

# Double taxation agreements: the way forward

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# Agenda

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- ▶ Overview of Double Tax Agreements ( DTAs)
- ▶ Current Treaty Landscape in Kenya
- ▶ Review of the effectiveness of the DTAs
- ▶ Conclusion

# Overview of DTAs



# The Purposes of DTAs

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- ▶ The main reason that States sign DTAs is to eliminate double taxation
- ▶ There are basically two types of double taxations that DTAs seek to eliminate
  - ▶ Economical double taxation
    - ▶ means the inclusion, by more than one state's tax administration, of the same income in the tax base when the income is in the hands of different taxpayers
  - ▶ Juridical Double Taxation
    - ▶ The imposition of income taxes in two (or more) states on the same taxpayer in respect of the same income

# The Purposes of DTAs (Cont'd)

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- ▶ Other reasons that motivate conclusion of DTAs
  - ▶ Allocating of taxing rights between States
  - ▶ Prevention of fiscal evasion and tax avoidance
  - ▶ Promotion of foreign direct investments ( FDI)

# Models of DTAs

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- ▶ There are 3 models for DTA including
  - ▶ The OECD Income and Capital Model Convention Model;
  - ▶ United Nations Model Double Taxation Convention between Developed and Developing Countries; and
  - ▶ US Model Income Tax Convention
- ▶ The OECD model is the most dominant method for drafting and negotiating tax treaties between States.
  - ▶ The model advocates for the residence taxation principle which is considered more favorable to developed countries.
- ▶ The UN Model emphasizes more on source based taxation which is more favorable to developing countries .

# Overview of DTAs:

## How double taxation is eliminated

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- ▶ DTAs typically eliminate double taxation through two major approaches
  - ▶ **The exemption method:**
    - ▶ The State of residence does not tax the income which according to the DTA may be taxed by the Source State or PE/Fixed Base
  - ▶ **The credit method:**
    - ▶ The State of residence calculates its tax basis of the taxpayer's total income including the income from the other State.
    - ▶ It then allows a deduction from its own tax for the tax paid in the other State

# Categories of DTAs

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- ▶ DTAs can be broadly classified into two categories:
  - ▶ **Limited treaties:**
    - ▶ deal with a specific type of income or subject matter for instance, most countries have signed treaties with respect to international air carriers and shipping companies whereby the destination principle is used to determine taxation
  - ▶ **Comprehensive treaties:** address most sources of income



# DTA Landscape in Kenya



# Kenya DTA Landscape:

## Kenya's process of treaty making

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- ▶ Process is governed by the Treaty Making and Ratification Act of 2012.
- ▶ The responsibility of initiating the treaty making process, negotiating and ratifying lies with the Executive but it can delegate the responsibility to the relevant state department.
- ▶ The Cabinet Secretary responsible for Foreign Affairs prescribes the manner in which a State department initiates and conducts a treaty making process.
- ▶ The treaty negotiation process is bound by the provisions of the Constitution of Kenya .
- ▶ Before a treaty is ratified it must receive the approval of the Cabinet and the National Assembly

# Kenya DTA Landscape:

## Benefits attributable to conclusion of DTAs

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- ▶ For a developing economy such as Kenya the need to attract FDI into the Country is one of the major motivating factors for conclusion of DTAs .
- ▶ DTAs motivate foreign investors by providing certainty on:
  - ▶ how the incomes/capital will be subject to taxation both in the source and resident country
  - ▶ Without suffering double taxation .
- ▶ Studies that have been conducted on the impact of tax treaties have on FDIs is inconclusive .
- ▶ Some studies even suggest that increased investments witnessed as a result of signing a tax treaty could be as a result of treaty shopping

# Kenya DTA Landscape:

## Kenya's trade partners

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- ▶ Kenya is the 106<sup>th</sup> largest export economy in the world and the 92<sup>nd</sup> most complex economy according to the Economic Complexity Index (ECI).
  - ▶ In 2014, Kenya exported \$5.96B and imported \$18B, resulting in a negative trade balance of \$12B
  - ▶ The top export destinations of Kenya are:
    - ▶ Zambia (\$741M), Tanzania (\$646M), Uganda (\$569M), the Netherlands (\$519M) and the United States of America (\$519M).
    - ▶ The top import origins are China (\$4.9B), India (\$4.39B), Japan (\$928M), Malaysia (\$739M) and South Africa (\$718M).

# Kenya DTA Landscape:

## Is tax a key factor in investment decision?

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- ▶ According to studies conducted by the UN and the IMF, tax is not among the top considerations for foreign investors setting up in developing countries.
  - ▶ Factors such as political stability, security, infrastructure and an educated work force take precedence over the tax implications
  - ▶ Is it possible that the conclusion and ratification of DTAs by developing countries does not always achieve the targeted result of attracting FDI ?

# Kenya DTA Landscape: Status of the various DTAs

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## ▶ In force:

- ▶ Zambia, UK, France, India, Denmark, Germany, Norway, South Africa, Sweden and Canada.

## ▶ Signed but not yet in force:

- ▶ Mauritius, Kuwait, Iran, Netherlands, Italy, UAE, Seychelles, Korea (Rep of), Nigeria, Qatar, Seychelles, Thailand,
- ▶ The EAC DTA - Kenya, Uganda, Tanzania, Burundi and Rwanda

## ▶ Under negotiations:

- ▶ Belgium, China, Egypt, Ghana, Israel, Malaysia, Pakistan, Sri Lanka

## ▶ Multi- lateral agreements:

- ▶ Kenya signed the [Multilateral Convention on Mutual Administrative Assistance in Tax Matters](#), 12<sup>th</sup> African country to sign the Convention and the 94<sup>th</sup> jurisdiction to join it.

# Kenya DTA Landscape:

## Source or residence skewed – important safeguards

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- ▶ Do these DTAs include provisions in favor of source taxation?
- ▶ Under domestic law:
  - ▶ outbound dividends and interest taxed at 10% and 15% respectively,
  - ▶ outbound royalties taxed at 20%,
  - ▶ technical service & management fees paid to non resident taxed at 20%
  - ▶ tax incentives available
- ▶ Key provisions included in Kenya DTAs:
  - ▶ article 5: threshold for building site: 6 months
  - ▶ article 7: no limited force of attraction rule
  - ▶ shared taxation for dividends, interest and royalties (reduced rates)
  - ▶ UN definition of royalties + taxation at source for technical fees (technical, managerial or consultancy service) → separate article

# Kenya DTA Landscape: Emerging Issues

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- ▶ Introduction of a Limitation of Benefit Rule .
  - ▶ The aim of the rule was to curb treaty shopping.
  - ▶ However the no guide lines have been forth coming on the its implementation.
  - ▶ It is also unclear if the Rule is applicable given that the existing DTAs do not provide for such a Rule
- ▶ Tax litigation related to DTAs
  - ▶ Tax Justice Network Africa (TJNA) in October 2014 sued the Cabinet Secretary (Treasury), Kenya Revenue Authority and the Attorney General challenging the constitutionality of the DTA between Kenya/Mauritius. The DTA has not come into effect as a result of the case



# Questions

