

## If you want to know who's really keeping billions in po...

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I was [fascinated by an article in Businessdayonline](#), emanating from Nigeria, that hit my inbox this morning. It reported (and this issue is very important, so I trust they will forgive some lengthy quotes):

*Transfer pricing if well optimised could serve as a veritable instrument that could help Nigeria create strong economic value in terms of driving strong revenue growth for the government, by blocking all revenue leakage through offshore tax havens.*

*This was made known by Taiwo Oyedele, tax director/partner at PriceWaterhouseCoppers, at the company's monthly Tax Academy seminar organised for multinational companies and tax practioners.*

*According to Taiwo, this will only be achieved if potential and actual impacts on all relevant value drivers are known and optimised within the boundaries of external constraints such as fiscal and other legal regulations, like in the case of Uganda that has done well to make the best use of TP, as it helped grow the country's GDP by a significant 20 percent.*

That's a big claim. It's also technically wrong of course: that income was already Uganda's. It just wasn't recorded there.

It's important to put his motives in context. He said:

*"A lot of debate about tax and developing countries nowadays tends to focus on how to reduce revenue leakage through offshore tax havens. But there is another hot issue called transfer pricing which developing countries have to be mindful of, particularly if they want to avoid the risk of losing out on tax revenue from cross-border transactions carried out by multinational enterprises," according to Taiwo.*

I hope he is not claiming that the tax haven issue is not important. If so that would clearly be a mistake, and might also represent a conflict of interest: PwC are, after all, in every major tax in the world. Tax havens are also, almost invariably, the places to which transfer mispriced profits are relocated. He is therefore describing the flipside

of one issue and not two separate ones.

What he went on to say is, however, also interesting in the context of [India's recent complaints](#) about the wholly inappropriate nature of the OECD's transfer pricing guidelines in developing countries. Taiwo added:

*“developing nations need to instate modern transfer pricing legislation to increase tax revenues, and assistance offered to these countries must be targeted, in order to maximise effectiveness, based on their current state of legislation and tax infrastructure.” He explained that, “transfer pricing is an issue in International Taxation which has continued to befuddle both the taxpayer and the tax authorities. It is a valid business practice for associated companies in the pricing of inter-related sales within the group and on the other side of the divide; it creates a suspicion for the tax authorities that the pricing may be a form of profit shifting with the result of providing avenues for tax avoidance.”*

As a matter of fact transfer pricing will take place, day in day out, around the globe. It happens whenever two companies under common control trade with each other, whether within a country, or across national borders. It is an issue that needs regulation, of course. I would not dispute that, and PwC were right to point out that in the Nigerian context the issue is not helped by an absence of any clear transfer pricing regulations. That is a problem throughout much of Africa, and has led to a haemorrhaging of funds from that continent into tax havens, and on to multinational corporations based in the UK, USA and elsewhere.

But it is not enough for PwC to note that it is complicated to put proper OECD style transfer pricing regulation into place. If they were really doing their job properly on behalf of Nigeria they would be noting that, as India has stated, those regulations fail Nigeria, just as much as they do India. There are good economic reasons for saying this, and the most important by far is that the OECD's transfer pricing regulations supposedly ensure that proper prices are charged within multinational groups of companies and yet in doing so completely ignore the existence of that multinational group, which is, of course, absurd. That is because the arm's-length pricing model, on which the whole OECD principle of transfer pricing is based, assumes that there is a third party market in the goods or services that are transferred across international boundaries. In the vast majority of cases there aren't such third-party markets. In most cases the particular goods or services supplied only exist within the multinational group, and with the concentration of economic power in an increasingly small number of global companies, it is now possible that up to [60% of world trade, according to the OECD](#), is in fact undertaken on an intra-group basis, meaning that finding any relevant basis for comparison of intergroup prices with market prices is almost impossible. The OECD then simply suggest in most cases that a markup be applied to the sale of goods or services from a country like Nigeria, and this almost invariably understates the level of profit attributable to such a country because the markup allowed tends to be too low because that markup is meant to be a third party markup when there is in fact

supernormal profit released within the vertical supply chain that the transfer priced transaction is a part of. The OECD model captures none of that supernormal profit in Nigeria or any other developing country meaning that they will inevitably under record the profits that are due to them on the goods or services that they export.

This just has to be wrong. A model for intragroup pricing that ignores the existence of the group, and a model for intragroup pricing that ignores the supernormal profits that drive the existence of that enterprise has to be inappropriate as a basis for allocating tax on an international basis within multinational groups of companies. Surely that is glaringly obvious? No wonder this issue, as the OECD acknowledges, is so difficult when, by definition, the answer that their methodology produces will always, inherently, be flawed. And yet this is exactly what PWC suggested in Nigeria. The article says:

*The key principle of transfer pricing is based on the arm's length rule. This being that pricing terms between related party in the exchange of goods and services should achieve same result as if parties are unrelated. In other words, related parties must act as if they are unrelated. The essence of this requirement is that the quantum of profit which ordinarily should be subjected to domestic tax does not become a gain to another country to which profit is shifted.*

PWC are doing their very best to promote this flawed model in Africa and you have to wonder why, although the answer is not hard to find. The whole OECD transfer pricing process is extremely expensive to create and document, a fact that is well exploited by the Big 4 firms of accountants. This [promotion by Ernst & Young is typical of the breed](#) and I admit I have my doubts about what they mean by the term "effective". to put it bluntly, the OECD model of transfer pricing is a massive profit centre for those firms, including PWC. No wonder they are so keen on it. As they note in the article:

*Taiwo, went on to say, when [ a new Nigerian law on transfer pricing] becomes effective, any entity involved in any transactions with a related party whether a price is charged or not including: purchase of materials or finished products; sale of goods or procurement of services e.g. rep office, management and technical services etc; any agreement for the use of intellectual property e.g. trademark, royalty agreements etc.; a tripartite contract or subcontracting arrangement; intercompany loans, receivables or payables; guarantees indemnities, commitments or other obligations; transfer acquisition or lease of assets.*

Every single one of those will require suspensive documentation and analysis. You can hear PWC's cash register going "kerching" right now.

Please don't get me wrong: I want to control transfer pricing abuse. I have a chapter in a recent [World Bank book, 'Draining Development'](#), in which I suggest it is plausible that \$160 billion a year may be lost to developing countries as a result of transfer

mispricing. This is a massive issue. But the answer is not to use the arm's-length model, which is inherently flawed, costly to implement, almost impossible to audit, and which always leaves out of account the whole of the supernormal profit that multinational corporations can generate, all of which can then float off into tax havens.

The answer is, instead, to ensure that there is global accountability for the world's multinational corporations. [Country by country reporting would](#), of course, deliver this if required by an International Financial Reporting Standard, as it could be, but which the International Accounting Standards Board refuses to deliver because it says that transfer pricing issues must not be reflected in the accounts its regulations produce, even though, of course, inherently that must be true, making this a disingenuous statement on its part.

They are not the only ones to duck the issue of country by country reporting though; the OECD is also doing so. Only last week a report was presented to the OECD that said, I am told, that country by country reporting would not tackle this issue. That is just wrong, and may well have been influenced by PWC, who have put enormous effort into opposing country-by-country reporting and into proposing in its place their Total Tax Contribution, which is wholly unrelated to any form of accounting recognised by anyone but is a deliberately designed piece of manipulative political propaganda, [as I explain here](#) ( for the invention of which, incidentally, John Whiting got promoted to the Office of Tax Simplification in the UK).

[No wonder India is annoyed.](#)

With country by country reporting in place another basis of allocation of the profit of multinational companies is available. It would apply to all the profits, not the part that can be anchored into a particular location using the OECD rules, leaving much to roam free. That method of profit attribution would be unitary formula apportionment. Under this rule the profit is allocated very simply. One third of the profit is allocated on the basis of where the group's customers are. One third is allocated on the basis of where the group's staff are. One third is allocated on the basis of where the group's fixed assets are. You can't make a profit without customers, staff for infrastructure. It is always impossible to do so. That's why this system will work. Now I know that there are issues, such as ourselves to be recorded in their place of origin or in their place of destination and asked staff to be counted on the basis of a headcount or on the basis of total salaries paid, for example. These issues need to be resolved, and I would actually do it by spitting the relevant thirds into further halves so that one sixth of sales were used to allocate profit on the basis of the point of origin and one sixth on the point of destination, for example. Of course that's a compromise, but such is the nature of this whole exercise, let's not pretend otherwise. There may also need to be a formula for allocating part of profits to the place where the extraction of natural resources takes place or developing countries will lose: I admit that this is a component that has yet to be developed.

The point though is that this formula attributes the entire profit of multinational corporation to countries. That is coincidentally extraordinarily liberating. Individual countries can then decide for themselves what allowances they wish to give for capital expenditure. Individual countries can also decide for themselves what allowances they wish to give for research and development, and even what rate they wish to apply to their tax base, knowing that the tax base is itself secure from international challenge so long as the fundamental underlying economic drivers of allocation exist. In that case competition will be about securing employment in the place, securing capital investment in the place and in developing markets, which should of course be the basis on which any such activity is based, and not on the basis of regulatory and tax haven abuse, as it is undertaken now.

But there is a downside to this obvious form of tax justice, and that is that the Big 4 firms of accountants will lose out, badly. No wonder they are working so hard to defeat country by country reporting and are working so hard to oppress developing countries by keeping the OECD's arm's length pricing model of transfer pricing in place.

As a consequence I do, however, make an explicit allegation: those Big 4 firms are deliberately ensuring that tax is not paid in developing countries by promoting the systems that they espouse. As such they are all party to the poverty seen in those developing countries at this time. They are not only preventing, to the best of their ability, the proper allocation of profits into Africa, but the process of transfer pricing they promote will, as they all know, still encourage the transfer of profits into tax havens, [where all the Big 4 firms are heavily represented, as my research has shown](#). As such we have to recognise that there is a real chance that a very small number of partners in the Big 4 firms of accountants (and through them the International Accounting Standards Board and the tax committee of the OECD) are amongst the biggest obstacles to relieving poverty for literally billions of people around the world. It is an un-edifying thought, but I think it unavoidable as well.