Double Taxation Agreements

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Outline

Revisiting the basics

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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)

Revisiting the basics

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

Revisiting the basics

WHT rates where Kenya has DTA

Payment	UK	Germany & Canada	Denmark, Norway, Sweden, Zambia	India	France	South Africa	South Korea	Qatar	United Arab Emirates and Iran	Mauritius*
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 or 10*
Interest	15	15	15	10	12	10	12	10	10	5

Kenya Mauritius DTA – the operation of the Kenya Mauritius DTA is arguable, my view it is not in force.

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

Revisiting the basics

WHT rates where Kenya has no DTA

Payment subject to WHT	Resident payee or Non-Resident with a Kenyan PE	Non-resident payee without a Kenyan PE
Management fee	5%	20%
Royalties	5%	20%
Leasing equipment	N/A	15%
Dividend	5%	10%
Interest from financial institutions and Government 2 year bearer bonds	15%	15%
Interest from bearer certificates	20%	25%
Housing bond interest	10%	15%
Rents	10%*	30%
Pension and taxable withdrawals from pension/provident funds	10% - 30%	5%
Insurance commissions: Agents Brokers	10% 5%	20% 20%
Contractual fees Consultancy and agency fees	3% 5%	20% 20%
Surplus Pension fund withdrawal/s	30%	30%

DTA authority

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**

➢ The supreme law of the land.

➢ 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.

DTA authority

Controversy – Domestic Legislation 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**

➢ Some post-2010 (Kenya India DTA) – expressly note that DTA provisions may by limited through domestic legislation.

  – ***Sec 41 (5) -2014"where an arrangement made under this section provides that income derived from Kenya is exempt or excluded from tax, or the application of the arrangement results in a reduction in the rate of Kenyan tax, the benefit of that exemption, exclusion, or reduction shall not be available to a person who, for the purposes of the arrangement, is a resident of the other contracting state 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 DTAs

Model DTAs

- 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
- Which model does Kenya adopt?
- Should Kenya reconsider revising some DTAs?

DTA format

- 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 format

- Article 23: Methods for elimination of double taxation
  - Exemption method
  - Credit method
- 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
- Articles 31 and 32: Final provisions
  - Entry into force
  - Termination

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

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

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

Focus on key DTA provisions

Permanent **Establishment- Article 5**

UN Model Tax Convention	OECD Model Tax Convention
A PE includes a building site or construction or assembly project or supervisory activities in connection therewith which exists for more than **six** months	A PE includes a building site, a construction, assembly or **installation**, project which exists for more than **twelve** months
Provides for ‘services permanent establishments, whereas furnishing of services, including consultancy services, **for a period or periods aggregating to more than 183 days (six months) within any 12 month period.**	No special provision covering services
‘Delivery’ does not form part of preparatory and auxiliary services.	‘Delivery’ is expressly listed as a function that constitutes part of preparatory and auxiliary services.

- **Key issues to note-Commentary to Article 5:**
  - ***Auxiliary nature or preparatory:*** *The Decisive criterion on activities being of a preparatory or auxiliary character is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. A fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity.*
  - ***Fixed place of business****: "Again the place of business may be situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise".*

Business profits

UN Model Tax Convention	OECD Model Tax Convention
Allows for the taxation of certain profits not attributable to the PE such as **sales of similar goods or merchandise** as well as **other business activities of the same or similar kind carried on by the enterprise in the source country**.	Only profits attributable to the PE are taxable.
There is a restriction on expenses/fees for the use of patents.	Accorded the same right as resident enterprises to deduct the trading expenses other than restrictions imposed on resident enterprises.

Other income

Items of income of a resident of a Contracting State, wherever arising, not dealt with in the DTA

UN Model Tax Convention	OECD Model Tax Convention
Provides for source country taxation of other income, as an exception to the general approach of allowing only residence country taxation of income not expressly dealt with in the underlying DTA	Maintains residence taxation of income not expressly dealt with in the underlying DTA.

- Article 21 (3) of the UN Model Tax Convention provides for source based taxation of other income. It gives states the right to tax other income where their domestic legislation provides for the taxation of that income.
- Kenya-UK DTA – Mainly based on the OECD Model. Grants UK favourable taxation rights at Kenya's expense- (e.g management fees for a PE, other income) VS
- Kenya-India DTA –Based on UN Model for some articles but revised some clauses in line with OECD Model. Attempts to balance taxation rights between the two entities (other income, deductibility of expense).
- ***Does management and professional fees form part of other items of income?***

Management and professional fees

UN Model Tax Convention	OECD Model Tax Convention
Covered under article 14	Covered under article 7 following the repeal of article 14
Taxable as Independent Personal Services in the contracting state unless: ➢ The independent person has a fixed base regularly available to him in the other State for the purpose of performing his activities; or ➢ Spends an aggregate of 183 days in a year in the other state	▪ Taxed as business profits in the contracting state unless a PE is created. ▪ Prior to its deletion only provided for taxation of professional income if the independent person has a fixed base regularly available to him in the other State for the purpose of performing his activities

- **Profit from services- Commentary to article 5 OECD:** *"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".*

Management/professional Fees

OECD Application

- Commentaries to the 2017 OECD Model Tax Conventional note *'The effect of the deletion of Article 14 is that **income derived from professional services** or other activities of an independent character **is now dealt with under Article 7 as business profits**.'*
- **Commentary to article 5:** *the profits from the sale of goods that are merely imported by a resident of a country and that are neither produced nor distributed through a permanent establishment in that country are not taxable therein and the same principle should apply in the case of services. The mere fact that the payer of the consideration for services is a resident of a State, or that such consideration is borne by a permanent establishment situated in that State or that the result of the services is used within the State does not constitute a sufficient nexus to warrant allocation of income taxing rights to that State.*

KRA's interpretation

- Where not expressly mentioned, management fees are taxable as other income.

Recent developments

Base erosion profit shifting

Base Erosion and Profit Shifting (BEPS)

- ***Tax avoidance*** strategies that ***exploit gaps*** and ***mismatches in tax rules*** to artificially shift profits to ***low or no-tax*** locations.

BEPS strategies – tax avoidance or tax evasion?

- Not necessarily illegal, but:
  - Undermine the fairness and integrity of tax systems.
  - Enable multinational enterprises (MNEs) gain a competitive edge over enterprises operating on a domestic level.

Domestic legislation on tax avoidance/evasion

- **Tax Procedures Act, 2015, Section 85** – introduces severe penalties (double the principal tax) should a tax payer be found engaging in tax avoidance schemes. Equal penalty for tax agent
- **Income Tax Act, 2014, Section 23** – empowers the commissioner to assess tax on transactions designed to avoid or reduce tax liability.

Base erosion profit shifting

BEPS Inclusive Framework

- Spearheaded by OECD in conjunction with G20.
- OECD has developed 15 standards Action Plans.
- Incorporated into the 2017 OECD Model Tax Convention.
- Four Action Plans directly affect DTAs:
  - Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements.
  - Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances.
  - Action 7: Preventing the Artificial Avoidance of PE status.
  - Action 14: Dispute resolution- Making Dispute resolution more effective

Base erosion profit shifting…cont'd

BEPS Action 2

Neutralizing the Effects of Hybrid Mismatch Arrangements

- Hybrid mismatch arrangements – arrangements that exploit differences in the tax treatment of instruments, entities or transfers between multiple jurisdictions.
- **Transparent entities-** Treated as income of a resident of contracting state subject to the same being taxed in that contracting state.
- **Dual residents-** Competent authorities to determine otherwise no tax relief or deduction.
- Aims to prevent double deduction (double non-taxation)- Exemption in both states or reduced tax rates.
- Refers to the interaction of domestic tax systems that may lead to income not being taxed anywhere.

Base erosion profit shifting…cont’d

BEPS Action 6 :Preventing the Granting of Treaty Benefits in Inappropriate Circumstances’

Treaty Abuse

- Refers to a tax avoidance mechanism purposed at taking advantage of tax relief offered by DTAs in multiple jurisdictions.
- BEPS Action 6 recommends that DTAs structured to prevent double taxation as well as double non-taxation (preamble clause).
- **Required preamble Clause** “Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions

Article 29, Entitlement to Benefits (Signing MLI): An entity qualifies to the entitlement to DTA benefits if they meet:

A principal purpose test rule: obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit .

Base erosion profit shifting…cont'd

BEPS Action 6 :Preventing the Granting of Treaty Benefits in Inappropriate Circumstances'

- **The limitation of benefits rule;-** Benefits to be limited to active conduct of a business which shall not include the following activities or any combination thereof:

  a) operating as a holding company;

  b) providing overall supervision or administration of a group of companies;

  c) providing group financing (including cash pooling); or

  d) making or managing investments, unless these activities are carried on by a bank, insurance

  – Shareholding percentage to also be introduced

Application of Section 41 (5) ITA

- What does that mean for other DTAs, is Section 41 applicable to them?
- OECD recommendations?

Base erosion profit shifting…cont'd

BEPS Action 7

Additional Guidance on Attribution of Profits to PEs

- Permanent establishments redefined with an objective to prevent artificial avoidance of PE status and PE threshold reduced.

Key issues:

- **Commissionaire arrangements:** Taxpayers replace subsidiaries that traditionally acted as distributors by commissionaire arrangements, with a resulting shift of profits out of the country where the sales took place without a substantive change in the functions performed in that country. On the basis on non binding contracts
  - ➢ If intended to result in conclusion, then PE.
- **Auxiliary or preparatory activities/character**: each of the exceptions included therein is restricted to activities that are otherwise of a "preparatory or auxiliary" character.
  - ➢ Not possible to avoid PE status by fragmenting a cohesive operating business into several small operations or splitting contracts in order to argue that each part is merely engaged in preparatory.

Base erosion profit shifting…cont'd

BEPS Action 14: Dispute resolution-Mutual Agreement Procedures

- MAPs are procedures that allow Competent Authorities from the governments of the Contracting States/Parties to interact with the intent to resolve international tax disputes.

- BEPS Action Plan aim to strengthen the effectiveness and efficiency of the MAP process-e.g effective and timely resolution of disputes

- MAPs provides an alternative for resolving tax disputes giving rise to double taxation. Issues resolved through MAPs:
  - ➢ Permanent establishment issues;
  - ➢ Characterisation and classification of income;
  - ➢ Residency of a taxpayer;
  - ➢ Applicability of specific withholding tax rates; and
  - ➢ Adjustments arising from transfer pricing assessments

Kenya India DTA revised

- The Kenya India DTA, initially concluded in 1985, was revised in 2016 and later ratified on 29 June 2017, with an effective date of 01 January 2018.
- The revised Kenya India DTA introduced a number of key changes, including:

Issue	Change
Residency	Introduces the 'Place of incorporation' as a determinant for residency.
Permanent establishment	Expands the definition of a PE to include **sales outlets** and **warehouses** providing storage facilities for others. Additionally, services companies including consultancy firms will be deemed to have a PE after an aggregate of 90 days.
Business profits	Gives the contracting parties the right to limit the allowability of executive and general administrative expenses through domestic legislation. Similarly, the revised DTA expressly disallows head office expenses (royalties, patents, commissions and interest).
Limitation of Benefits	Gives contracting parties the right to use domestic legislation to address tax avoidance and evasion issues.
DTA guaranteed WHT rates	Reduces the applicable WHT rates in relation to certain payments.

Q & A

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