Tax treaties in corporate tax planning

Presentation by:

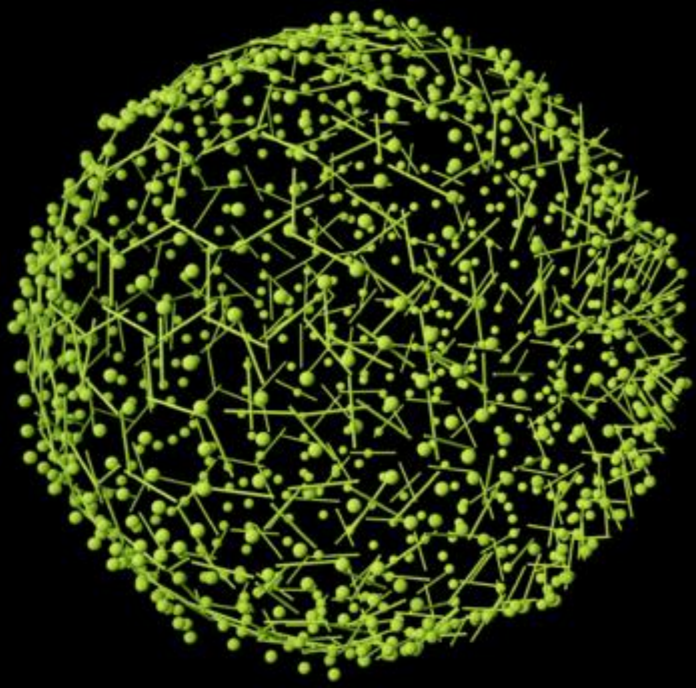
CPA Esther Wahome
Senior Manager Taxation Services
Deloitte & Touche

Thursday, 16 August 2018

Contents

- Introduction
- Summary of tax planning objectives and techniques
- DTA provisions and Tax planning strategies
- Case study
- Q&A

Introduction



Double taxation

- The imposition of tax on the same income by multiple jurisdictions.
- Two forms exist:
  - Economic double taxation – the taxation of the same income, ***in the hands of different taxpayers***, by multiple jurisdictions.
  - Juridical double taxation – the taxation of the same income, ***in the hands of the same taxpayer***, by multiple jurisdictions.
- Implications of double taxation
  - Discourages international trade;
  - Discourage foreign direct investment; and
  - Slows economic growth.
- Measures to avoid double taxation
  - Double Taxation Avoidance Agreements (DTAs)

Double Taxation Agreements

- Bi-lateral international treaties/agreements purposed at allocating taxation rights between multiple jurisdictions.
- What are the objectives of DTA's?
  - Eliminate double taxation
  - Encourage exchange of tax information
  - Promote foreign direct investment

14 DTAs since independence: France, Germany, India, Iran, Norway, South Africa, Sweden, United Kingdom, Zambia, United Arab Emirates, Qatar, South Korea, Denmark and Canada

DTA Authority

International Law

- **Vienna Convention on the Law of Treaties (VCLT)**

➢ **Article 2 –** Defines a treaty as an international agreement concluded between States and governed by international law.

➢ **Article 27:** Provides one cannot invoke internal law for failure to perform a treaty- Supremacy of the DTA's

DTA Authority

Domestic Legislation

- **Article 2 (6) Constitution of Kenya, 2010**

➢ Provides – 'Any treaty or convention ratified by Kenya shall form part of the Law of Kenya under this Constitution.

- **Treaty Making and Ratification Act, 2012**

➢ Domestic legislation implementing Article 2 (6) Constitution of Kenya, 2010.

➢ Provides the treaty entering, ratification and enforcement process.

- **Income Tax Act, 2014**

➢ Section 41 – seeks to implement DTAs in domestic legislation.

➢ Section 41 (5) – Limitation of Benefits clause.

Controversy – Domestic vs. International Law

- **Income Tax Act, 2014**
  - Section 41 (5) – Limitation of Benefits clause.
  - Seeks to limit the application of DTA in domestic legislation.
- **Hierarchy of Laws**
  - Per VCLT, international law trumps domestic law. Can the Income Tax Act limit the application of DTAs on the domestic level?
- **DTAs Post-2010**
  - Kenya India DTA – expressly note that DTA provisions may by limited through domestic legislation.
  - ***Sec 41 (5) -2014"benefit not to apply if fifty per cent or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other contracting state for the purposes of the agreement".***

Model DTA

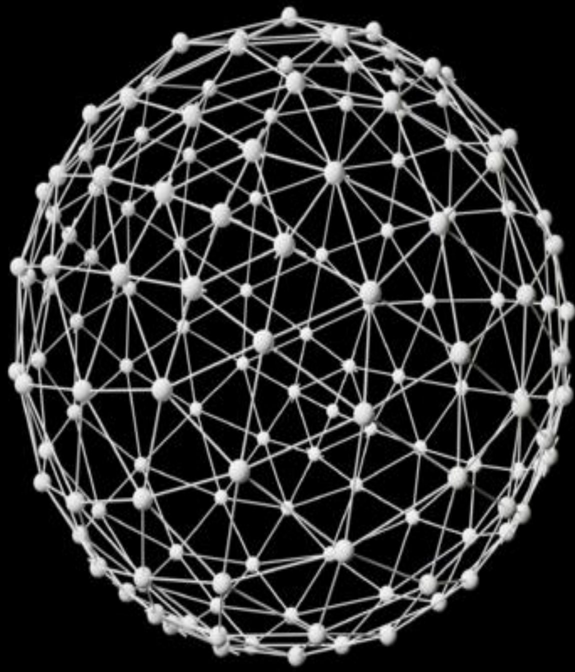
- States free to structure DTAs in ways that best captures their mutual interest.
- The DTA models available are:
  - ➢ OECD Model Tax Convention on Income and on Capital;
  - ➢ United Nations Model Double Taxation Convention between Developed and Developing Countries; and
  - ➢ US Model Income Tax Convention
- Should Kenya reconsider revising some DTAs?

Kenya DTAs-WHT rates

Payment	UK	Germany & Canada	Denmark, Norway, Sweden, Zambia	India	France	South Africa	South Korea	Qatar	United Arab Emirates and Iran	Iran*
Management or professional fees	12.5	15	20	10	**	**	**	**	**	**
Royalties	15	15	20	10	10	10	10	10	10	10
Dividends	10	10	10	10	10	10	10	10	5	5
Interest	15	15	15	10	12	10	12	10	10	10

****Management fees -** business profits?

Summary of tax planning objectives and techniques



Tax planning objectives

Every company strategy is to maximize shareholders value:

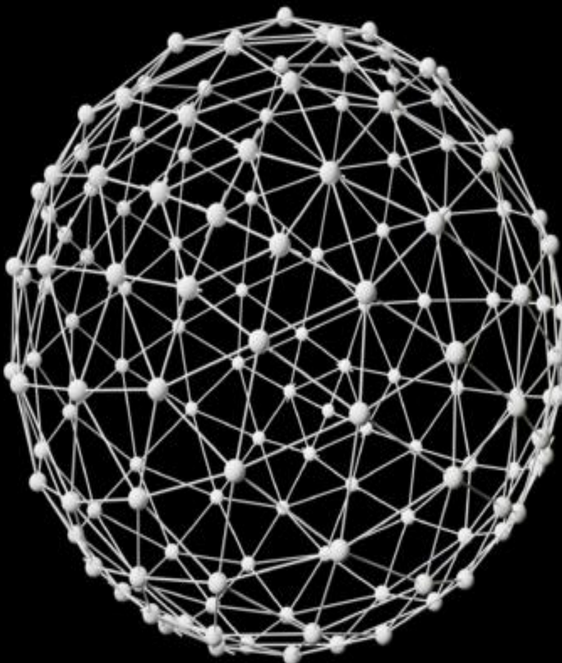
No/reduced tax in the state of investment	No/reduced tax on cross border profit migration	Reduce tax at the Ultimate parent
• No physical presence • Maximise deductible expense • Transfer pricing • Global Value chain structures	• No WHT on income payments • No Tax on transfer of profit drivers- restructuring by moving assets/risks	• Holding companies • Double Tax reliefs

Summary of tax planning techniques

- Key tax planning techniques and DTA provisions

	Note
Divert	Business restructuring/transfer of ownership of intellectual property- Functional and risk remuneration (routine functions- low return) Use of PE/Business profit provisions in the DTA: • *Commissionaires* • *Limited risk distributor* • *Warehousing*
Deduct	Double deduction of expenses, Non deduction of WHT and non inclusion as taxable income. Use of Low/no WHT in the DTA (Dividends, Management fees, Interest and Royalties)
Defer	Use of a holding company in a low tax jurisdiction or country with favourable treaty networks

DTA provisions and Tax planning strategies



DTA provisions

- Articles 1 and 2: Scope of the Convention
  - Persons covered
  - Taxes covered

This highlights the beneficiaries of the DTA, and taxes covered.

- Articles 3 to 5: Definitions
  - General definitions
  - Residency status
  - Permanent establishment

This defines specific terms utilised in the DTA.

- Articles 6 to 21: Taxation of income
  - Income from immovable property
  - Business profits
  - International shipping and air transport
  - Associated enterprises
  - Dividends
  - Interest
  - Royalties
  - Capital gains
  - Income from employment
  - Directors' fees
  - Entertainers and sportspersons
  - Pensions
  - Government service
  - Students
  - Other income

This provides the basis for taxation of the various income heads noted, as well as allocating taxation rights to the relevant State

- Article 22: Taxation of capital
  - Capital

This provides the basis for the taxation of capital.

DTA provisions

- Article 23: Methods for elimination of double taxation
  - Exemption method
  - Credit method

This provides the methods through which relief from double taxation can be sought.

- Articles 24 to 30: Special provisions
  - Non-discrimination
  - Mutual agreement procedure
  - Exchange of information
  - Assistance in the collection of taxes
  - Members of diplomatic missions and consular posts
  - Entitlement to benefits
  - Territorial extension

This provides for special concerns addressed by the DTA, such as exchange of information and non-discrimination provisions.

- Articles 31 and 32: Final provisions
  - Entry into force
  - Termination

This highlights the process required in order for the DTA to come into force as well as termination procedures

Key DTA provisions and tax planning strategies

Concept of residency- ***DTA applies to persons who are residents of both or one of the contracting state.***

DTA

"resident of a Contracting State"

means any person who, *under the laws of that State*, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature,-

Dual Residency

Individual

Permanent Home
Personal and economic relations
Habitual aboard
National
Authorities to agree

Other persons

Place of incorporation
Place of effective management
(***BoD, CEO, HQ, Law, Accounts*****)**
Authorities to agree

Key DTA provisions and tax planning strategies

Employment income- DTA Provision

- Employment income - taxable only in the residency state except remuneration derived from the other State.

- Remuneration derived in the other state is not taxable in that state if:

  – Present in that state for **less** than 183 days, and

  – the remuneration is paid by, or on behalf of, an employer who is **not** a resident of the other State, and

  – the remuneration is **not** borne by a permanent establishment which the employer has in the other State.

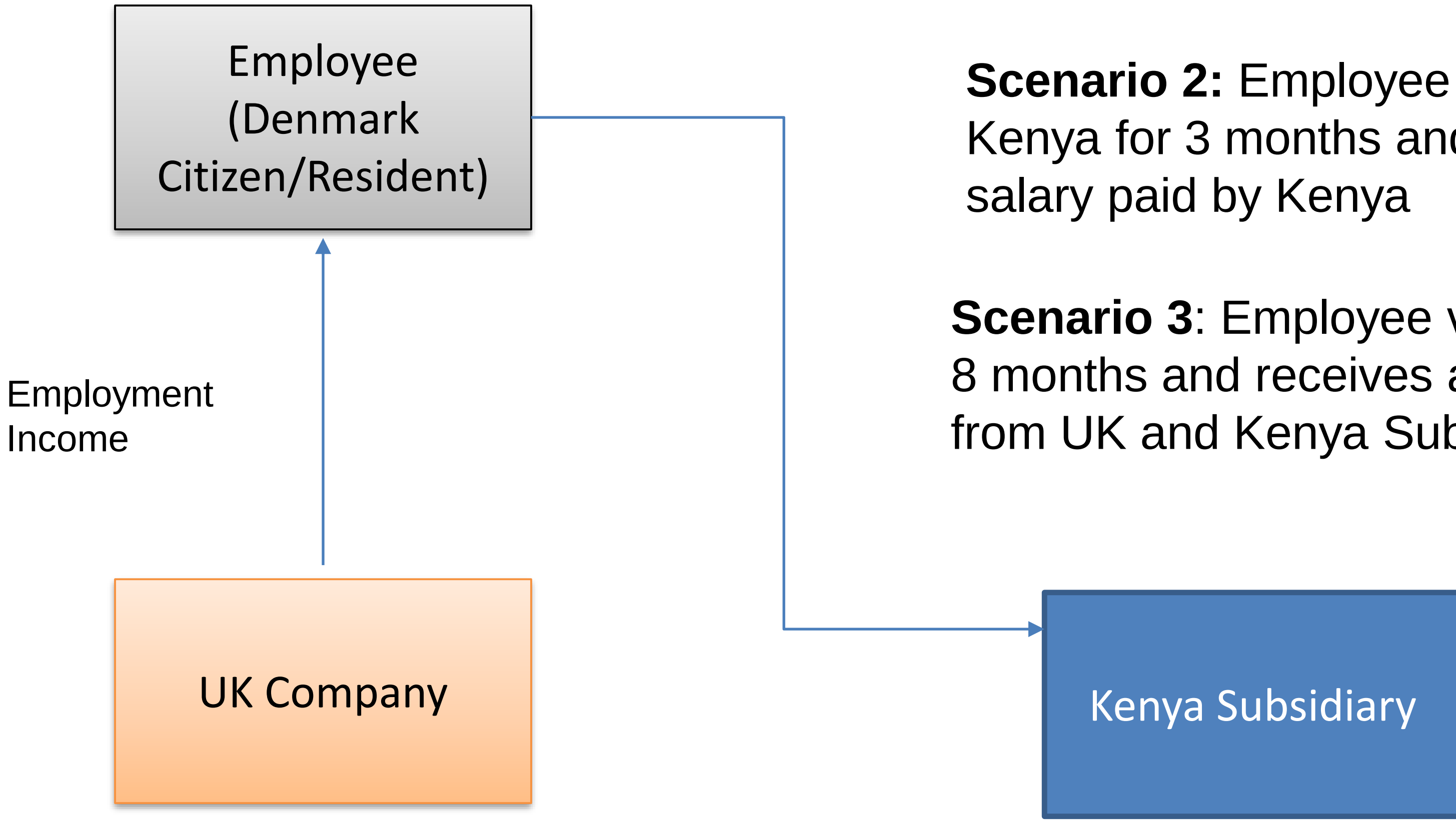
Key DTA provisions and tax planning strategies

Employment income

Scenario 1: Employee seconded to Kenya for 3 months and employee salary paid by UK

Scenario 2: Employee seconded to Kenya for 3 months and employee salary paid by Kenya

Scenario 3: Employee visits Kenya for 8 months and receives a salary portion from UK and Kenya Sub



Key DTA provisions and tax planning strategies

Employment income- Tax planning

- Period of stay in a given state- Limit to below 183 days;
- Employment contracts with non resident employer
- Remuneration paid by non resident.

Tax credits.

- Foreign tax credit deduction for citizens; and
- Tax credits under DTA- Such deduction, however, shall not exceed that part of the Kenya tax as computed before the deduction is given.

Key DTA provisions and tax planning strategies

Business profits- Article 7

- Profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other state through a Permanent establishment.

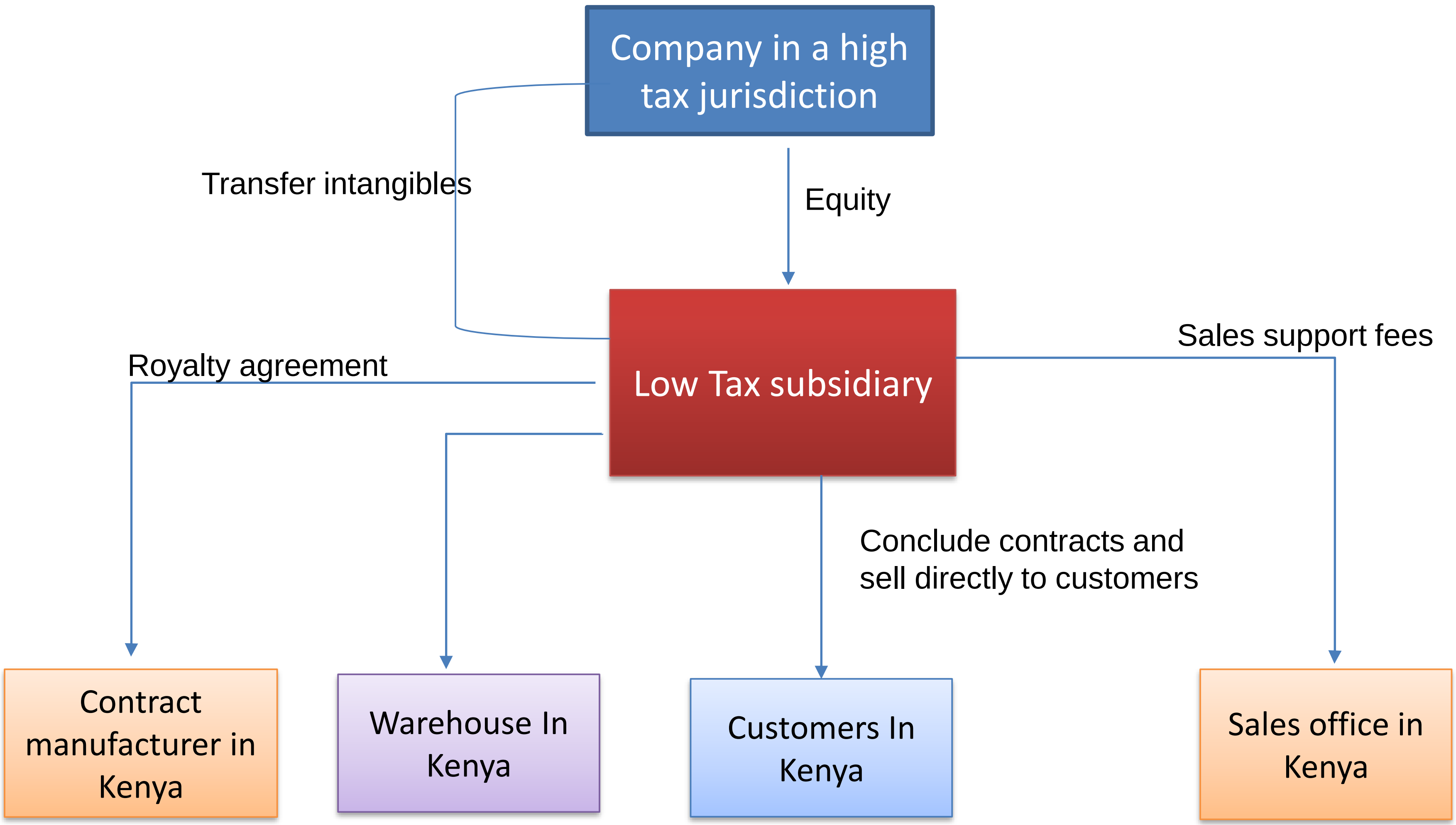
Provision	Tax planning
Only profits attributable to the PE are taxable.	Functions and risks allocation- Business modelling (Low risk distributors, Contract manufacturers, agency and commissionaire arrangements)
Accorded the same right as resident enterprises to deduct the trading expenses other than restrictions imposed on resident enterprises.	Recharge of costs- shared service Centre (SSC) location in a low tax jurisdiction or Jurisdiction with a wide network of DTA's.

Key DTA provisions and tax planning strategies

Permanent Establishment (PE)- Article 5

DTA Provision	Tax planning
PE -fixed place of business through which the business of an enterprise is wholly or partly carried on. A PE includes a building site, a construction, assembly or **installation**, project which exists for more than **twelve** months. Specific activity exemption and preparatory and auxiliary services	- Limiting period in a state (less than six months) - Commissionaire arrangements- contracts finalized or authorized abroad. - Split of contracts and fragmentation- warehousing, display and delivery; - Auxiliary and preparatory activities- Information gathering

Global Value Chain



Key DTA provisions and tax planning strategies

Management, Royalty fees and Interest expenses

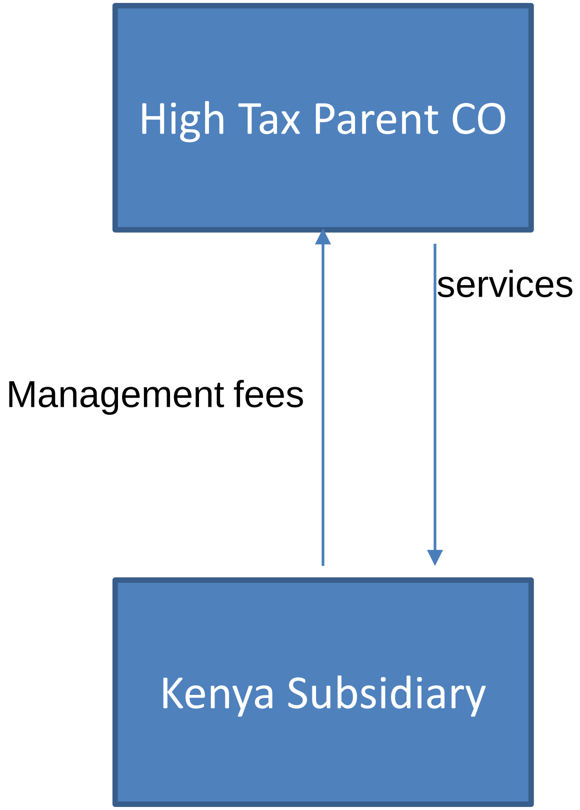
DTA Provision	Tax planning
▪ Taxed as business profits in the contracting state unless a PE is created in the other state. ▪ Allowable as an expense. ▪ Reduced withholding tax rate.	• Strategic management services- High value services centrally provided. • Concept of shared services in a low cost jurisdictions (India) • Thin capitalization planning- debt equity mix. • Transfer of intangibles

- **The taxation of services- Commentary to article 5 OECD (par 132):** *"The profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State are not taxable in the first-mentioned State if they are not attributable to a permanent establishment situated therein".*

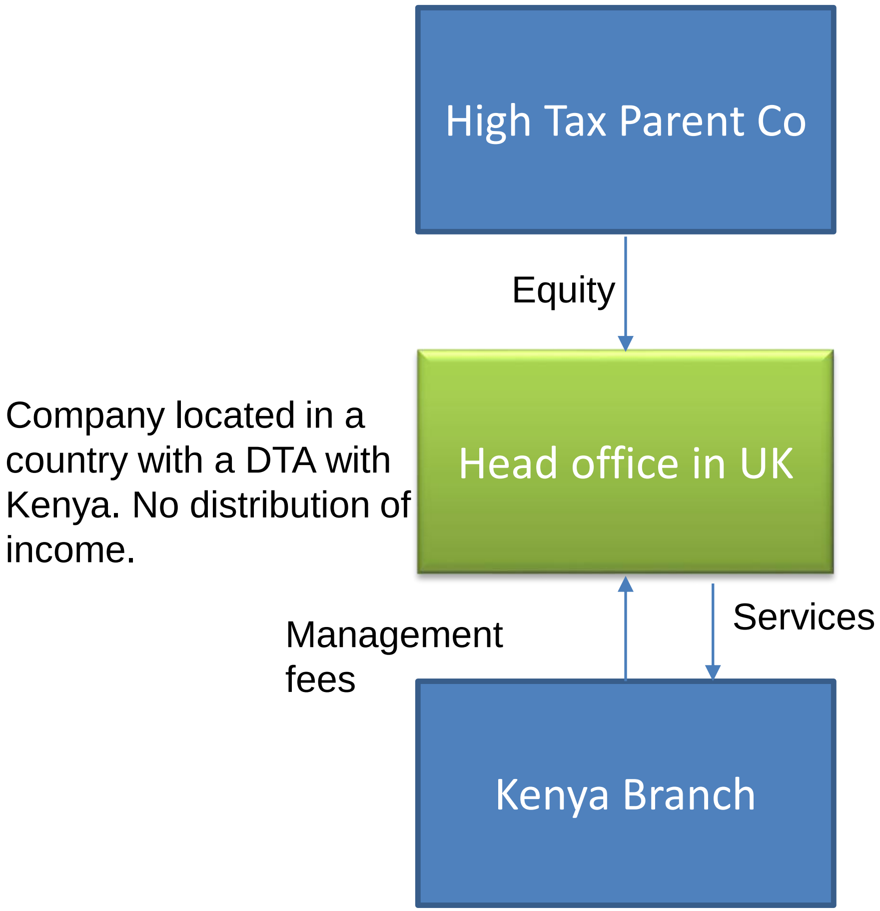
Key DTA provisions and tax planning strategies

Management fees

Scenario 1

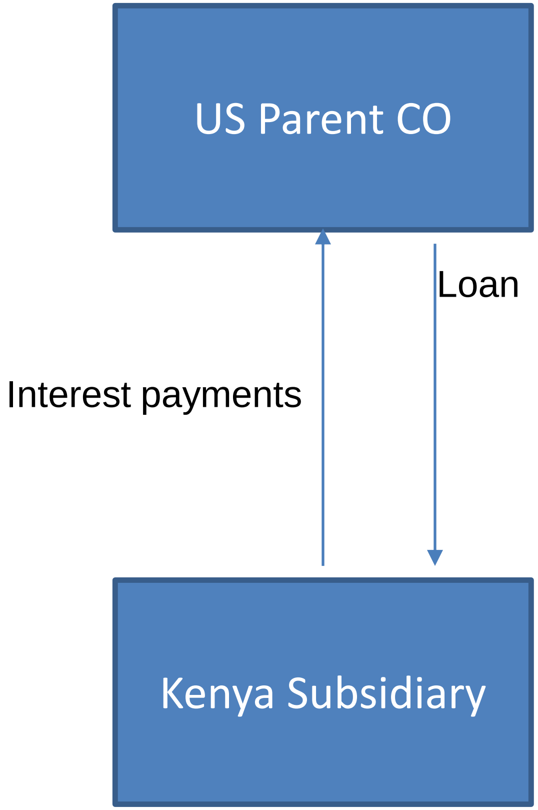


Scenario 2

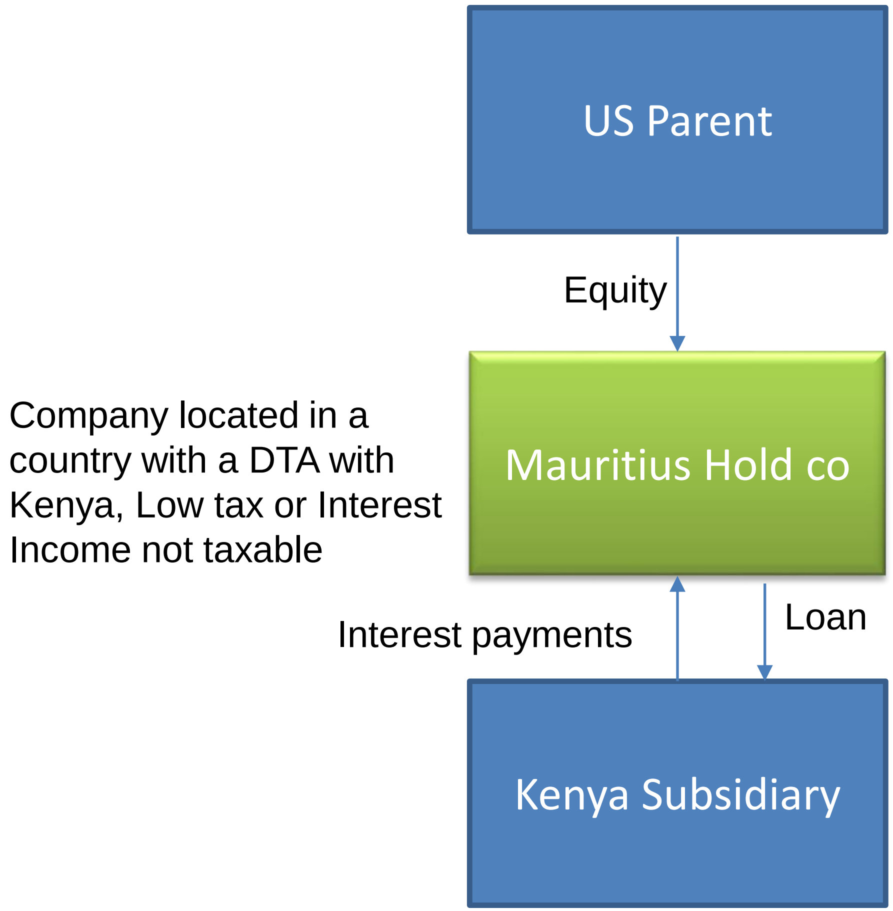


Interest Income- Debt financing

Scenario 1



Scenario 2

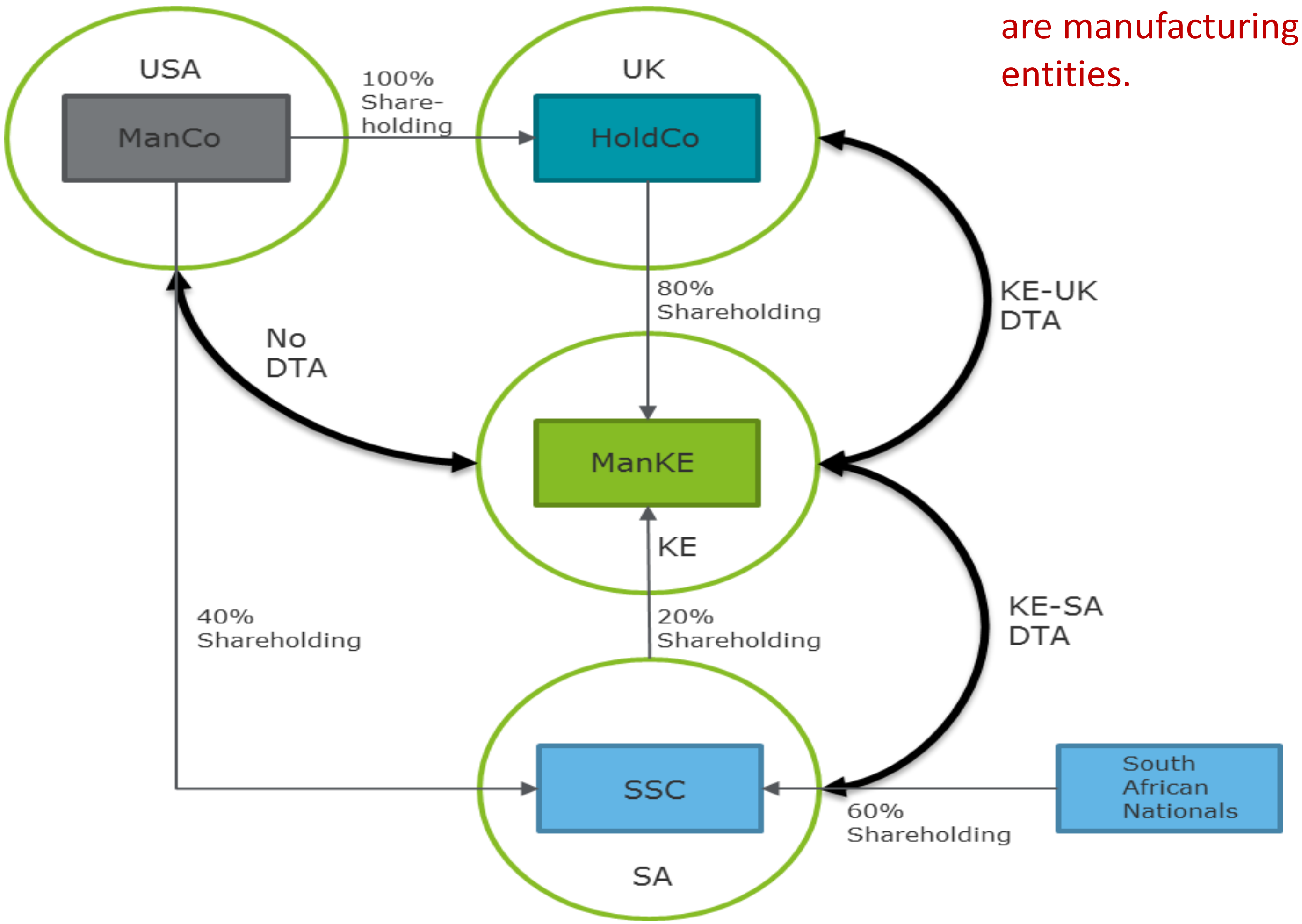


Case study

Case Study

The proposed organisational structure is set out below:

ManCo USA and ManKE are manufacturing entities.



Case Study

Applicable WHT rates are as follows:

	United Kingdom	South Africa	Non-Residents
Management and Professional fees	12.5%	Taxed as business profits	20%
Royalties	15%	10%	20%
Dividends	10%	10%	10%
Interest	15%	10%	15%

Analysis

•Discuss the possible tax planning opportunities based on the structure above and the tax implications for each.

•What are some of the issues that the revenue authority would raise on the tax planning strategy and what would be the defence.

•Assume that SSC SA is a branch of US ManCo and ManKE is a branch of UK hold Co. What key aspects of the tax planning would change and why.

Q & A

Contact details

Esther Wahome

Taxation Services | Deloitte & Touche
P O Box 40092, Muthangari, Waiyaki Way, Nairobi, 00100, Kenya
cmokaya@deloitte.co.ke | www.deloitte.com

Direct Line: +254 719 039 356