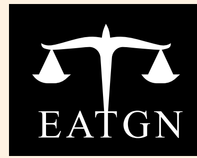

Protected Cell Companies as Potential Tax Avoidance Vehicles Under the Kigali International Financial Centre

By
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Introduction

Over the years, significance of the offshore financial system in the global financial architecture has been growing. In 2000, 60% of the world's money was held in the offshore financial system.[1] Two decades later it continues to be disruptive as evidenced in the Pandora Paper leaks amongst other leaks.[2] In recent years, African countries have been striving towards playing a bigger role in the offshore financial system. The Mauritius International Financial Centre is one of the most well-known African offshore financial centre.[3] Rwanda is one of the countries in the East African region setting up an International Financial Centre (IFC). In setting up the legal framework for the Kigali International Financial Centre (KIFC), there have been several changes to Rwanda's laws including its company laws. New corporate structures such as protected cell structures, social benefit companies and limited life companies have been introduced.

This policy brief shall focus solely on protected cell structures, examining their structures, attributes that allow for tax avoidance and the risk they pose towards financial transparency. Examining such corporate structures and the legal framework surrounding them will provide a clearer picture of whether the KIFC will foster illicit financial flows.

Perpetrators of capital flight and Base Erosion and Profit Shifting (BEPS) such as multinational corporations (MNCs) and wealthy individuals use these offshore financial centres to aggressively reduce their tax liabilities, hide their wealth, carry out illicit activities such as money laundering and shift their capital to lower tax jurisdictions where they pay minimal to zero income taxes. Certain jurisdictions capitalise on this and set up corporate structures that allow for secrecy and provide preferential tax regimes that impose very little taxes as well as high levels of secrecy, thereby encouraging practices such as profit shifting, base erosion and aggressive tax avoidance. These jurisdictions, often known as tax havens or secrecy jurisdictions, enable people to hide their wealth for the purpose of illicit activities such as money laundering. Collectively, they form part of the offshore financial system. Such offshore financial centres are legitimised through the establishment of international financial centres. The IMF has described them as: "*…jurisdiction(s) that provide financial services to non-residents on a scale that is incommensurate with the size and the financing of its domestic economy*".[4]

The tax avoidance that is facilitated through such centres is concerning. The The Organization for Economic Cooperation and Development (OECD) estimates that corporate tax avoidance costs countries between USD 100- 240 billion annually.[5] This is likely

1. Oguttu A.W., 'Curbing Tax Avoidance – Investments in Offshore "Protected Cell Companies and Cell Trusts": The American and British Approach – What Is South Africa's View?' [2011] South Africa Mercantile Journal, https://journals.co.za/doi/epdf/10.10520/EJC54449.
2. ICIJ (International Consortium of Investigative Journalists), 'Pandora Papers', 2021, Accessed 17 December 2021 https://www.icij.org/investigations/pandora-papers/
3. FSD (Financial Sector Deepening) Africa and Emerging Markets Private Equity Association (EMPEA), *Conduits of Capital Onshore Financial Centres and Their Relevance to African Private Equity* (2015), https://www.fsdafrica.org/publication/conduits-of-capital-onshore-financial-centres-and-private-equity-in-africa/
4. IMF (International Monetary Fund), 'Offshore Financial Centers IMF Background Paper' (2000), Accessed 10 December 2021 https://www.imf.org/external/np/mae/oshore/2000/eng/back.htm#II_A
5. OECD (Organisation for Economic Co-operation and Development), *The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles* (2010) https://www.oecd.org/tax/treaties/45359261.pdf

to affect developing countries more acutely compared to developed nations as they *"tend to rely more heavily on corporate income tax…"*[6] A recent United Nations Conference on Trade and Development (UNCTAD) report showed that Africa is losing USD 80 billion annually to illicit financial flows through several activities including base erosion and profit shifting.[7]

Furthermore, the report named Rwanda as one of the African countries experiencing capital flight estimated at 5% of its GDP. This raises concern towards efforts by Rwanda to achieve sustainable development.[8]

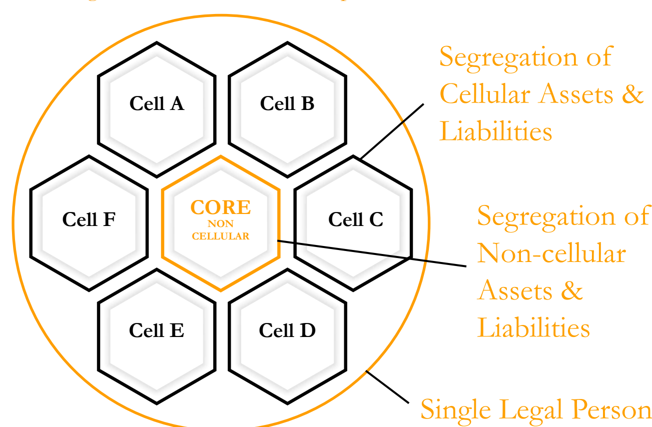
To achieve sustainable development by 2030 Rwanda will need to spend 18.7% of its GDP annually in the selected areas of education, electricity, water and sanitation, health and roads.[9] Domestic resource mobilisation will be critical towards financing this development that Rwanda desires. Taxation is one of the most sustainable means of mobilising resources for development and tax revenue is indeed a significant source of revenue in Rwanda. In 2019, Rwanda collected taxes amounting to 16.7% of its GDP.[10] Since the advent of the COVID-19 pandemic, there has been a negative impact on revenue collection despite increased pressure on public resources such as health services and social protection. For these reasons, in order to bridge the financing gap required to achieve development by 2030, Rwanda will need to put in place stringent measures against revenue leakages.

What are Protected Cell Companies (PCCs)?

Protected cell companies (PCCs) are a unique corporate structure whose main attraction is its legal segregation of assets and liabilities.

To accommodate PCCs, the Law Governing Companies (henceforth the Company Laws) was amended and enacted in Rwanda in 2021 thereby introducing PCCs. Article 2 (24) of the Company Laws describe protected cell companies as *"A company in which a single legal entity consists of a core linked to several cells, each with separate assets and liabilities."*[11]

Figure 1: Protected Cell Companies



A PCC is a company that consists of several units referred to as cells. Each cell has its own assets and liabilities which are kept separate from those of other cells. These cells have no legal identity. A protected cell company also has general assets that are not attributable to any cell, these are referred to as core assets/non-cellular assets.[12] At the end of the day, it is only the protected cell company as a whole that has a legal identity.

Why are Protected Cell Companies Used?

PCCs are utilised for two main important reasons. The first is asset protection. Legal liability arising out of any transactions that a cell participates in, is attributable only to that cell. Creditors will have recourse to that cell alone unless there are any written agreements providing otherwise (recourse agreements.) This level of asset protection makes it suitable for managing risks in collective investment vehicles, Special Purpose Vehicles (SPVs) as well as insurance, specifically captive insurance. An SPV is a separate legal entity created by an organisation.

An SPV is 'a distinct company with its own assets and liabilities, as well as its own legal status. Usually, they are created for a specific objective, often to isolate financial risk. As it is a separate legal entity, if the parent company goes bankrupt, the special purpose vehicle can carry on.'[13]

6. *Ibid*
7. UNCTAD (United Nations Conference on Trade and Development), Tackling Illicit Financial Flows for Sustainable Development in Africa: Economic Development Report in Africa (2020), https://unctad.org/system/files/official-document/aldcafrica2020_en.pdf
8. *Ibid*
9. Lledo V.D. and Perrelli R.A, 'SDG Financing Options in Rwanda: A Post-Pandemic Assessment' (April 2021) WP/21/115
10. IMF (International Monetary Fund), 'Rwanda: Interim Performance Update under the Policy Coordination Instrument—Press Release; And Staff Report' (October 2020) IMF Country Report No. 20/285, https://m.elibrary.imf.org/view/journals/002/2020/285/002.2020.issue-285-en.xml?rskey=NfDOtx&result=12 pg. 9
11. Laws No. 4 of 8/2/2021 Governing Companies, Article 2 (24)
12. *Op.Cit.* Oguttu A.W.
13. CFI (Corporate Finance Institute), Special Purpose Vehicle (SPV): A separate legal entity created by an organization for a specific objective, 21 January 2022, https://corporatefinanceinstitute.com/resources/knowledge/strategy/special-purpose-vehicle-spv/

The other purpose of using PCCs is in the provision of financial privacy.[14] The PCC as a whole entity is what is visible, but the assets and activities of each cell are concealed especially since these assets may be held outside the country the PCC is domiciled. Keeping track of the number of cells poses quite a challenge as there is no limit to the number of cells that can be formulated.

Understanding The Business Of PCCs And Their Tax Implications

To understand the tax implications of PCCs, it is necessary to identify and understand the underlying business activities that utilise PCCs as a legal vehicle.[15] Captive insurance and collective investment vehicles are some of the business activities that employ PCCs as a corporate structure.[16]

Collective Investment Vehicles (CIVs)

As earlier mentioned, the asset segregation and protection that is provided by PCCs has made them suitable for collective investment vehicles (CIVs). PCCs allow investors to diversify their portfolio through the segregation provided by the cells while maintaining low costs since a new company does not have to be formed. Article 4(2)(c) of the recently enacted Rwanda Law governing Collective Investment Vehicles (CIVs) provides that CIVs can be established in various structures including PCCs.[17]

CIVs as per the OECD definition is *"a fund that pools the investment of many investors … holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established"*.[18] Tax treatment for CIVs is based on the aim of ensuring that those who invest directly into various securities and those who invest in the same through CIVs, end up in the same economic position after taxation.[19] This encompasses the tax principle known as tax neutrality. To achieve this goal, the tax treatment for CIVs will often vary. This is because in some instances, CIVs will be charged taxes as an entity. In other instances, CIVs will be considered tax transparent, and the investors would have to pay taxes on their income gained from the CIV in order to achieve tax neutrality.[20] This is especially so when a CIV has been set up using legal vehicles that are tax transparent such as partnerships. However, companies are not fiscally transparent so there will be other means of ensuring that tax neutrality is achieved. This would be through taxing the CIV as an entity; investors are, however, not taxed on the distribution of income carried out by the CIV.[21] Another approach would be to tax the CIV as an entity and then deduct distributions or by providing investors with a tax credit for the tax paid by the CIV entity.[22]

It is not yet clear how tax neutrality will be maintained for CIVs in Rwanda though it is presumed this will be dependent on the legal vehicle that they take take up. For instance, they can be registered as a partnership, a contractual scheme, an investment company with variable or fixed capital or a PCC.[23] However, it is clear that CIVs under the Rwandan investment regime provided under the recently amended Investment Promotion Code of 2021, will benefit from a preferential tax regime.

CIVs will be subject to 15% Corporate Income Tax. Further, if a CIV meets the substance requirements laid out in the Investment Promotion Code relating to requirements such as employment of Rwandans, ensuring that a certain percentage of directorship is held by Rwandans amongst others, then the CIV will only be subject to Corporate Income Tax of as low as 3%. These CIVs will be subject to 0% withholding tax for any dividends, interests or royalties paid.

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14. *Ibid*
15. *Ibid*
16. *Ibid*
17. Law No 062/2021 of 14/10/2021 Governing Collective Investment Schemes, Article 4(2) (c)
18. OECD (Organisation for Economic Co-operation and Development), *The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles* (2010) https://www.oecd.org/tax/treaties/45359261.pdf
19. UN (United Nations) Committee of Experts on International Cooperation in Tax Matters, *Report of the Subcommittee on Updating the United Nations Model Double Taxation Convention between Developed and Developing Countries: Tax Policy Considerations related to the Tax Treaty Treatment of Collective Investment* (E/C.18/2019/CRP.20), https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-03/N1841485.pdf
20. *Ibid*
21. Ongore M. and Nyamori B., 'The Legal and Tax Architecture of Collective Investment Funds in Mauritius' (2020) 1(2) Financing for Development, http://uonjournals.uonbi.ac.ke/ojs/index.php/ffd/article/view/561/589
22. *Ibid*
23. Law No. 062/2021 of 14/10/2021 Governing Collective Investment Schemes
24. Pannike G., 'The Kigali International Financial Centre' (Agema Analysts), 9 December 2020, Accessed 21 December 2021, https://www.agema-analysts.com/the-kigali-international-financial-centre/

The preferential regime that has been set up for CIVs as well as the widening of Rwanda's tax treaty network indicates deliberate signalling of its readiness to competitively promote investment through taxation. Reportedly 24 double taxation agreements have been initiated under the Kigali International Financial Centre initiative including with countries such as Luxembourg.[24] This presents two main challenges. Firstly, the tax treaty treatment of CIVs is still a matter of contention. This is due to the mismatches caused by the different individual tax treatment of CIVs in contracting states. For instance, CIVs may be treated as tax transparent in one country while being taxed at entity level in another.[25] The question of whether CIVs should in the first place receive any treaty benefits much less whether they qualify as persons in accordance with the tax treaties is still up for debate. While the United Nations (UN) Model Convention and the African Tax Administration Forum (ATAF) Model Convention do propose various methods of dealing with this, these approaches are yet to be adopted in actual double taxation agreements.

Secondly, investment funds have been used for tax abuse. The use of low tax jurisdictions for the purpose of reducing investors' tax liability is popular. This is so much so that several countries have made attempts at enhancing their laws in order to curb the revenue leakages experienced. The changes in policy and law have included enhancements in the controlled foreign companies (CFC) laws as well as alterations in the tax treatment of offshore CIVs.[26] This has been made especially challenging due to the nature of PCCs.

Controlled Foreign Companies (CFC) Rules and PCCs

Controlled foreign company rules ideally should prevent the diversion of profits to low tax jurisdictions from high tax jurisdictions between related companies/ entities. The OECD generally describes a CFC as 'a foreign company that is either directly or indirectly controlled by a resident taxpayer'.[27] Whether or not a resident taxpayer controls a foreign company is often determined by the voting rights or shareholder value held by the resident. It will be difficult to determine this in the case of PCCs because of the segregation of income and assets to cells which are not considered to have any legal personality. Therefore, a resident can fall below the control threshold easily while holding a minority of shares of the total shares spread over offshore cells.[28] This means that the resident country will not be able to impose taxes on the income gained from these offshore cells. At the same time, there are little to no taxes that will be imposed on the income gained from those offshore cells in the jurisdiction in which it is established. This leads to a case of double non taxation. For this reason, countries such as South Africa have proposed stronger control tests for PCC structures whereby each cell should be treated as a separate company rather than limiting it to the PCC as a whole.[29]

Captive Insurance

A "captive insurer" is an "… *insurance company that is wholly owned and controlled by its insureds; its primary purpose is to insure the risks of its owners, and its insureds benefit from the captive insurer's profits.*"[30] It has been described as a form of reinsurance. Captive insurance has not been taken up by many African Countries. Only Mauritius and South Africa within the Sub-Saharan African region have taken up captive insurance. Rwanda has, however, been encouraging the establishment of captive insurance under the Kigali International Financial Centre.[31] The Rwandan Investment Promotion Code describes captive insurance as a *"business aimed at undertaking liability solely to the risks of the parent company and entities within the same group structure in accordance with relevant laws."*[32] Registered

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25. Waris A. and Atim J., 'Kenya/Mauritius/Morocco/South Africa/OECD/UN - Defining Collective Investment Vehicles for Tax Purposes in Developing Countries: Focus on Kenya, Mauritius, Morocco and South Africa' (2021) 75(3) Bulletin for International Taxation, https://www.ibfd.org/shop/journal/kenyamauritiusmoroccosouth-africaoecdun-defining-collective-investment-vehicles-tax
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29. *Ibid*
30. *Op.Cit.* Byrnes W.H.,
31. *Op.Cit.* Pannike G.,
32. Law No 006/2021 of 05/02/2021 on Investment Promotion and Facilitation

investors operating captive insurance in Rwanda are to benefit from a preferential regime of payment of 15% Corporate Income Tax. A preferential withholding tax of zero per cent (0%) applies to dividends, interest and royalties paid by investors benefiting from preferential corporate income tax of (15%).[33]

To save on the costs of setting up a company for captive insurance and protecting the captive insurer from third party claims, the PCC structure was developed. The need to segregate assets and liabilities within a captive structure is what led to the formation of PCCs. The problem with these structures, as highlighted in the previous section, is the establishment of the captive cells in low tax jurisdictions or offshore jurisdictions in order to artificially lower tax liabilities and increase their profits gained from underwriting.

Financial Transparency and PCCs

Rwanda allows for the creation of PCCs through new registration, conversion from another kind of company as well as through continuation of foreign PCCs. The company law imposes no restrictions on the number of cells that a PCC can form however it does provide the following strict restrictions in the making of cells:

1. They must meet the required conditions of the relevant regulator
2. They must be of a similar business activity as that of the PCC as a whole

Additionally, Article 215 provides for the following in regard to the holding of cellular assets and core assets including:

1. That the assets can be held by a nominee,
2. That the assets can be held by a company whose shares are part of the assets of the PCC, and
3. That the assets can be managed by an investment manager

While it is highly commendable that the Law Governing Collective Investment Vehicles establishes the requirement for the maintenance of beneficial ownership registries and explicitly provides that a beneficial owner constitutes a natural person, some provisions concerning PCCs still raise the following concerns

1. It is not clear whether **Beneficial Ownership (BO) information will be required for the PCC as a whole or for each cell within the PCC structure.** It has been noted that there are two kinds of shares within a PCC;
    i. Namely management shares which control the core capital of the PCC. These shares often have voting rights[34] and are key in determining the ultimate owner of a PCC.
    ii. Cellular shares control individual cells but there are no voting rights. These shares can be owned wholly by a shareholder of the PCC, making this person the sole proprietor of that particular share. In Seychelles, BO information is only required for the PCC as a whole and not for particular cells.[35] But considering that shareholders often own such as a small percentage of core asset means that they will not artificially reach the required threshold needed to qualify as beneficial owners.
2. The allowance of the **holding of shares through nominees further complicates the process of identifying the ultimate owner.** FATF has previously recognised this as one of the most prevalent issues in enhancing transparency in legal persons.[36] Nominee arrangements are often to hide the identity of the nominator or to enable foreign persons to adhere to certain jurisdictional requirements for instance the requirement of a certain threshold of local/domestic ownership in certain protected industries.
3. **The risks of opacity are further heightened by related party transactions.** It is necessary to remember that PCCs are an 'improved' version of parent-subsidiary structures with the key difference being the heightened protection of assets through their segregation. Paragraph 2 in Article 21 allows for related party transactions which can lead to the creation of complex structures, a factor that increases opacity in corporate governance.[37]

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33. *Ibid*
34. EMD Advocates, 'Protected Cell Companies', http://www.emd.com.mt/advocates/protected-cell-companies/
35. FSA (Financial Services Authority) and FIU (Financial Intelligence Unit) Seychelles, 'Beneficial Ownership Guidelines' (2020), https://www.seychellesfiu.sc/FIU/Legislations/Guidelines/Beneficial_Ownership_Guidelines.pdf
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37. McCahery J.A. and Vermeulen E.P.M., 'Mandatory Disclosure of Blockholders and Related Party Transactions: Stringent Versus Flexible Rules' (2011) 030 European Banking Center Discussion Paper, https://pure.uvt.nl/ws/portalfiles/portal/1354167/2011-030.pdf

4. **The difficulty of effective enforcement with PCC structures:** In 2015, the Tax Justice Network (TJN) identified PCCs as harmful structures in its Financial Secrecy Report.[38] This is because of its features such as single tax declaration as a whole rather than through individual PCCs, the legal uncertainty of how mutual legal assistance laws would apply to PCCs and most of all, the huge risk of tipping off. TJN described it aptly when it said a PCC is like a double locked structure; one door is opened through inquiries at the PCC level, all the inside doors are locked. This means cell owners will get prompt warning of whatever is to come.

Treatment of PCCs: Taxing Cells?

The tax treatment of PCCs often involves the imposition of tax as a single entity. Tax is not imposed at a cell level. Taxing PCCs at the cellular level such as stronger and easier enforcement of financial transparency and prevention of tax avoidance rules. For instance, it would be more effective to track the beneficial owners and impose CFC rules at the cellular level rather than with PCCs as a single entity; this is especially the case when considering the nature of cross-border activities that PCCs are utilised for.

Conclusion

Examination of the legal framework surrounding the KIFC with regard to protected cell companies shows that there are gaps which could be exploited for tax avoidance. The financial activities for which PCCs are used such as collective investment schemes as well as captive insurance make PCCs especially vulnerable to practices of tax avoidance. Both activities will enjoy low taxes under the Rwanda investment regime which make them attractive for who wish to route their investment through a low tax jurisdiction.

While transparency mechanisms - such as beneficial ownership - exist in Rwanda, they are not adequate. The Rwandan law has not made it clear whether in the case of PCCs, beneficial ownership information will be required both at the cellular level as well as at the entity level. Further, the Rwandan law specifically allows for nominee shareholding of cellular assets which then makes the process of finding the beneficial owner more difficult.

Recommendations

1. Rwandan authorities must establish specific laws and regulations guiding the tax treatment of PCCs to avoid tax abuse due to the lacuna within the law.
2. Rwandan authorities should ensure that they establish foreign controlled company rules.
3. For the purposes of fiscal transparency measures such as beneficial ownership and control tests, Rwandan authorities should breach the 'veil' of PCCs and consider each cell in the determination of either of these tests.
4. Rwandan authorities must ensure that tax treaty treatment of CIVs is clarified within the Double Taxation Agreements that they enter into ensure that there is not an instance of double non-taxation due to mismatches in the legal personality of CIVs, especially those that are established as PCCs.
5. The Rwandan Parliament must amend the Company Laws to include a wider array of BO information required. Beneficial owners must disclose if they are using nominee shareholders/ directors to control their interests in the company so that not only are the beneficial owners disclosed, but also the manner in which they exercise control should is revealed.

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