Comments on the Agreement on Avoidance of Double Taxation Between the Government of the Republic of Kenya and the Government of Ireland

Table of Contents

1. Introduction

The Government of Kenya announced its intention to enter into a Double Taxation Agreement with the government of Ireland. It has thus requested comments on the treaty from members of the public. To this end the TJNA/EATGN has conducted an analysis of the draft treaty and presented it for consideration.

2. Rationale behind the ratification of tax treaties

Double tax treaties are agreements entered into between two jurisdictions with the aim of allocating taxing rights over income and capital between them in order to avoid double taxation. Overall they aim to increase trade between the two jurisdictions.

Although tax treaties between developing and developed countries have long been touted as a means of increasing Foreign Direct Investment (FDI) due to the elimination of double taxation, studies have shown that this fact is inconclusive. In any case, the same outcome can be achieved through the use of unilateral measures of tax relief. Kenya grants such unilateral tax relief under section 16(2) (c) of the Income Tax Act, Cap 470.

While the OECD makes the case that unilateral measures would not be best suited to eliminate double taxation where the source rules of two states are significantly different, [1] this would not affect Kenya as we generally only tax income accrued or derived in Kenya and obviates the need for the ratification of tax treaties. There are however a few instances when source income earned outside Kenya is subject to tax in Kenya. This includes:

i. Where a Kenyan resident earns employment income outside Kenya; and
ii. Where a Kenyan person receives business income from a business carried on partly in Kenya and partly outside Kenya.

Another reason for the opposition against the conclusion of double tax treaties with developed countries is the fact that tax treaties generally skew taxing rights in favour of residence state jurisdictions.[2] Given the reciprocal nature of DTA's, concessions made between two jurisdictions would balance each other out where capital flows between them were equal. This

[1] OECD Model Convention 2017
[2] Dauer, V., Krever, R. (2012). Choosing between the UN and OECD Tax Policy Models: An African Case Study. EUI Working Papers, RSCAS 2012/60. Robert Schuman Centre for 15 Advanced Studies, Global Governance Programme, European University Institute. http://cadmus.eui.eu/bitstream/handle/1814/24517/RSCAS_2012_60rev.pdf?sequence=3

however is not the case where tax treaties are ratified between developed and developing countries; the former are capital exporting nations while the latter are capital importing jurisdictions. As such, treaties that skew taxing rights in favour of residence states would thus disadvantage developing countries. [3]

Finally, it is also argued that tax treaties facilitate loss of revenue through aggressive tax avoidance by taxpayers through treaty shopping. This takes place where investors who are resident in a jurisdiction that does not have tax treaties with a jurisdiction route their investments through a state that does, in order to enjoy treaty benefits. As earlier indicated, DTAs generally will work where there is reciprocity. Such treaty shopping therefore results in significant revenue loss especially where tax treaties are ratified with low tax jurisdictions and tax havens. [4] To prevent foreign investors from claiming benefits to shift profits out of the country, several countries have recently terminated or renegotiated tax treaties with tax havens.[5] Kenya's proposal to ratify a tax treaties with Ireland which is a low tax jurisdictions, with its corporation tax rate being a mere 12.5% is definitely a questionable policy direction. The next section will deal with the tax landscape in Ireland and highlight reasons against investing in the jurisdiction.

3. Ireland tax landscape

Although Ireland's headline corporate tax rate is 12.5%, the effective tax rate is as low as 2-5% depending on the type of structure used. Significant profits are repatriated to Ireland to take

[3] See, e.g., Tsilly Dagan, The Tax Treaties Myth, 32 N.Y.U. J. Int'l L. & Pol. 939 (2000) at 941; Kim Brooks & Richard Krever, The Troubling Role of Tax Treaties, in Tax Design Issues Worldwide 159 (Geerten M. M. Michielse & Victor Thuronyi eds., 2015) at **162-63;** Victor Thuronyi, Tax Treaties and Developing Countries, in Tax Treaties: Building Bridges between Between Law and Economics (Michael Lang et al. eds., 2010) at 441-42; Reuven **S.** Avi-Yonah, Double Tax Treaties: An Introduction, in The Effect of Treaties on Foreign Direct Investment: Bilateral Investment Treaties, Double Taxation Treaties, and Investment Flows **99, 100-01** (Karl P. Sauvant and Lisa **E.** Sachs eds., **2009);** Kim Brooks **&** Richard Krever, The Troubling Role of Tax Treaties, in Tax Design Issues Worldwide **159** (Geerten M. M. Michielse **&** Victor Thuronyi eds., **2015);**

[4] Hong, S. (2017). Tax Treaties and Foreign Direct Investment: A Network Approach. Work Paper NTA, National Tax Association. https://www.ntanet.org/wpcontent/uploads/proceedings/2016/012-hong-tax-treaties-foreign-paper.pdf

[5] Martin Hearson, When Do Developing Countries Negotiate Away Their Corporate Tax Base?, **30 J.** Int'l Dev. **233,** 234 **(2018)** [hereinafter Corporate Tax Base], https://doi.org/10.1002/jid.3351 (reporting that Argentina, Malawi, Mongolia, Rwanda, and Zambia have terminated or renegotiated tax treaties); Martin Hearson, Tax Treaties **in** Sub-Saharan Africa: **A** Critical Review, Tax Justice Network ***(2015),*** https://martinhearson.files.wordpress.com/2015/11/tjnatreaties.pdf. In 2012, Mongolia cancelled its tax treaty with several countries, including the Netherlands, because the zero or low withholding rates on dividends, interest, and royalties allowed MNEs engaged in the mining sector to shift profits out of the country with little or no tax liability. See Hearson, Sub-Saharan Africa, at **26;** see also IMF, Mongolia: Technical Assistance Report- Safeguarding Domestic Revenue-A Mongolian **DOUBLE TAX AGREEMENT** Model, IMF Country Report No. **12/306,** at 4-5 (Nov. 2012).

advantage of its low effective tax rates and vast global network of bilateral tax treaties - it has 73 treaties thus far.

In order to achieve this low effective tax rate, Ireland often uses structures that manipulate its intellectual property accounting. As a result, most multinationals that are headquartered in Ireland are tech companies with significant intellectual property assets that pay next to no taxes on income.

Despite the phasing out of the Double Irish tax structure which enabled many multinationals to avoid taxes through aggressive tax planning, this has been replaced by other structures that are similar in effect including the Single Malt tool and the Capital Allowances for Intangible Assets (CAIA). In addition, there are also debt based tools that can be used to reduce the effective tax rate such as the Section 110 SPV. As a result, Ireland remains one of the largest conduit offshore financial center (OFC) as well as a sink OFC.

Conduit OFCs usually have low or zero taxes imposed on the transfer of capital via interest, dividends or royalties. That way they play a part in shifting profit from one country to another without paying taxes. Increasingly Ireland is also acting as Sink-OFC which means that it attracts and retains foreign capital. It is therefore effectively a tax haven. [6]

The risk that Kenya exposes itself to in ratifying a treaty with Ireland is that profits will be shifted out of Kenya. This could potentially be through the booking of sales made in Kenya to Ireland. The effect of this is to shift profits to Ireland for onward shifting to tax havens. This practice was already being used by Microsoft which creates phones for developing markets in Africa and Asia and have a regional center in Ireland book sales for those markets. Kenya therefore stands to suffer the same fate if it ratifies treaties with Ireland.[7]

What follows next is an analysis of select articles in the Kenya-Ireland DTA. The review will consider Articles that are beneficial for Kenya followed by a review of Articles that should be renegotiated.

4. Positive Articles in the Kenya/Ireland DTA

- Article 1 (2) – Persons covered
  The adoption of this Article which was introduced in the OECD 2017 Model is a positive step. This article clarifies the tax treatment of fiscally transparent entities and ensures that treaty benefits are not denied where investments are made through fiscally transparent entities. This provides clarity for taxpayers who invest using entities such as Collective Investment Vehicles.
- Article 4 (3) – Resident
  This provision reflects the OECD 2017 Model update by adopting a replacement tie-breaker rule for dual resident persons other than individuals. Whereas the old tie breaker

[6] J. Garcia-Bernardo et al., *Uncovering Offshore Financial Centers: Conduits and Sinks in the Global Corporate Ownership Network*, 7 Sci Rep 1 (Dec. 2017), available at 10.1038/s41598-017-06322-9.
[7] Christian Aid, *'Impossible' Structures: Tax Outcomes Overlooked by the 2015 Tax Spillover Analysis* (2017).

rule gave preference to the place of effective management of the person, this article requires contracting states to reach a consensus via the mutual agreement mechanism having regard to having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors.

- Article 5 (3) – Permanent establishment
  Based on the recommendations of BEPS Action 7 anti-contract splitting rules have been introduced in building site/construction permanent establishments. The duration for the existence of the PE is in line with the UN Model's 6-month recommendation rather than the 12 months preferred by the OECD. This lower threshold for the existence of a PE is beneficial to developing countries and secures their tax base.

- Article 8 (2) - International Shipping and Air Transport
  Whilst Article 8(1) grants primary taxing rights to the state of residence of the enterprise, this paragraph grants limited taxing rights to the source state as well. This is commendable for developing countries.
- Article 13 – Fees for technical services
  This article imposes withholding tax on technical services. This is a step in the right direction as it technical services are increasingly significant. Previously contracting states would attempt to assimilate technical services within the definition of royalties however the adoption of a standalone section brings clarity to taxpayers. Residence states can now be liable to pay WHT despite the lack of physical nexus to the source jurisdiction. Retaining the same withholding tax rate for royalties and technical services will remove the temptation to pick and choose between which article the fees fall under.
- Article 14(4) - Capital gains
  This section preserves the taxing right of the source state where a resident of a contracting state sells shares if, at any time during the 365 days preceding the alienation, those shares derive more than 50 per cent of their value directly or indirectly from immovable property in the source state. This is a welcome move that will prevent revenue leakage through indirect sale of assets.
- Article 22(3) – Other income
  Whilst paragraph 1 of the article gives the residence state primary taxing rights of other income, paragraph 3 follows the UN Model and grants taxing rights to the source state as well. This is a useful provision for Kenya it being a source state.
- Article 23 - Miscellaneous Rules Applicable to Certain Offshore Activities
  This article bears no similarity to either the UN or OECD model but is a welcome addition to the treaty. This is because it has a very low threshold for the existence of a PE and secures source state taxing rights.

- Article 30 - Entitlement to Benefits

This article adopts the Principle Purpose Test to assist in preventing tax treaty abuse. This is a useful addition to the tax treaty as it signifies commitment to avoid the granting of treaty benefits in inappropriate circumstances.

5. Negative Articles in the Kenya/Ireland DTA

- Article 1 - Persons Covered

While it is commendable that the treaty includes the transparent entity clause which was included in the OECD 2017 Model update which clarifies the tax treatment of fiscally transparent entities, the treaty has failed to include the accompanying savings clause in paragraph 3 to Article 1.

Although there are instances in which tax treaties restrict the taxing rights of a contracting state over its residents, the saving clause confirms that the overarching aim of tax treaties is to restrict source taxation rather than to restrict a contracting state's taxing rights over its own residents. The few instances in which the treaty does constrict a contracting state's rights to tax its own residents include instances where the source state makes an adjustment of profits attributable to a permanent establishment which have already been taxed in the country of residence and the residence state is forced to make a corresponding adjustment in order to eliminate double taxation pursuant to paragraph 3 of Article 7. It will also include instances where corresponding adjustments are required to be made where associated enterprises have not transacted at arm's length pursuant to paragraph 2 of Article 9, where government services are provided to a contracting state and the services are rendered from the state of residence of the employee pursuant to Article 19, or where students resident in a contracting state receive payments from their home state pursuant to article 20, or where credits or exemptions are made to relieve double tax.

It is therefore recommended that the savings clause in article 1(3) of the OECD Model is included in the treaty.

- Article 5 – Permanent Establishment

An important aspect of the negation of a treaty for developing countries is the threshold for the existence of a permanent establishment. The existence of a permanent establishment brings with it the right to tax income of an enterprise in the residence state that is attributed to the permanent establishment. As a result, it is in the interest of developing countries which are often capital importing countries, and hence source states, to have as broad as possible of a definition of a permanent establishment.

The first weakness of the treaty is that it follows the OECD model in article 5 para 4 (a) and (b) by including the use of facilities for the purpose of "delivery" and the maintenance of stock of goods for "delivery" as auxiliary activities that cannot result in the existence of a permanent establishment.

The next issue is the failure to include service permanent establishments in the Ireland-Kenya DTA. Given that management and consultancy services can generate large profits, it is advisable that a services PE be included in the treaty.

Finally, the dependent agent provisions in Article 5 para 6 and 7 remain outdated and are largely similar to the OECD 1977 model. Unfortunately, the treaty fails to take in to account, the recommendations in BEPS Action 7 that relate to commissionaire and other similar arrangements under article 5(5) and (6).

Article 5(5) of the OECD Model 2017 Convention determines the existence of a PE where a dependent agent who does not conclude contracts that are binding on the enterprise but who plays the principal role in negotiating contracts that are routinely concluded by the enterprise without material modification where these contracts are for the transfer of ownership of or the right to use property owned by the enterprise or that the enterprise has the right to use, or for the provision of services by the enterprise.

Article 5(6) of the OECD Model 2017 excludes the finding of a PE for situations where an independent agent is acting in the ordinary course of his business. It however provides that this exemption will not apply where the independent agent acts exclusively or almost exclusively for an enterprise to which the agent is closely related.

As it stands the Article 5(6) restricts the finding of a dependent agent PE where the person concludes contracts in the name of the enterprise while Article 5(7) of the Ireland treaty requires a higher threshold for the deeming of a PE by requiring the conditions imposed between the enterprise and the agent in their commercial and financial relations to differ from those which would have been made between independent enterprises. It is therefore recommended that Article 5(6) and 5(7) of the treaty be amended to follow the OECD 2017 model to deal with such commissionaire agents.

Finally, in addition to amending Article 5(6) we should also include the stock agent provision of article 5(5)(b) of the UN Model (2017) which deems a PE to exist where a person habitually maintains stock in a contracting state from which they regularly deliver goods/ merchandise on behalf of the enterprise even though they do not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts.

- Article 7 – Business Profits

At present, Article 7(1) corresponds with the most current version of the OECD 2010 Model which has remained unchanged in the OECD 2017 model. The UN model in addition to requiring taxation of profits that are attributable to the PE adds profits attributable to “(b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment”

This limited force of attraction rule allows the source country to tax any other profits of the enterprise derived in that country irrespective of the fact that those profits were not necessarily attributable to the permanent establishment. Thus the source state would not be restricted to taxing only income attributable to a PE. They would also be able to tax other profits derived by the enterprise in that country even where the activity when carried out on its own is not enough to create a permanent establishment. These force of attraction rules allow the source country to attribute income to the PE where the enterprise carries out activity that is similar in nature to those conducted by the permanent establishment. These rules expand the taxing rights of the source country and determine that once an entity establishes a PE, all the income that enterprise are deemed to be taxable. The UN rules create a force of attraction where there is a direct sale of similar goods/services without involvement of the PE. It also covers business activities carried out that are similar in nature to those activities carried out by the PE. The rule was justified on the basis of administrative convenience, i.e. the difficulty of separating similar transactions as connected or not to a PE, and consequent possibilities of avoidance.

In addition, member states may choose to include the deduction rule found in article 7(3) of the UN model which restricts deduction of notional payments such as royalties, interest and service charges between the PE and the rest of the enterprise. This is because, these notional internal payments may be abused and used to allow expenses that exceed what was incurred by the PE and cost developing countries tax revenue. While it is normal for jurisdictions to allow the deduction of expenses that are wholly and exclusively incurred in the course of their trade, it could be argued that the expenses incurred by the PE from the head office are not incurred locally; second these general administrative expenses are also incurred for the benefit of the enterprise as a whole and not exclusively for the PE and finally, these deductions are often abused and used to repatriate profits.

- Article 10 – Dividends

The OECD Model 2017 has a lower withholding tax rate of 5% where there is substantial participation i.e. where the recipient of dividends has a 25% shareholding. In all other instances the withholding tax rate is 15%. In addition, there is an anti-abuse provision included in the OECD 2017 Model which requires the shares to have been held by 365 days in order to qualify for the reduced WHT rate.

Under the treaty Kenya/Ireland DTA majority of the shareholders will be subject to the 8% rate. This is significantly lower than the 15% rate for portfolio shareholders. It is recommended that a higher rate of WHT is adopted to prevent tax leakages.

6. Conclusion

While it is not advisable to enter into a tax treaty where Kenya can only be exposed to significant revenue leakages, loose ends will need to be tightened up during negotiation of the tax treaty. It is suggested that the BEPS recommendations be taken seriously and reflected in the final version of the treaty.