Double Taxation Treaties and Treaty Shopping

Introduction

A Double Taxation Treaty (DTT) is an agreement of an international nature entered into between two states, with a view to protecting the residents of the two states from having their income taxed twice (double taxation). In international taxation, double taxation is said to occur when the same income is subjected to tax in more than one tax jurisdiction.

Double taxation occurs because of the bases on which income is subjected to tax in different states. Some states tax based largely on source jurisdiction, others residence jurisdiction and others both. In a few cases, tax is also based on citizenship. Source jurisdiction refers to the authority to tax income which has its source in a state irrespective of whether the person who has earned the income is a resident or not. On the other hand, residence jurisdiction is the authority of a state to tax income earned by resident persons without regard to the source of the income. In states where tax is based on citizenship, citizens are liable to declare income and pay tax on it even if the income has no relationship with the state other than the fact that the person who earned it is a citizen. Though Kenya seems inclined towards being a source jurisdiction, it has legislated in favour of both source and residence jurisdiction.

Section 5 of the Income Tax Act, for instance, provides that the employment income earned by a non-resident individual employed by a Kenyan employer is taxable in Kenya. The section further provides that a resident individual is taxable on employment income earned both in Kenya and outside Kenya. Section 8 provides that a pension received by a resident individual from a pension fund or pension scheme established outside Kenya is taxable in Kenya to the extent to which it relates to employment of the individual or the husband or parent of the individual, in Kenya. These are some of the provisions of the Income Tax Act that deem income derived from outside Kenya to be derived from Kenya.

From these provisions, it is easy to understand how the same income can be taxed by two states. Take the case of pension income for instance. The country in which the pension scheme or fund is established may tax the pension when it is paid. It is also taxed in Kenya. The pension income is therefore subjected to double taxation.

As early as the 1920s, the League of Nations took cognizance of the adverse effects of double taxation on international commerce and global growth. Its efforts contributed a great deal to the development of uniform model treaties.

Although DTTs are intended mainly to address double taxation of income, other taxes may also be covered. Towards avoidance of double taxation, they may provide for reduced tax rates and exemptions from tax for income earned in one contracting state by residents of the other contracting state and granting of relief in one state for tax paid on the other state. DTTs create other benefits as well. They provide for resolution of disputes arising between an investor of one contracting state and the revenue authority of the other contracting state.

Treaty shopping

It is a common practice for entities engaged in cross border activities to adopt corporate and operational structures that help mitigate taxes. A simple corporate structure may involve rerouting of profits to take advantage of DTTs. Take an example of 3 countries A, B and C. Country A has a DTT with Country C but not with Country B. Country B also has a DTT with Country C. All the countries charge withholding tax on dividends paid to non-resident persons. However, the DTTs in place provide for exemption of dividends from withholding tax if they are paid to a person resident in a contracting state. None of the countries taxes dividends received from companies resident in other states.

A person (Investor) is resident in Country A and owns a company (DCo) which carries on business in Country B. Whenever DCo distributes dividends, they are subjected to withholding tax. To avoid paying the withholding tax, Investor registers a company (HoldCo) in Country C and transfers his shares to it. HoldCo does not do any business in Country C; it is established for the sole purpose of exploiting the treaty benefits. Henceforth, DCo pays dividends to HoldCo and they are exempted from withholding tax because of the DTT between Country B and Country C. The dividends are not subject to any tax in Country C. HoldCo then pays dividends to Investor and they are not taxed because of the DTT between Country A and Country C.

This is just one simple example of how international business people can structure their businesses to take advantage of treaties that they would otherwise not benefit from. Arrangements can take many other forms.

This practice of establishing conduit entities to take advantage of treaty benefits is known as treaty shopping and is seen as a form of treaty abuse. Countries are increasingly frowning upon treaty shopping. Kenya is one of the countries that have taken steps to combat the practice. In 2014, Kenya enacted a provision which requires that for a company resident in a state with which Kenya has a DTT to get relief from double taxation, exemption from tax or reduced tax rates provided for in the DTT, more than 50% of its underlying ownership must be held by individuals who are resident in that state.

Effectively, only companies controlled by persons resident in the other contracting states can benefit from treaties. A person who is not resident cannot establish a conduit entity unless he is willing to cede more than 50% of his shares to residents. This would defeat the purpose of establishing the conduit company. The rule does not apply to companies listed in a securities exchange operating in the other contracting state. Thus, the law has still left room, albeit limited, for persons engaged in cross border activities to structure their corporate arrangements to take advantage of treaties that they would otherwise not benefit from.

Uganda, Kenya’s neighbour, has had an anti-treaty abuse provision in its income tax law since

2011. In 2016, the provision was amended. In its present form, it provides that except for a public listed company, where a DTT concluded by the Government of Uganda with another contracting state provides that income derived by a person resident in the other contracting state from sources in Uganda is exempt from Ugandan tax or is subject to a reduction in the rate of Ugandan tax, the benefit of that exemption or reduction is not be available to any person who:

i. receives the income in a capacity other than that of a beneficial owner and who does not have full and unrestricted ability to enjoy that income and to determine its future uses; and
ii. does not possess economic substance in the country of residence.

Interpreting the provision strictly, a resident of a contracting state who is not a public listed company cannot enjoy the benefit of reduced Ugandan tax rates or exemption from Ugandan tax under a DTT where the person meets both conditions (a) and (b) above. An entity that is a conduit entity would therefore not benefit from reduced tax rates and tax exemptions. An entity would not be caught by the provision if, for instance, it is able to create economic substance in the other contracting state even if it receives income in a capacity which is not that of a beneficial owner.

Tanzania also has an anti-treaty abuse provision. Under its Income Tax Act, where a DTT entered between Tanzania and another state provides for residents of the other state to enjoy reduction of Tanzanian tax rates or exemption from Tanzanian tax for income derived from Tanzania, such benefits are not available to an entity where 50 percent or more of the underlying ownership of the entity is held by persons who are not residents of the other contracting state. The provision is substantially similar to Kenya’s. Conduit entities are squarely caught by the provision.

Notably, just like the provision in the Kenyan Income Tax Act, the Ugandan and Tanzanian anti-abuse provisions do not apply where the entity is a public listed company. All the three Acts therefore leave some room for cross border structuring to take advantage of DTTs. Comparing the provisions of the three countries, Uganda’s provisions leave more room than

Kenya’s and Tanzania’s.

In conclusion, we note that it would be advisable for people looking to change their enterprise holding and operational structures with a view to taking advantage of DTT benefits to find out from a knowledgeable tax advisor, whether or not the intended structure would avail the desired benefits and if not, what modifications could be made to the structure.

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