. GOVERNANCE INST., 5 (2017), <https://www.resourcegovernance.org/sites/default/files/documents/preventing-base-erosion-south-africa-limitation-rule.pdf>. (“A major purpose of interest limitation rules is to reduce reliance on the arm's length principle as a means of controlling the interest rate for related party debt.”).

156. OECD, *supra* note 112.

non-residents, Uganda, South Africa, and Ghana institute withholding taxes of fifteen percent, fifteen percent, and eight percent, respectively.<sup>157</sup> Still, countries should be attentive to MNEs' abilities to shift the costs of withholding taxes to domestic companies.<sup>158</sup> Other options to simplify tax administration and limit debt shifting include benchmarking interest rates to international rates and adding a margin to reflect their country's degree of risk, or alternatively tying the interest rate attributed to subsidiaries to the interest rates of the consolidated MNE.<sup>159</sup> Thin capitalization rules provide another option. Ghana and Uganda apply thin capitalization rules to resident companies that are majority foreign-owned. When the ratio of foreign debt to foreign equity is greater than two to one, Uganda restricts interest deductibility during that year on the part of the debt exceeding the ratio,<sup>160</sup> while Ghana uses a ratio of three to one.<sup>161</sup> To ensure these thin capitalization rules are effective and administrable, countries need to clearly define the difference between interest and equity.<sup>162</sup>

While limiting interest deductions and debt-to-equity ratios can have a significant impact on addressing debt shifting, intangible assets are more difficult to control because there is a wider range of possible transactions to consider. Countries have applied methods such as capping management service charges, and they could take a similar approach and set limits on the permissible proportion of intellectual property fees in relation to revenue.<sup>163</sup> While setting benchmarks similar to market rates for all possible intangible transactions would be impossible, countries could consider setting benchmarks for the most common types of intangible transactions.

These hard limits to prevent debt shifting and the abuse of intangible assets may rule out rare instances in which legitimate business transactions exceed the limit, but this situation remains preferable to rampant abuse. Countries could consider a system in which companies could apply for waivers from these limits, but the issue of waivers again highlights the tension between flexibility and reducing profit shifting. The flexibility provided by waivers could prevent cases where simplified rules contradict other policy goals, but they would also increase opportunities for MNEs to find loopholes. Waivers would also increase the administrative burden on tax authorities, and MNE tax departments would have far more time and resources to file detailed waiver requests than tax authorities would have to carefully analyze them.

### *iii. The Sixth Method*

In order to avoid abusive transfer pricing, countries can benchmark commodity transfer prices to international market prices. Referred to as the "sixth method" due to its differences with the five standard methods of

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157. Wanyana Oguttu, *supra* note 147, at 11.

158. *Id.*

159. See Guj, Martin & Readhead, *supra* note 20, at 29.

160. Income Tax Act, Ch. 340, § 89 (1997) (Uganda).

161. Income Tax Act 896 § 33 (2015) (Ghana).

162. See Wanyana Oguttu, *supra* note 147, at 10.

163. See, e.g., Readhead, *supra* note 30, at 40.

calculating transfer prices, this approach is particularly well suited to commodities like minerals and oil because there are standardized and easily observable international prices. The sixth method originated in Latin America in the early 2000s and has slowly gained momentum.<sup>164</sup> Although few African countries use it, Zambia has instituted the sixth method by requiring all mineral sales to related parties to be calculated according to the price listed on the London Metals Exchange, the Metal Bulletin, or another approved metal exchange.<sup>165</sup> The sixth method arguably strays from the arm's length principle because it does not account for the individualized circumstances of a transaction beyond the internationally-traded commodity price.<sup>166</sup> However, given the difficulty of applying the arm's length principle—especially when African governments lack access to adequate data on comparable transactions—the sixth method is a far more administrable method and it still accounts for fluctuations in commodity prices.

Application of the sixth method can vary in several dimensions. First, due to commodity price fluctuations, countries must decide what date's reference price to apply to any particular transaction. Latin American countries provide varying models. Uruguay uses the reference price on the date a commodity was shipped,<sup>167</sup> while for crude oil exports Ecuador uses the monthly average.<sup>168</sup> Second, countries must determine the range of transactions to which the sixth method should be applied. Argentina limits the application of the sixth method to transactions with companies with no economic substance. However, Argentina has encountered large administrative barriers to proving a company lacks economic substance, and MNEs can also give minimal economic substance to their intermediaries in order to use transfer prices below a commodity's market price.<sup>169</sup> Brazil applies the sixth method to exports to entities that are related parties, in a low-tax jurisdiction, or benefit from different fiscal regimes.<sup>170</sup> However, due to financial secrecy and complex corporate arrangements, tax authorities frequently struggle to identify which entities are related parties.<sup>171</sup> As these ambiguities about economic substance and related parties highlight, adding additional criteria to the application of the sixth method risks undermining the simplicity that the sixth method is supposed to provide. Readhead argues that, “consequently, tax authorities should consider extending the sixth method to all mineral sales, whoever the buyer is.”<sup>172</sup>

Deductions and adjustments bring similar risks. While they provide greater

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164. See, e.g., *id.* at 10.

165. See *id.* at 16.

166. See Veronica Grondona, *Transfer Pricing: Concepts and Practices of the 'Sixth Method' in Transfer Pricing*, SOUTH CTR., 4 (2018), [https://www.southcentre.int/wp-content/uploads/2018/05/TCPB2\\_Transfer-Pricing-Concepts-and-Practices-of-the-%E2%80%98Sixth-Method%E2%80%99-in-Transfer-Pricing\\_EN.pdf](https://www.southcentre.int/wp-content/uploads/2018/05/TCPB2_Transfer-Pricing-Concepts-and-Practices-of-the-%E2%80%98Sixth-Method%E2%80%99-in-Transfer-Pricing_EN.pdf).

167. *Id.* at 4.

168. *Id.* at 5.

169. *Id.* at 9.

170. *Id.* at 6.

171. *Id.*

172. Alexandra Readhead, *Special Rules for Commodity Sales: Zambia's Use of the 'Sixth Method'*, NAT. RES. GOVERNANCE INST. 4 (2017).

nuance and flexibility, they decrease administrability and increase the potential for abuse. For example, Zambia allows companies to reduce the transfer price of low-quality ore to a level below a mineral's reference price. However, Zambia's tax authority lacks adequate facilities to test mineral ore and therefore struggles to verify the validity of these adjustments.<sup>173</sup> Still, if a transfer price exceeds the applicable reference price, it is standard practice to accept the price as submitted.

Last, countries must decide whether to apply reference prices as a standalone method of calculating transfer prices or as a variation of the comparable uncontrolled price (CUP) method, which requires greater comparability analysis and adherence to the arm's length principle.<sup>174</sup> Although Action 10 of the OECD BEPS Project has accepted the use of reference prices, it only endorses the use of reference prices if the commodity transaction in question is sufficiently comparable to the reference price, as determined by the CUP method.<sup>175</sup> The administrative burden required to complete the CUP comparability analysis significantly detracts from the simplicity the sixth method is supposed to provide.<sup>176</sup>

Although the sixth method does not eliminate all manipulation of transfer prices, countries that use it have experienced a reduction in profit shifting. Zambia's tax authority reports that not only does it deter companies from abusing transfer prices, the administrative simplicity it provides allows tax officials to devote scarce resource to other transfer pricing issues.<sup>177</sup> Moreover, Zambia has successfully litigated to enforce the sixth method, winning a \$13 million judgment against a subsidiary of Glencore for excessively deviating its copper transfer prices from the London Metal Exchange price.<sup>178</sup> Although Argentina's use of the sixth method has reduced transfer pricing abuse, it still experiences an average of ten percent undervaluation of soybean exports.<sup>179</sup> These challenges may be due to the complexity of administering Argentina's economic substance criteria.

#### *iv. Safe Harbors*

Safe harbors—in which tax submissions are accepted provided they fall within a certain range of standards—can similarly reduce administrative complexity. Safe harbors can differ in several dimensions. They can focus on the price or terms of transactions by, for example, accepting transfer prices that fall within a certain margin of profits or losses. Alternatively, safe harbors can focus on the scale of transactions or taxpayers, exempting small enterprises or small transactions from transfer pricing requirements. Safe harbors can also loosen documentation requirements based on these standards.<sup>180</sup> These safe harbor

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173. *Id.* at 3.

174. *See* Grondona, *supra* note 166, at 4.

175. *See* Readhead, *supra* note 172, at 3.

176. *Id.*

177. *Id.* at 4.

178. *Zambia v. Mopani Copper Mines, Plc.*, Case No. 2017/24 [SC] (2020) (Zam.).

179. *See* Grondona, *supra* note 166, at 9.

180. *See* Ezenagu, *supra* note 24, at 14.

policies reduce the need to monitor low-risk enterprises and transactions, thus allowing tax authorities to devote administrative capacity to the most important potential sources of profit shifting.<sup>181</sup>

Safe harbor regimes are not without risks. Countries need to be sure the standards they set for safe harbors are effectively tailored to their national circumstances. An excessively narrow safe harbor will apply to few taxpayers, but a safe harbor that accepts a broader range of transfer prices could allow significant transfer price manipulation to go unchallenged because it falls within the safe harbor. MNEs may also find ways to take advantage of loopholes.<sup>182</sup> For example, if safe harbors exempt small transactions from additional tax requirements, companies may be able to divide up larger transactions in order to qualify for the exemptions. However, if well designed, safe harbor regimes can greatly reduce administrative burdens and replace complex individualized analysis of MNE taxpayers with a clear range of acceptable outcomes.

#### v. *Advance Pricing Agreements*

Like safe harbors, advance pricing agreements (APA) streamline tax administration but carry risks. In an APA, tax authorities and taxable entities agree on a method of calculating transfer prices for a fixed period. Provided that the taxpayer complies with the agreement, the tax authority agrees not to adjust transfer prices.<sup>183</sup> APAs reduce the burden for tax authorities once signed, but it is debatable whether they should be considered a form of tax simplification. The negotiation of APAs requires consideration of complex technical details and the individualized circumstances of the taxpayer.<sup>184</sup> As a result, many African countries have avoided APAs. Readhead writes that “this reluctance is largely due to concerns about being ‘outgunned’ in negotiations with sophisticated mining taxpayers.”<sup>185</sup> While the issue of inferior capacity and expertise compared to the entities from which tax authorities seek to collect tax is not unique to APAs, APAs could lock in bad terms for a number of years. The need to look far into the future only accentuates these capacity concerns, as MNEs are much more likely to have a good understanding of what an extractive project and the global market for the commodity will look like later in the term of the APA. If low-capacity African tax authorities seek to agree on APAs, sticking closely to a favorable template APA may help reduce these risks.

#### vi. *Double Taxation Agreements*

African governments should be hesitant to enter tax treaties that could possess unfavorable terms, and reliance on favorable model treaties can help simplify the double taxation agreement (DTA) negotiations they choose to

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181. *Id.* at 10-14.

182. *Id.* at 26.

183. *See, e.g.*, Readhead, *supra* note 30, at 17.

184. *See* Guj, Martin & Readhead, *supra* note 20, at 39.

185. *See, e.g.*, Readhead, *supra* note 30, at 17.

pursue.<sup>186</sup> Guj, Martin, and Readhead note that an increased number of DTAs increases the chance that an MNE will be able to “treaty shop” and route investment through a low-tax jurisdiction.<sup>187</sup> Reducing the number of tax treaties will not necessarily harm investment. The authors argue that “despite some claims that a broad tax treaty network is needed to attract investment, the empirical evidence on the effects of [foreign direct investment] is mixed,” and “exchange of information provisions can be accessed without entering into bilateral treaties.”<sup>188</sup> Almeida and Toledano also argue that because “most developed countries already include measures in their domestic legislation to alleviate the effects of double taxation, such as providing companies with a tax credit for taxes paid abroad . . . one could question the real need for implementing such treaties that have had deleterious impacts on the tax revenues for source States.”<sup>189</sup> African governments should be particularly hesitant to sign DTAs with low-tax jurisdictions. African countries’ DTAs with Mauritius often serve as an entry point for broader networks of treaty shopping, while “the IMF estimates that treaties with the Netherlands led to foregone revenue for developing countries of at least €770 million in 2011.”<sup>190</sup>

When African countries do negotiate tax treaties, they can refer to a set of standardized conditions to reduce the risk that they are being outmaneuvered by more skilled negotiators.<sup>191</sup> For this reason, the United Nations Economic Commission for Africa recommends the use of the African Tax Administration Forum’s model treaty.<sup>192</sup> Neither the U.N. Model DTA nor the OECD Model DTA are designed to meet the needs of resource-rich countries<sup>193</sup> but the U.N. Model is superior, offering as much as two times greater taxing power to the resource-rich source country than the OECD Model DTA.<sup>194</sup>

## CONCLUSION

The international tax system is extraordinarily complex. To determine an MNE’s tax liability, tax authorities typically must sort through mountains of documents and assess the legitimacy of reported data by comparing it to counterfactual transactions. The principal problem with this complexity is not that it is inefficient but that it produces biased outcomes. Greater capacity increases actors’ abilities to manipulate complexity to their advantage, and MNEs can almost always devote more resources and better-trained staff to

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186. See Luis M. Almeida & Perrine Toledano, *Understanding How the Various Definitions of Permanent Establishment Can Limit the Taxation Ability of Resource-rich Source Countries*, COLUM. CTR. ON SUSTAINABLE INV. 1 (2018).

187. Guj, Martin & Readhead, *supra* note 20, at 41.

188. The authors write that exchange of information provision “are available by entering into Taxation Information Exchange Agreements (TIEAs) or by becoming a signatory to the OECD multilateral treaty on mutual administrative assistance in tax matters.” *Id.*

189. Almeida & Toledano, *supra* note 186, at 4.

190. Wanyana Oguttu, *supra* note 147, at 15.

191. *Id.*

192. UNITED NATIONS ECONOMIC COMMISSION FOR AFRICA, *supra* note 97, at 42.

193. See Almeida & Toledano, *supra* note 186, at 1.

194. See Calderon Gomez, *supra* note 12, at 213.

avoiding taxes than governments can devote to collecting them. Simplifying international corporate tax rules reduces MNEs' ability to exploit this complexity. Simplification should not be the only goal of international corporate tax law and policy. Capacity building, increasing transparency, and the OECD-led tax reforms all bring benefits, despite their limitations. And tax systems seek to achieve a number of policy goals. Some of these goals can stand in tension with tax simplification, but for too long tax simplification has been overlooked as a goal that deserves similar attention.

This Note has focused on the African extractive sector, but simplifying international corporate tax rules could bring benefits in a wider range of settings. Many resource-rich countries outside of Africa also struggle to benefit from their natural wealth, and profit shifting hampers low-capacity countries in many sectors in addition to the extractive sector. Even tax authorities in wealthy countries experience extensive profit shifting and are often outmaneuvered by MNEs.

Discussions of international tax have tended to focus on wealthy countries, but this Note has shifted the focus. This Note has focused its analysis on African countries that tend to be among the countries that lose the greatest proportions of their revenue to profit shifting, have the greatest need for the missing revenue, and face the largest asymmetries between the capacities of their tax authorities and the MNEs from which they seek to collect revenue. From this angle, complexity's corporate bias is all the more apparent. The international tax system is in a moment of enormous flux, but it is hardly certain that these changes will meet the needs of African countries. There is far too much revenue flowing out of resource-rich African countries—and often into OECD countries—for them to pin all their hopes on an OECD process in which they hold a largely consultative role.<sup>195</sup> African countries should not hesitate to act.

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195. See Wanyana Oguttu, *supra* note 9, at 19.