

Sagamore Hill.

TAX NEWSLETTER.



Understanding Global Tax Treaties: Kenya's Milestone with Singapore.

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Double taxation treaties.

Kenya recently ratified its double taxation treaty with Singapore, signalling a positive move towards enhancing trade between the two countries. The double taxation treaty provides for reduced rates of interest, royalties, dividends and professional fees as follows to the qualifying beneficial owners.

Payment	Rate	Non-residents
Dividend	8%	15%
Royalty	10%	20%
Interest	10%	10%
Technical fees	10%	10%

Double taxation treaties are, by and large, formulated in the structure of the Organisation of Economic Corporation and Development Model Tax convention, even though some do consider the United Nation model tax convention with only slight distinctions between the two conventions. The underlying fundamental principle of double taxation treaties is that, they do not create tax where none exists in the domestic laws, but they seek to relieve qualifying persons of both countries from double taxation.

This means that, where a double taxation treaty specifies a rate of tax where none exists in the country's domestic laws, then the rate in the treaty will not be applied.

There are notable distinctions in tax systems between the two countries, for example, while Kenya recognises tax residents for body corporates if they are incorporated in Kenya, if management and control is exercised in Kenya, or if the corporate has been declared vide a gazette notice to be tax resident in Kenya, Singapore only recognises tax residence if control and management of the business is exercised in Singapore.

Differences in domestic tax laws, give rise to the need for careful understanding of the individual tax laws of the countries to better understand how a person can benefit from the ratified and soon to

be implemented treaty which will thereafter have a date of entry into force. For instance, the reduced rates for dividends, imply that the beneficial owner of the dividends in Singapore would only pay a difference of the Singaporean corporate tax and the 8% already paid in Kenya. Additionally, the Singapore allows for credits on the corporate tax already paid if the shareholding is up to a certain level, *inter alia*.

The concept of beneficial ownership is not defined in the treaty, but the OECD has given emphasis the **control of income**, and courts across the world have additionally provided further elements in consideration for attribution of beneficial ownership which include, **Risk Assumed, Possession and Use** as it was decided in the *Prévost Car Dutch* case.

The treaty further aligns with the OECD criteria for what constitutes a permanent establishment. The threshold for determination of existence of a permanent establishment is provided for as follows.



Description	Minimum No of Days.
A building site, a construction, assembly or installation project or supervisory activities in connection therewith	Site, project or activities lasts more than 6 months.
The furnishing of services, including consultancy services, by an enterprise of a Contracting State through employees or other personnel	183 days in a 12 months period.
The carrying on of activities by an enterprise that consist of, or that are connected with, the exploration for or exploitation of natural resources	91 Days in a 12 months period.
An installation or structure used in the exploration for natural resources	Installation/structure continues for more than 91 Days in a 12 month period.

It's imperative to note that double treaty agreements are not merely tied to the concept of residency, but mostly to the concept of beneficial ownership. To this end, many countries have put measures in place in line with OECD BEPs Action, in an effort to curb treaty shopping or abuse. Most countries define in their local domestic tax laws, the threshold to be met, for any person to qualify for the treaty benefits. These provisions are called limitation of benefits.

In Kenya, for instance, Section 41 of the Income Tax Act provides two criteria of identifying who qualifies for relief of double taxation treaties.

1. Section 41(2) provides a limit the treaty benefit shall not be available to a person if that person is a resident of the other contracting state with 50% 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. This means that more than 50% of the ownership of the company must be by persons who are themselves 'qualifying persons'.

Other countries add emphasis to this provision by requiring that the person should be paying less than 50% of its pre-tax income in the form of payments that represent a return on investment

which is tax deductible; for example, royalties and interest, to person who are not residents in either of the states.

2. Section 41(3) provides that the above limit in section 41(2) shall not be applicable to a resident of the other contracting state if they are listed in the stock exchange of that other state. The main reason behind this provision is that, globally, if a company meets the requirements of listing in the country's stock exchange, it will be a company having substantial business activities in that country and will equally be heavily regulated by the stock exchange authorities. This seals the gap of having shell company set up in the foreign company for purposes of obtaining the treaty benefit.

Many other jurisdictions have different criteria to help deter treaty shopping. These provisions align with Article 29 of the OECD MTC. Some of them are,

How countries deter treaty shopping/abuse

Article 29(3) Active trade test - The structure of most businesses set up as conduits set to benefit from the treaty, barely have any other activity other than acting as channels of receiving dividends, royalties and interest. Thus, companies with active trading activities may in some countries qualify for a treaty benefit even if they fail the ownership test set above, that is, they do not meet the 'qualifying person' criterion in themselves. The derivative benefit test - If a person is perfectly entitled to a perfect treaty benefit between their country with another, then they would not pursue a treaty shopping arrangement with another country. The aim is to establish that a legal person is not being used as a conduit in an arrangement.

Article 29(5) Headquarter test - Many countries want to attract headquarters of multinational enterprises, therefore, they grant treaty benefit to such MNEs that have headquarters in the countries. To avoid

exploitation of this provision, the commentaries of Article 29 Par 5 further provide that the MNEs must be actively and effectively managed from the said headquarters.

Discretionary test - This is also defined as a motive test, to enable a person claim the benefits even if they do not qualify. It is, therefore on the taxpayer to convince the competent authority that the establishment of residency and the conduct of its operation have nothing to do with obtaining the treaty benefit.

Methods of double tax relief.

Further to obtaining the treaty benefits, different states operationalised the relief through the following different methods.

1. **Credit method.** This is the method provided in the Kenya Singaporean treaty. In this method, the foreign income is added to the income earned domestically, the combined income is then taxed applying the local tax methods and rates, and a credit is granted for the foreign tax paid. There is a caveat to this where many countries, including Kenya limit the amount of tax available to a maximum of local tax payable on the income. This simply means that a credit should not put a taxpayer in a refund position. This is as per section 42(4) of the Kenya Income Tax Act
2. **Exemption method.** In this method, the foreign income is exempted from tax for its tax residents.
3. **The deduction method** - In this method, the foreign taxes paid are treated as expenses incurred in generation of income. The income earned in the two countries is added together and the taxes paid in the foreign country are expensed together with other business expenses while arriving at the tax payable.

Treaties require careful reading.

It is important to note that treaty interpretation is broadly governed by Article 31 of Vienna Convention on the Law of Treaties which provide

that *A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.* A stand that has been held in the Kenyan High Court in the case of **Commissioner of Domestic Taxes vs Total Kenya Limited 2024,**



Individual treaties require careful reading of what the terms of the treaty provide. Take for example the treaty between Ghana and UK, Article 11(2), dealing with interest payments, provides ... *However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest **and is subject to tax in respect of the interest** in that other Contracting State the tax so charged shall not exceed 12.5 per cent of the gross amount of the interest.* This implies that if the receiving entity being in UK was tax exempt, then the provision of this paragraph would not apply, and therefore the entity would not enjoy the treaty benefit, even though it meets the residency, shareholding and other rules.

Paragraph 6 of the same article further provides that following.

*Where, by reason of a **special relationship between** the payer and the beneficial owner or between both of them and some other person, **the amount of the interest paid exceeds**, for whatever reason, the amount which would have been agreed upon by the payer and the beneficial owner in the **absence of such relationship**, the*

*provisions of this Article shall apply **only to the last-mentioned amount of interest. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.***

The implication of this article is that if the company in the UK was a Ghanaian subsidiary and the rate of interest applied is higher than what a Ghanaian entity would borrow from a party in absence of a relationship, only a portion attributable to market rate of interest would qualify for the lower tax of 12.5% and the remainder of the interest would be subjected to the normal tax rate.



Treaty interpretation.

Traditionally, double taxation treaties are interpreted in three different ways.

1. Textual Interpretation/Literal Approach

– This is in line with the starting point of Vienna Convention Article 31(1). The article provides that the words in the treaty be given their “ordinary meaning”, in their context and light of the treaty objectives and purpose. This means the readers reads the words as they are written, assuming the words reflect the intent of the parties. For example, most provide income will be taxed if it is effectively connected with, or income from assets or properties will not be taxed if the paying entity is effectively connected with another related in the paying country. Words such as us

“effectively connected” might not require further reading and interpretation. However, there are those terms that will require further look into.

2. Contextual/Systematic interpretation.

This is where a treaty is interpreted in the context of the entire treaty and words are not read in isolation. The preamble, the annexes and other articles are factored in. This ensures that no clause is interpreted in a way that undermines the entire structure of the treaty. For example, when a treaty defines the term ‘resident’ in one section, ordinarily in the definition of terms, then the reader will have to refer to the definition of the term so as to apply it well in the article.

3. Intent-Based/Purposive/Teleological Interpretation

– In this methods, the intent of the treaty drafters is taken into consideration. The objective and purpose of the treaty, which are, to avoid double taxation, prevent tax evasion and promoting cross border investments and trade also guides its interpretation. This is factored in where a company enters into an arrangement that if looked into further, points to an objective of evading tax, then even though the company may meet the requirements to be granted treaty benefits, then the reduced rates of taxes, be it in royalties, dividends or interest or the method of reduction of double taxation provided for in the treaty, may be denied. In another example, if a strict interpretation might discourage international trade, interpreters might look at the treaty purpose to broaden the application of a provision. This ensures that the intent of the treaty benefit is realised rather than being thwarted by a strict literal reading.

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