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TAX NEWSLETTER.



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Every month, we publish a newsletter analysing an outstanding Case law and further providing additional commentaries and notes to help you equip yourself better on tax matters.

In this month's newsletter, we will delve into the issue of dividends by looking into a recent court judgement involving ***Heritage Insurance Company Kenya Limited v Commissioner of Legal Services and Board Coordination***.

Back ground of the case.

Kenya revenue authority conducted an audit and raised an assessment on various issues, amongst them,

1. Whether expenditure on licence fees is a revenue or capital expenditure.
2. Bad debts Provision disallowed in 2018
3. Taxation of Dividend Income.

A, On whether the expenditure on licence fees is a revenue or capital expenditure.

On this subject matter, the appellant was in a contract with a foreign entity that supplied it gadgets that it affixed on motor vehicles to allow the vehicle traceability. The nature of the contract with the supplier of the gadgets was that the gadget was affixed on the motor vehicle to allow the monitoring of the drivers' activities at a cost of Ksh 2,000 borne by the owner of the vehicle.

The appellant further argued that it received a **non-exclusive** and **non-transferable right** to use the Technology, that is, solely for the intended purposes, for a specific term and subject to payment of a license fee.

Further, the appellant relied on the case of **Commissioner of Income Tax vs. Kencell Communications Limited (Now Airtel Kenya Limited) 2016**, where the Appellant stated that several test factors and key principles were applied to distinguish between capital and revenue expenditure. These factors are;

1. **Purpose of Expenditure:** If the expenditure has been made to create a new asset, it is likely to be capital in nature.
2. **Manner of Expenditure/Principle of Recurrence and Regularity:** a one-time expenditure as opposed to recurrent expenditures, is likely to suggest that the expenditure is capital in nature although this factor is inconclusive.

3. **Consequence or Result of Expenditure:** if the taxpayer's existing core business structure, or adds to the taxpayer's existing co business structure, it is more likely to be capital in nature. Conversely expenditure for "assets" which are themselves the stock-in-trade of the business (or which comprise the cost of earning that income itself), such expenditure is more likely to be revenue in nature.
4. **Relation to Business:** If the expenditure is related to the actual conduct of the business and is seen as an integral part of the profit-earning process, it can be classified as a revenue expenditure.
5. **Enduring Advantage:** If the expenditure leads to an acquisition of an asset or a right of a permanent character, it is likely to be seen as a capital expenditure. In contrast, costs that do not confer an enduring advantage on the taxpayer are likely to be revenue in nature.
6. **Exclusivity:** If the expenditure confers an exclusive right or a monopoly to the taxpayer, it is more likely to be seen as a capital expenditure.

The tribunal picked on the **principal of exclusivity**, which the appellant was not able to refute, by failing to avail the agreement between itself and the software provider.

The assessment on this matter was upheld.



B, On whether the Respondent was justified in disallowing the accrued expenses relating to decrease in provision necessitated by changes in the financial reporting standards;

On this matter, the respondent had disallowed

expenses relating to additional provision of bad debts which the appellant did so as to align with the provision of IFRS 9.

However, the respondent contended that the bad debts written off for year 2018 and 2019 did not meet the threshold of section 15 (2)(a) as read together with the Legal Notice 37 of 2011 which among other things, the appellant was required to demonstrate failure in the effort to get the debts from the debtors, approaching debtors for debt restructuring. The Respondent was justified in disallowing the said bad debts, which the appellant did not challenge. The mere compliance with the IFRS9 did not absolve the appellant from complying with the domestic tax laws. The assessment on this issue was also upheld!

C, Taxation of Dividend Income.

On this matter, the appellant had a 60% shareholding on its subsidiary in Tanzania from which it received dividends.

The point of contention was on whether the dividends received from Tanzania was taxed in Kenya. This matter raised two issues.

First was on the provision of Section 7(2) which states that *Notwithstanding section 3(2)(b), a dividend received by a resident company, other than a dividend received by a company which controls directly or indirectly less than twelve and one-half per cent of the voting power of the company paying the dividend, shall be deemed not to be income chargeable to tax*. This gave the impression that the dividends were not taxable by the sheer fact that the appellant had more than 12.5% shareholding of the subsidiary.

The second issue was on the taxation of income derived outside of Kenya.

In its determination, the court held that according to section 3(1), provides that income be charged to tax, both for residents and non-residents. The same section further provides that the income must be derived in or was derived from Kenya.

As such, the court ruled that the income was not derived from Kenya and was therefore not taxable.

Article 10(2)(b) of the OECD MTC taxes these dividends by portfolio investors at the rate of 15%

It was therefore inconsequential on the ratio of shareholding, and also on the mandatory taxation of dividends received by financial institutions as provided for in Section 7(2) and (3).



Dividends payments can be done two broad classes of investors.

Foreign direct investments. This is an investment in a foreign country by a non-resident person where the shareholding is significant. The domestic laws of each country define the distinction depending on their very own specific criteria. This can include setting up a factory as opposed to only a financial investment. This type of investment will involve setting up a subsidiary or a branch.

Portfolio investors – This is investment which does not involve the day-to-day running of the business and may include minority and very small holdings in company shares. This holding might be part of a portfolio of other similar small shareholdings. Companies and individual investors hold shares in this manner so as to spread their risk of total investment across many companies to reduce their losses should one of the company in their portfolio perform badly.

Article 10 of OECD MTC

The OECD Model Tax Convention in Article 10 details the different dynamics for the taxation of dividends. For instance, a portfolio investor is taken to be shareholding of less than 25%, even though most countries have different threshold. Article 10(2)(b) of the OECD MTC taxes these dividends by portfolio investors at the rate of 15%. The rate across countries

also varies even though this is the recommended rate. Kenya adopt this rate for non-residents even though lower rate is provided for in most tax treaties. In contrast, Article 10(2)(a) of the OECD recommends that Direct investors be taxed at the rate not exceeding 5%, if the beneficial owner is a company holding at least 25% of the capital of the company paying the dividends **directly**.



Emphasis is given on direct shareholding. The reason for this is, for example, assume X Co holds 70 per cent of Y Co and that Z Co is held as to 30 per cent by each of X Co and Y Co. X Co will not qualify for the reduced rate on dividends distributed to it by Z Co. While directly and indirectly it holds 41 per cent of C Co (20 per cent + 70 per cent of 30 per cent), directly it only holds 20 per cent.

Most double taxation treaties, do count both direct and indirect shareholding, with emphasis is given to the voting power, which might not equate to the shareholding, though rare.

In the definition of term, Income Tax Act defines dividends as ***any distribution (whether in cash or property, and whether made before or during a winding up) by a company to its shareholders with respect to their equity interest in the company...***

The determination of the applicable rate for withholding tax on the dividends is determined by percentage of **the voting power**. Each shareholders voting power can be different from one company to the other, and also depending on which jurisdiction they are in. For instance, in some countries, the voting power is outlined in the Company's Article of Association and any shareholders' agreement. However, in most cases, the voting power goes hand in hand with the amount of ordinary shareholding the party has.

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The other caveat to this, is that OECD further requires that the shareholding must be held throughout a 365 days period including the day of payment of the dividends so as to reduce the scope of **dividend stripping**.

Dividends and Permanent Establishments – Further, Article 10 (4) deals with the unique situation where dividends received by a non-resident from a resident company are '*effectively connected*' with a Permanent Establishment, that the non-resident has in the source country. This simply reconciles the fact that in such a case, the dividends are to be taxed as business profits in accordance with Article 7 and not as dividends in accordance with Article 10.

On the other hand, Article 10(5) prohibits the taxation of a treaty partner resident corporation's undistributed profits. This is because if the Permanent Establishment was to be taxed on the undistributed profits, it would mean the taxation of undistributed profits of a non-resident corporation given that a branch or a permanent establishment is legally not a separate person.

Countries use their tax system to compete with each other to attract both portfolio and direct investments. Most countries have a very reduced rate for non-residents with a defined rate, usually a considerably high rate of shareholding or voting power, or whatever the criteria the country may be using as the basis of defining what a payment would fall within the ambit of its definition of dividends.

In Kenya, the rate of tax for non-resident is 15% whilst for residents, the rate is 5% for residents with voting power of less than 12.5% and those with voting power of more than 12.5% are exempt. This benefits a holding company and large shareholders who are resident.

Concept of Beneficial Ownership.

The concept of Beneficial ownership is critical as this goes along in determining the resident country of the non-resident and to justify oneself whether the receiving party qualifies for the benefits of a reduced rate of tax as per the provision of a double taxation treaty. This concept is essential as it refutes the simple notion that a payment to a resident, including an agent, should be enough to secure a treaty benefit. In one of a very defining case, that of **Indofood**, the Indonesian company used an intermediary company registered and resident in Mauritius so as to take a benefit of the Mauritius-Indonesia reduced tax rate.

When the treaty came to an end, the parent company

opted to restructure and include Netherlands as the new place of registration of a new subsidiary. The courts ruled that this concept of beneficial owner was to be given international fiscal meaning and not be derived from local Indonesian laws. Further, the concept was incompatible with the concept of “formal owner” who does not have **full privilege to the direct benefit from the income.**

benefit from the income.

This aligns with the OECD concept of identification of a beneficial owner. However, some countries have different domestic laws that give light to the concept of beneficial owner. For example, in the case of *Prévost Car* a Canadian manufacturing resident was used as a joint venture for a corporation resident in Sweden and another resident in the UK. The two partners held the Canadian company through a Dutch holding company and drew up a shareholder agreement where the Dutch company would distribute 80% of its profits to the two shareholders. When the question of whether the Dutch company was the beneficial owner was raised, it was the court’s view that; the Dutch

company was not a party to the

shareholders’ agreement, did not have any assets or employees and was therefore taken not to be an agent, trustee, or nominee of the joint venture partners.

The caveat to the proceedings was that according to the Dutch laws, **the holding company would only be regarded to be a beneficial owner if it were legally obliged to pay the dividends to the shareholders.** Further, the shareholders’ agreement did not put a limit to the discretion of the directors in deciding whether to declare dividends, and which dividends. The lack of any written requirement to the Dutch

company to distribute dividends meant that the shareholders would not have any recourse should the company not distribute dividends. Additionally, the domestic laws in Canada, beneficial ownership was used in the context of assets and not income. The court also noted that dividends are property owned by someone. Therefore, **until the Dutch company declared dividends, the dividends remained its property and its property alone.**

In this case, the courts decided that there are four elements in consideration for attribution of beneficial ownership. These are,

1. Use.
2. Risk.
3. Possession.
4. Control of income.

It is therefore important to pay attention to the specific treaties and domestic laws for such provisions, as is the norm.

Due to the complexities of defining a beneficial owner is, yet it’s a concept widely used for tax planning, countries, and in some treaties as well, have in them provisions geared towards sealing these gaps. One such way is enacting the Limitation of benefit clauses. For instance, in the Kenya’s *Income Tax Act Sec 41,(2) and (3)* provides for who qualifies for the relief from double taxation treaties.

1. ... is a resident of the other contracting state if fifty per cent or more of the underlying ownership of that person is held by a person or persons who are not residents of that other contracting state for the purposes of the agreement.
2. ... listed in the stock exchange of the other state.

The local courts have previously held that the shareholding should not only be on form, but rather substance has played a central role in determining the residency for the 50% of more of the shareholders, who should not only be on paper, but should be real persons’ residents in the other state.

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