CHOOSING BETWEEN THE UN AND OECD TAX POLICY MODELS: AN AFRICAN CASE STUDY

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I. INTRODUCTION

Most of the world's income tax systems impose tax on the worldwide income of their residents and on profits with a source in the country where the income is derived by a non-resident. In the event of cross-border investments or business activities, two jurisdictions may wish to tax the same profits: the source country because the income is attributable to factors within that country and the residence country because all residents are taxed on their worldwide incomes. In the absence of any agreement between the source country and the residence country of the cross-border investor or business operator, the source country would have primary taxing rights if only because it is in a position to extract the tax before the profits are repatriated to the residence country. Unless the residence country wished to double tax the income and in effect discourage any outward investment or business activities by its residents, it will have no choice but to forgo its claimed taxing rights and limit its tax to the difference, if any, between a lower tax rate imposed in the source country and a higher rate imposed in the residence country.

Wealthier countries, particularly OECD nations, very often enter into treaties with each other to divide more evenly the taxing rights flowing from their competing claims to tax the same income. Treaties limit the source country's taxing rights, leaving more room for the country in which the investor or business is resident to tax the profits. Where two capital exporting nations enter into a tax treaty, the limitation of the source country's taxing rights has little overall impact if they enjoy roughly equal cross-border investment from one another. If one party to a treaty is a capital importing nation, a treaty would shift overall taxing rights (and tax revenue) from the poorer country to the richer country.[1] Many African

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1 A. Easson, 'Do We Still Need Tax Treaties?', 54(12) *Bulletin for International Taxation* (2000): 619–25.

African Journal of International and Comparative Law 22.1 (2014): 1–21
Edinburgh University Press
DOI: 10.3366/ajicl.2014.0077
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countries have nevertheless signed tax treaties with capital exporting nations, presuming other strategic or economic benefits from the treaties outweigh the immediate fiscal cost of sacrificed tax revenue. Locking in limits to a source country's taxing powers may, for example, help ameliorate investors' concerns over sovereign risk of rule changing after an investment has been made[2] or enhance the jurisdiction's attractiveness as an investment location by acting as a 'badge of international economic respectability',[3] increasing 'international economic recognition'.[4] Also, tax administrators may view treaties as helpful enforcement tools as the treaties include 'exchange of information' that can allow administrators to learn if their residents have bank accounts or other investments abroad in the treaty partner.[5]

Country representatives commonly draw on two model treaties prepared by the OECD and UN respectively when negotiating tax treaties. The OECD treaty shifts more taxing powers to capital exporting countries while the UN treaty reserves more taxing powers for capital importing countries. A study of East African countries reveals reliance on both treaties, but some jurisdictions have been able to retain more taxing rights than others by greater reliance on approaches based on the UN model. The extent to which a capital importing nation relies on precedents drawn from the OECD treaty rather than from the UN treaty may reveal the degree to which it is willing to pay a price by way of reduced tax revenue in the short term to generate hoped-for benefits over the longer term. A comparison of treaty positions taken by neighbouring countries may also reveal the relative negotiating strengths of the countries and the positions taken by other members of the target group with respect to each other, as well as the positions taken by different outside groupings of countries when dealing with the target group generally. Finally, a look at treaty positions taken by a single country across different types of investment and business income may reveal the relative importance different countries attach to maintaining or sacrificing taxing rights over profits from different elements of the economy.

This paper reports on a study of the tax treaty policy of a group of eleven East African countries. It compares the policy outcomes in treaties signed by these countries with African nations, with relatively wealthy OECD countries, and with non-African countries that are not members of the OECD. It also compares selected outcomes in African–OECD treaties with those results in treaties between a group of Asian countries and OECD members to see whether African countries have been more or less successful at wringing preferences from wealthier nations.

2 K. P. Sauvant and L. E. Sachs (eds), *The Effect of Treaties on Foreign Direct Investment*, Oxford University Press (2009); E. A. Baistrocchi, 'The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications', 4 *British Tax Review* (2008): 352–91.

3 D. Rosenbloom, 'Current Developments in Regard to Tax Treaties', *Institute on Federal Taxation* (1982): 31–61.

4 T. Dagan, 'The Tax Treaties Myth', 32(4) *New York University Journal of International Law and Politics* (2000): 939–96.

5 Easson, *supra* note 1, at 623.

The substantive findings part of this paper charts all tax treaties entered into by the eleven target nations post independence.[6] All but one of the treaties are bilateral treaties between two countries. The bilateral treaties comprise ninety-two treaties between individual countries in the target group and single country partners outside the group[7] and three bilateral tax treaties between countries within the eleven-member target group.[8] In addition to these ninety-five bilateral treaties, there is one multilateral treaty applying to five members of the group.[9] The multi-lateral treaty in effect operates as ten separate treaties between pairs of countries that are party to the multi-lateral treaty. There are a small number of treaties signed by the former colonial power that as a matter of international law were inherited by former colonies.[10] Although it might be argued that post-independence retention of colonial-era policy has been implicitly endorsed by the new nations through their failure to repudiate their inheritance of the treaties, the study is limited to treaties reflecting policy choices explicitly adopted by the countries through new treaties. Inherited colonial-era treaties are therefore excluded from the study.

Nearly all African countries are former colonies of European powers and, not surprisingly, their trade orientation is (still) towards Europe, with some investment from other OECD countries and some non-OECD countries. Over the last decade, a shift towards new investors coming from emerging economies can be observed. However, the treaty patterns still reflect alignment according to the former trade orientation with fifty-one of the 105 treaties entered into by these countries signed with OECD countries and a further twenty with non-OECD, non-African countries, leaving less than one-third of the total treaties with other African countries (Figure 1). Only two countries in the target group have a majority of their tax treaties with other African nations – both of them due to signing the multilateral treaty.

The study reveals patterns in treaties and hence the willingness of these target countries to give up taxing rights with different types of partners. The data does not reveal whether the fiscal cost of forgoing tax revenues is offset by other investment, strategic or administrative benefits. While Figure 2 shows that there is no apparent nexus between the number of effective treaties entered into and the level of foreign direct investment, it may have been the case that foreign direct investment would have been lower or perhaps higher but for the treaties.

6 Not all of them are already in effect (as of 1 January 2012).

7 Of the 92 treaties, two are between the same countries: Tanzania and India. The second treaty, however, has not yet entered into effect.

8 These are between Zambia and Kenya, Zambia and Tanzania, and Zambia and Uganda.

9 The signatories to the multi-lateral treaty are Kenya, Tanzania, Uganda, Burundi and Rwanda. This treaty, signed in 2010 and not in effect yet, replaced a 1997 treaty between Kenya, Tanzania and Uganda which never came into force.

10 These are Malawi's treaties with France, the Netherlands, Norway (soon replaced by a new treaty already signed but not yet in effect), Switzerland and the United Kingdom; Zambia's treaties with South Africa, Switzerland and France; and Zimbabwe's treaty with South Africa.

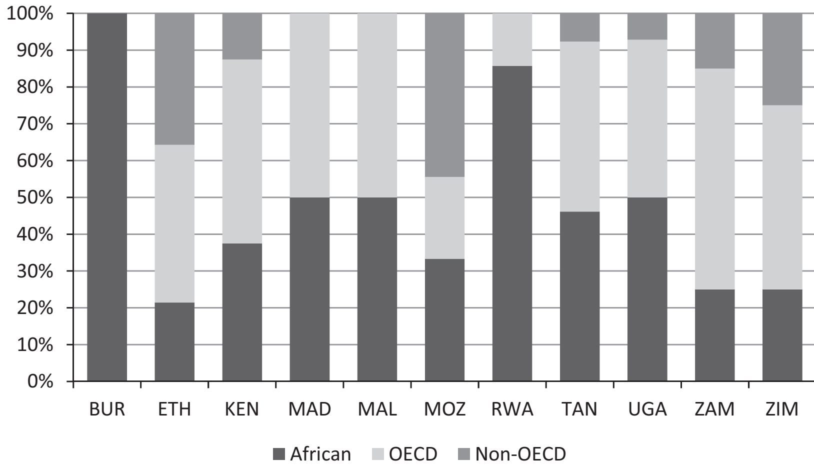

Figure 1. Distribution of target jurisdiction treaties with African, OECD and non-OECD/non-African partners.

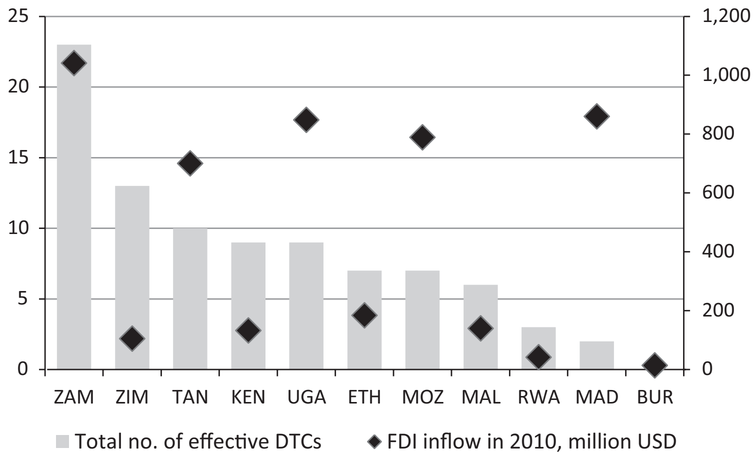

Figure 2. Relation between FDI inflows and number of tax treaties.[11]

II. UNITED NATIONS AND OECD MODEL TREATIES

Both the United Nations and OECD Model Treaties have their genesis in work by the League of Nations following World War I. Although a limited number of jurisdictions had imposed income taxes prior to World War I, the number grew significantly during that war as an increasing number of countries adopted income taxation to fund war expenditures. A combination of post-war rises in tax rates

11 The number of treaties differs from the figures above because it takes into account effective tax treaties, including treaties stemming from before independence and excluding treaties signed more recently but not in force yet.

in countries that imposed income tax and a rise in cross-border investments had led to increasing instances of international double taxation. While some countries had adopted unilateral solutions to the problem – providing a credit for taxes paid abroad on foreign-source income (the United States) or exempting foreign income from tax in the residence state (the Netherlands) – many had not and the inconsistent unilateral responses adopted often did not mesh well. Seeking a multilateral solution to the problem, the Financial Committee of the League of Nations commissioned four prominent economists to investigate the issue.[12] Their report canvassed several options but the final conclusions lent support to an international regime that would transfer most taxing rights to creditor or capital exporting nations (the residence country). It did, however, suggest this rule be complemented by a system of compensation payments from capital exporting nations.[13]

The 'experts' report' was subsequently passed to a group of technical experts comprising official government representatives from seven European countries. The technical experts, drawing upon experience from a number of recently concluded European treaties, did not share the economic experts' preference for residence taxation,[14] supporting neither the source nor the residence principle completely, though the bias was towards greater taxing rights for capital exporting nations.[15] The initial draft treaties developed by the technical experts proved incompatible with the tax systems of most nations, leading to further revisions[16] but some key design principles remained in subsequent drafts prepared prior to the outbreak of World War II. The most important structural feature was the adoption of a 'schedular' approach, derived largely from the schedular tax systems in place in most of Europe. Anglo countries outside Europe had adopted what became known as 'global' income tax systems that imposed one tax on income of all sorts. In contrast, almost all European income tax systems (including that of the UK) were schedular in nature, imposing tax separately on a range of different income types.

The incorporation of schedular principles into the draft treaties allowed the drafters to propose different allocations of taxing rights for different types of income. One of the most important allocations of taxing rights was that over business profits. A 1935 draft distinguished between profits in a source jurisdiction earned directly by a firm and those earned through a permanent establishment

12 League of Nations, Economics and Financial Commission, *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, League of Nations Document no. E.F.S.73.F.19 (1923).

13 K. Brooks, 'Tax Treaty Treatment of Royalty Payments from Low-income Countries: A Comparison of Canada and Australia's Policies', 5(2) *eJournal of Tax Research* (Michigan Issue) (2007): 169–98.

14 M. J. Graetz and M. M. O'Hear, 'The "Original Intent" of U.S. International Taxation', 46(5) *Duke Law Journal* (1997): 1021–110.

15 K. C. Wang, 'International Double Taxation of Income: Relief through International Agreement', 59(1) *Harvard Law Review* (1945): 73–116.

16 H. Debatin, 'Handbuch der Vereinten Nationen für Verhandlungen über Doppelbesteuerungsabkommen zwischen Industriestaaten und Entwicklungsländern', *Der Betrieb* (1980), appendix 15.

being a fixed place of business,[17] a distinction that was to prove of crucial importance in the design of modern tax treaties.

Surprisingly, work continued on the tax treaty project during World War II and a conference of country delegates held in Mexico in 1943 produced a new model treaty. With war raging in Europe, the conference was attended mostly by Latin American countries as well as Canada and the United States and, perhaps not surprising given the make-up of the majority of participants, the Mexico Model, as it became known, granted capital importing nations or source countries almost exclusive taxing rights over many types of income.[18] Sometimes viewed as the predecessor for a model treaty developed by the United Nations almost four decades later,[19] the Mexico model can be seen as 'the first attempt by the developing countries to write a model treaty reflecting their particular problems'.[20]

The Mexico model, with its clear bias towards taxing rights for capital importing nations, won little support amongst high-income countries and in 1946 another series of meetings was organised, this time in London attended by the full Fiscal Committee of the League of Nations. Though it drew heavily from the wording of the Mexico Model,[21] the London Model, as it became known, that resulted from those meetings was considerably more favourable for residence countries. Soon afterwards, the League of Nations dissolved and its successor organisation, the United Nations, failed to follow up on the League's tax programme. The London Model became a *de facto* model for tax treaty negotiations between developed countries for nearly twenty years.[22]

It was in the late 1950s that the work on tax treaties was resumed by the OEEC (Organisation for European Economic Co-operation), the predecessor body for the OECD (Organisation for Economic Cooperation and Development). A permanent Fiscal Committee, created for the express purpose of developing a model tax treaty, reviewed the London and the Mexico Models and in 1963, as a body within the OECD, released a new model, based for the most part on the London Model.[23] Like the London Model precedent, the OECD's first model limited the rights of a source (capital importing) country to tax profits derived by a resident of a capital exporting country.

The bias in favour of capital exporting nations was not as unreasonable as it might at first sound. The model was explicitly intended for use between OECD members – countries sharing similar levels of industrialisation and external trade, with relatively balanced income and investment flows. While the allocation of primary taxing rights to the investors' countries of residence will have a direct

17 M. B. Carroll, 'International Tax Law: Benefits for American Investors and Enterprises Abroad', 2(4) *International Lawyer* (1968): 692–728.

18 Wang, *supra* note 15.

19 M. Lennard, 'The Purpose and Current Status of the United Nations Tax Work', 14(1) *Asia-Pacific Tax Bulletin* (2008): 23–30.

20 United Nations, *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*, ST/ESA/PAD/SER.E/37 (2003).

21 Debatin, *supra* note 16.

22 Carroll, *supra* note 17.

23 Lennard, *supra* note 19.

impact on tax revenues from any one transaction, if cross-border investment flows between a range of treaty partners overall are not dissimilar, all countries using a similar set of allocation rules should end up in almost the same position they would be in if the treaties had allocated greater taxing rights to source countries. This is, of course, not going to be true in the case of treaties between richer and poorer countries, where the adoption of a model with a bias towards taxing rights for capital exporting (residence) countries must favour the country on one side of the treaty only. As the OECD noted, income flows between developed and developing countries are not balanced and therefore if the OECD model treaty were used as the basis for treaties between richer and poorer countries, 'revenue sacrifice would be one-sided'.[24]

Nevertheless, as decolonisation proceeded in the second half of the twentieth century and international trade grew, negotiations for double tax treaties gradually extended to an increasing number of nations outside the OECD. The reflexive starting point for most OECD nations was the model treaty with which they were most familiar, an approach decidedly not in the interest of poorer nations unless they genuinely believed forgoing tax revenues could lead to other benefits such as increased investment and consequent development.

Concern over the influence of the OECD model on treaties between richer and poorer countries and consequent revenue costs to the latter[25] prompted the Secretary-General of the United Nations, on the basis of a resolution of the UN's Economic and Social Council,[26] to appoint an ad hoc group of experts to report on the principles on which tax treaties between developed and developing countries should be based. Twenty experts were nominated with ten coming from developed nations and ten from less developed countries.[27] Their work culminated in the publication in 1980 of an alternative model tax treaty, based on the structure of the OECD treaty (which was, of course, in turn based on the structure of the League of Nations precedents) but providing for much greater taxing rights for capital importing (source) nations.[28] The model was subsequently updated twice, in 2001 and in 2011. The OECD treaty has been updated directly several times since 1963 and indirectly continually by way of changes to the 'Commentary' that sets out possible interpretations of the model treaty.

In contrast to the OECD model treaty that is officially recommended for (but not binding on) OECD member nations,[29] the UN model is regarded as a 'blueprint of matters to be considered in bilateral negotiations'.[30] Provisions from

24 E. van der Bruggen, 'A Preliminary Look at the New UN Model Tax Convention', 2 *British Tax Review* (2002): 119–34.

25 Brooks, *supra* note 13.

26 Economic and Social Council resolution 1273 (XLIII) of 4 August 1967 (in United Nations, First report of the Ad Hoc Group of Experts, Annex I).

27 K. Brooks, 'Tax Sparing: A Needed Incentive for Foreign Investment in Low-income Countries or an Unnecessary Revenue Sacrifice?', 34(2) *Queen's Law Journal* (2009): 505–64.

28 S. Surrey, *United Nations Model Convention for Tax Treaties between Developed and Developing Countries: A Description and Analysis*, International Bureau of Fiscal Documentation (1980).

29 H. Krabbe, 'UN-Musterabkommen 2000', *Internationales Steuerrecht* (2000): 618–20, at 618.

30 Surrey, *supra* note 28, p. 77.

the UN model are found in a number of tax treaties,[31] and a study carried out for the UN body responsible for developing the model suggested that most treaties concluded by developing countries between 1980 and 1997 included at least some provisions based on the UN model.[32] However, the study reported in the present paper suggests the penetration of the UN treaty is inconsistent at least in part of Africa.

III. ALLOCATING TAXING RIGHTS

In the absence of a treaty between a capital importing (source) country and a capital exporting (residence) country, as a simple practical matter, the source country would have the first right to tax all income sourced within the jurisdiction. This leaves the residence country with a residual right to tax income, to the extent the residence country's rates are higher than those of the source country (assuming the residence country wished to avoid double taxation that would discourage foreign investment completely). However, if the source country's taxing rights are limited by a treaty or removed entirely by a treaty, there is room for a shift to greater or even sole taxing rights to the investor's country of residence.

The model treaties and actual treaties based on them use three mechanisms to divide taxing rights. The first, and on the face of it most draconian, option for allocating taxing rights, is to remove entirely the source country's right to tax a particular type of income derived in its territory and assign taxing rights over that income exclusively to the investor's state of residence. Tax treaties use this rule for business profits, removing the source country's taxing rights over locally sourced business income derived by non-residents unless the non-residents earn the income through a 'permanent establishment' or actual fixed place of business in the jurisdiction. Both the OECD and UN treaties adopt this rule but there are substantial differences between them in terms of when a non-resident will be treated as having a permanent establishment in the jurisdiction.

The rule on business profits – removing the source country's taxing rights entirely – sounds at first to be an almost punitive measure from the perspective of capital importing source countries. In reality, however, it may not be as harsh as it appears. Tax administrations in all countries find it challenging to track all business transactions and the more limited capacity of administrations in many less developed, capital importing nations makes the task even more difficult. Giving up taxing rights over business income where the business enterprise has no permanent establishment in the source country may have little practical impact – in reality there may be little ability to actually collect tax on business income derived by foreign businesses with no permanent bases in the country that enter the

31 M. McIntyre, 'Developing Countries and International Cooperation on Income Tax Matters: An Historical Review' (2005), available at http://www.michielse.com/files/mcintyre_intl_cooperation.pdf (accessed 9 September 2012).

32 W. F. G. Wijnen and M. Magenta, 'The UN Model in Practice', 51(12) *Bulletin for International Fiscal Documentation* (1997): 574–85.

jurisdiction only to carry out profit-making transactions. This is not true of high-publicity businesses that must employ the services of local enterprises to carry out their transactions – the most common examples are high-profile entertainers and sportspersons. Accordingly, tax treaties have a carve out from the general business profits rule and allow source countries to tax business income derived by entertainers and sportspersons even if they have no permanent establishment in the jurisdiction.[33]

Also carved out from the general business profits rule is income related to ownership of land in the source country. Mere ownership of land or interests related to land such as mining or forestry rights is not included in the definition of a permanent establishment under either model treaty, and in the absence of any carve out from the normal business income rule is likely to fall within the prohibition on source country taxation. The drafters of the OECD model conceded that source countries should be able to retain taxing rights over profits from the sale of land or interests in land, and the OECD model (as well as the later UN model) provided an exception to the business income rule for these profits. Under both models, the source country is allowed to retain full taxing rights over profits from dealings with land and interests in land. Until recently the UN treaty had a broader reach but since 2003, both treaties also include profits from the sale of land-owning companies.

The second mechanism to divide taxing rights between source and residence countries is to allow the capital importing or source country to apply its domestic taxing law to income repatriated to foreign investors but to impose a ‘cap’ on the domestic taxing rights. This rule is used for three types of income derived by non-resident investors: interest, dividends and royalties. Because of the practical difficulties that would be encountered in assessing foreign recipients of interest, dividends and royalties for tax on their receipts and then collecting tax from them when they have no assets in the source jurisdiction apart from ownership of intangible property in the form of debt, company shares or intellectual property, countries commonly collect income tax on these three types of income via a ‘withholding tax’. Under a withholding tax system, the law formally imposes tax on the non-resident recipients of income but requires the payor to withhold a flat rate tax from the payments and remit the withheld amount to the tax authority. The law then states that the non-resident recipient of income has fully met her or his tax obligations with respect to the income provided the payments were subject to withholding tax. The lower the maximum withholding tax rate that can be imposed by the source country, the greater the room for the residence country to impose its tax rates on the income.

Finally, for some types of income, tax treaties allow the capital importing country to retain its full taxing rights. The capital exporting country in which investors and businesses are resident also retains its ordinary taxing rights on income derived by its residents but must give priority to the source country’s taxing rights. If the residence country wishes to use its residual rights and impose

33 The exception is found in article 17 of the treaties.

tax on the foreign source income, it must provide residents with a credit for the tax imposed by the source country.

IV. BUSINESS PROFITS

The most significant and one of the most severe treaty restrictions on a capital importing country's right to tax income sourced in the country is the removal of all taxing rights over business profits unless the profits are attributable to a 'permanent establishment' in the source country. As originally conceived, the permanent establishment concept was defined in terms of a long-term physical presence such as a factory or an office. While the question of whether there is a permanent establishment is probably the most frequently arising tax treaty issue,[34] with many decades of application, the tangible location elements of the definition attract relatively little controversy.[35] If a foreign business requires a place to operate from – the location of a mine, shop, office and so forth, they will knowingly subject themselves to source country taxation when they establish their presence in the source country. The key issue from the source country's perspective is thus whether other types of presence in the country such as activities without a fixed location can constitute a permanent establishment and give rise to source country taxing rights.

Both the OECD and UN model treaties deem a non-resident business to be operating through a permanent establishment in some circumstances where the business carries out specified activities in the source country. There are, however, significant differences between the deemed permanent establishment rules in the two treaties, with the UN treaty deeming permanent establishments and hence allowing source country taxing rights in respect of a significantly broader range of business activities. The points of difference arise in respect of four issues: (1) when a building site or construction or installation project will constitute a permanent establishment; (2) if an assembly project or supervisory activity can give rise to a permanent establishment; (3) whether the provision of services through employees amounts to a permanent establishment; and (4) whether activities carried on directly by the foreign owner of a permanent establishment should be attributed to the permanent establishment.

A. Building sites or construction or installation projects

Both the OECD and UN model treaties deem a building site or construction or installation project to be a permanent establishment if the site or project continues

34 K. van Raad, 'New Sources of Tax Revenue for Transit Countries: Can a (Rail) Road Qualify as a Permanent Establishment?', in P. Baker and C. Bobbett (eds), *Tax Polymath*, IBFD Publications (2010), p. 125.

35 From time to time various commentators speculate on new interpretations of the tangible site elements of the definition. For example, an academic Dutch treaty expert recently speculated that a road could constitute a permanent establishment of a foreign trucking company! See van Raad, *ibid*.

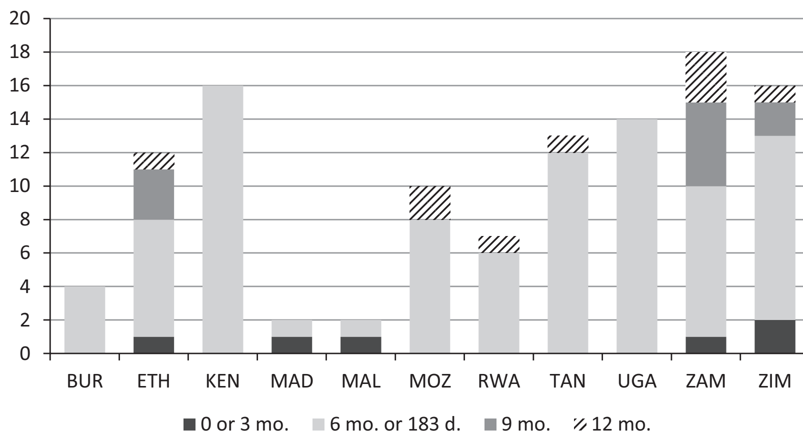

Figure 3. Building site or construction or installation project time threshold to constitute a permanent establishment – African countries.

for a set period.[36] If the site or project is deemed to be a permanent establishment, the source country retains full taxing rights over profits of the non-resident business resulting from work on the site or project. The crucial difference between the two treaties is the length of time activities must continue for the site or project to constitute a permanent establishment. The OECD model treaty deems a site or project to be a permanent establishment where the non-resident's work lasts for more than twelve months; the UN model treaty only requires a six-month project. As construction and assembly times have reduced with changing technology and work practices, countries adopting treaties based on the UN model are likely to retain taxing rights over income in many more circumstances.

As will be seen, the African target countries have accepted the more restrictive allocation of taxing rights under the OECD model in respect of rights to tax many types of income. But in the case of income from building sites or construction or installation projects, the vast majority of target country treaties have followed the UN model or even provided for more generous retention of taxing rights by the source country (Figure 3).

The eleven target countries are almost evenly divided in terms of those adopting the UN model (or a shorter period) in all treaties and those accepting longer threshold periods in some treaties. Five of the group (Burundi, Kenya, Madagascar, Malawi and Uganda) only use the UN recommended or shorter thresholds and six use longer thresholds in some treaties, though the majority of treaties in all countries adopt the UN or shorter thresholds. Not surprisingly, most treaties adopting the longer twelve-month OECD threshold for retaining taxing rights are with OECD partners. Only Mozambique, Rwanda, Zambia and Zimbabwe have treaties using the restrictive OECD threshold with non-OECD members. With two exceptions (a treaty between Rwanda and Mauritius and a

36 Article 5(3).

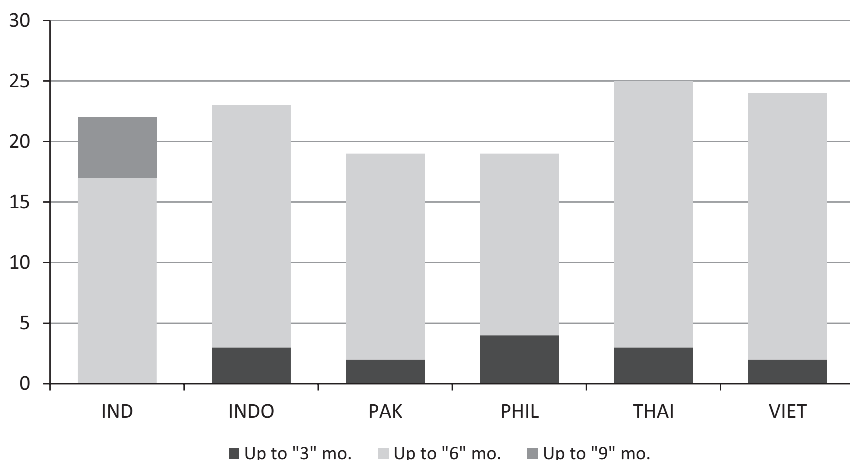

Figure 4. Building site or construction or installation project time threshold to constitute a permanent establishment – Asian countries.

treaty between Ethiopia and Tunisia), all the treaties with other African nations use the UN or a shorter threshold. There are slightly more treaties with non-African, non-OECD countries that use threshold times exceeding that in the UN treaty than there are treaties in this group that use the UN time or shorter.

It appears African nations, when negotiating with partners from outside Africa, may have less bargaining power than their counterparts in Asia. All but one of the sample group of six representative Asian nations (India, Indonesia, Pakistan, Philippines, Thailand and Vietnam) used to compare the relative performance of African countries were able to negotiate the UN or shorter thresholds in all their treaties, including treaties with OECD partners; none have accepted the OECD's twelve-month threshold (Figure 4).

B. Services permanent establishment

In contrast with the relatively strong position the target African nations hold on retaining taxing rights over profits from shorter-term building and construction sites, the target countries have been relaxed in their adoption of the UN model treaty rule that deems some types of service provision in the source country to amount to a permanent establishment. Under the UN model,[37] a non-resident enterprise that furnishes services of any kind in the source country for one or more periods aggregating more than six months within any twelve-month period is deemed to have a permanent establishment in the source country. Profits from the provision of services will be attributed to the deemed permanent establishment and thus can be taxed in the source country where the services are

37 Article 5(3)(b).

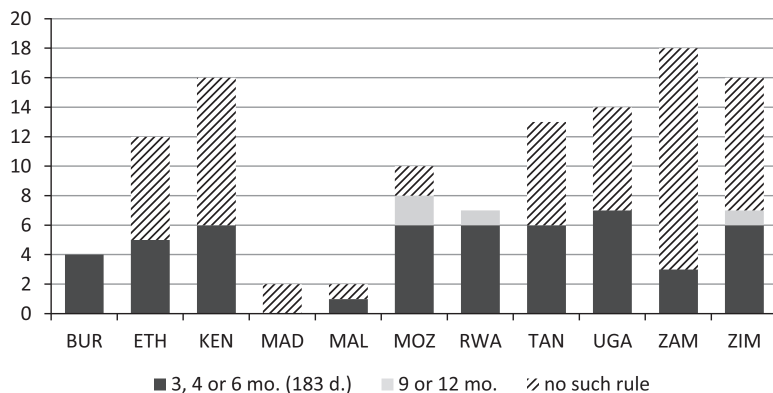

Figure 5. Services permanent establishment provisions.

provided. In contrast, the OECD model treaty has no measure that allows a source country to treat the long-term provision of services as a deemed establishment. Under the OECD treaty, therefore, the source country has no right to tax profits from the provision of services not connected with an actual permanent establishment.

More than half of the treaties signed by the target countries follow the OECD model and contain no 'services permanent establishment' provision (Figure 5). Only Burundi follows the UN model in all of its treaties; Madagascar uses the OECD model exclusively. However, all of Burundi's treaties are with African nations (in the form of one multi-lateral treaty); Madagascar has one treaty with an OECD partner and one with an African partner.

The intransigence of OECD countries on this issue becomes more obvious if treaties with OECD members are compared with treaties with non-members (including African partners). African countries have been able to add UN model-style deemed services permanent establishments to only thirteen of their fifty-one treaties with OECD members. Kenya and Madagascar have conceded the issue in every one of their treaties with OECD partners, followed closely by Tanzania, which gave up taxing rights over services in 83 per cent of its treaties with OECD partners, and Zambia, which signed away the rights in 80 per cent of its OECD treaties. Ethiopia, Uganda and Mozambique have a services permanent establishment measure in one-third of their treaties with OECD members, and Zimbabwe in a slightly higher proportion of its treaties with OECD partners. Malawi and Rwanda only have one treaty each with an OECD partner but so far they have achieved services permanent establishment recognition in all of their treaties with OECD members. As Madagascar has only one treaty with an OECD member, it seems that Kenya, with all of its eight treaties with OECD members following the OECD model and lacking any services permanent establishment recognition, has been the weakest treaty negotiator in respect of this issue.

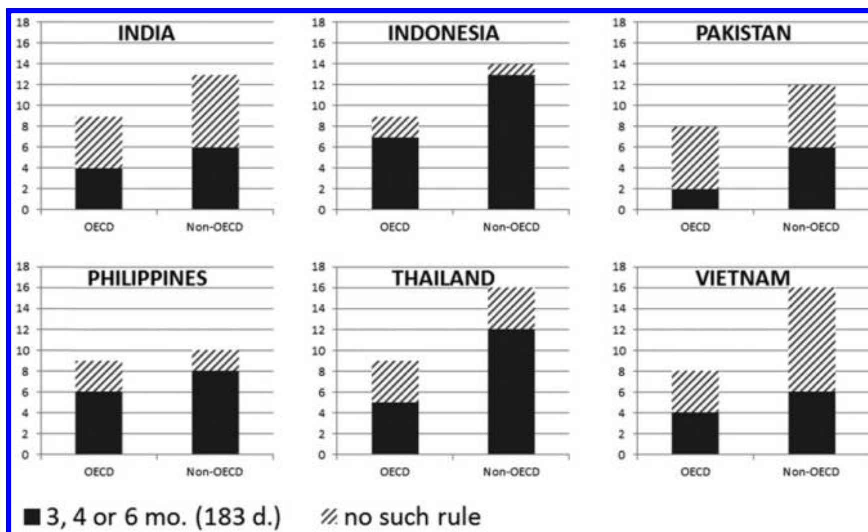

Figure 6. Asian comparison: treaties with deemed services permanent establishment provisions.

In contrast, the comparative Asian group have negotiated UN model services permanent establishment recognition insertions in almost half their treaties with OECD members (Figure 6). In those treaties, they have managed to secure relatively short thresholds for the recognition of a permanent establishment, with no treaty including a services permanent establishment requiring a presence over six months. Once again, it seems Asian developing countries have been able to extract greater concessions from OECD treaty partners than have African countries.

V. CAPPED TAXING RIGHTS

As noted earlier, tax systems usually provide for collection of tax on three types of investment income – dividends, interest and royalties – by way of a 'withholding' tax collected from the enterprise paying the income. In many cases, the 'taxpayer' receiving the income has no presence or tangible assets in the country; they receive income because they own shares in a local company, they have made a loan to a local business, or they hold a contract that allows the local payor to use intellectual property such as a copyright, patent or other rights owned by the investor in return for royalty payments. In these circumstances, where the non-resident receiving local source income is a 'passive' investor, the only practical way to collect the tax is via the withholding tax mechanism.

In terms of structure, the UN and OECD model treaties provide broadly similar rules that cap the source country's taxing rights on investment income by setting a maximum rate for the withholding tax it can impose. The crucial difference between the two models is that the OECD prescribes specific caps

for the three types of investment income (including a zero rate on royalties!) while the UN model leaves the setting of maximum source country rates open for negotiation, the implication being that capital importing nations can negotiate withholding tax rates higher than those thought appropriate by the OECD for investment flows between OECD countries.

A. Dividends

While all three types of capped investment income are commonly viewed as 'passive' income resulting from the ownership of shares, debt or intellectual property, the description is not necessarily accurate for all shareholdings that generate dividend income. Investors contemplating 'foreign direct investment' or investment in actual operating businesses have two potential paths for the investment: operating the local business as a branch of the foreign company or incorporating a local subsidiary (a separate locally incorporated company) and running the business through the local company. If the business is owned directly by the foreign investor, the local profits will be taxed once under the local tax laws. If the business is owned through a locally incorporated subsidiary, the profits are potentially subject to two layers of source country tax: once when the local company earns the business profits and again when the after-tax profits are distributed to the foreign shareholders.

An important principle of tax design is that taxes should have a minimal impact on business decisions and with this in mind, tax treaties commonly distinguish between small passive investments in local companies (known as 'portfolio' investments, as they are assumed to be part of the foreign shareholder's investment portfolio) and more substantial (non-portfolio) direct investments in a local operating company. The latter might substitute for operations via a branch of the overseas company that is not a separate legal entity. To reduce the discrepancy between the single level of tax imposed on a branch and the two levels of tax (company income tax and then dividend withholding tax) imposed when a business is operated through a locally incorporated subsidiary, treaties may set two caps on dividend income with a higher rate allowed on dividends paid to portfolio shareholders and a lower rate allowed on dividends paid to non-portfolio shareholders.

The provisions setting out the dual caps for portfolio and non-portfolio investors provide the only instance in which the UN model treaty is more favourable to the capital exporting nation than the OECD model treaty. Under the OECD model, the capital importing country will be required to use the lower withholding tax rate when the investor has a 25 per cent or greater interest in the company paying dividends. Under the UN model, the capital importing country must apply the lower rate when dividends are paid to investors with only 10 per cent or greater interests in a local company.

In the majority of their treaties, the target countries do not follow either the UN or OECD models in terms of adopting different maximum withholding tax rates for tax on dividends paid to portfolio and non-portfolio shareholders: Burundi

has the distinction in none of its treaties, and Kenya, Mozambique and Rwanda adopt it in a small number of their treaties. The only country which makes a difference between portfolio and non-portfolio dividends in most (all but two) of its treaties is Zimbabwe. The three countries with only a few treaties that adopt the distinction (Kenya, Mozambique and Rwanda) and the one that adopts it in most of its treaties (Zimbabwe) for the most part use the 25 per cent ownership threshold found in the OECD model to identify non-portfolio shareholders. Only a small number of the eleven countries' treaties adopt the 10 per cent threshold set out in the UN model. The general use of the higher 25 per cent threshold limits the number of shareholders who will be entitled to the lower withholding tax rate.

The OECD model treaty stipulates a maximum 5 per cent withholding tax for dividends to non-portfolio investors and a maximum 15 per cent withholding tax rate for dividends to portfolio investors. The UN model leaves it open to the negotiating parties to agree on a rate, the implication being that capital importing countries may settle for rates higher than those found in the OECD treaty. A number of African countries have been successful in negotiating higher rates in their treaties, particularly with non-portfolio investors. While Burundi, Rwanda and Zambia have agreed to the OECD 5 per cent rate in most of their treaties, Ethiopia, Kenya, Madagascar, Mozambique, Tanzania and Zimbabwe have been successful in negotiating higher withholding tax rates in the majority of their treaties. Significantly, the treaties in which the maximum rate exceeds 10 per cent are all, apart from a treaty between Kenya and India, treaties with OECD countries. In some cases – Ethiopia and Zimbabwe – treaties with non-portfolio dividend withholding tax rates exceeding the OECD model rate tend to be with OECD partners. Zambia, on the other hand, has accepted the OECD model treaty rate in almost all treaties with OECD countries.

OECD treaty partners appear not to be dogmatic in respect of the maximum withholding tax rates on portfolio dividends as well. While rates below the OECD maximum rate are not uncommon, in terms of the withholding tax rate on portfolio dividends, treaties with OECD members tend to be more generous to African countries than treaties with other African countries. Kenya, Tanzania and Zimbabwe have been successful in negotiating withholding tax rates higher than the maximum OECD rate of 15 per cent in more than half of their treaties and the higher rates are found in the treaties signed with OECD countries.

It is often argued that higher withholding tax rates, especially on dividends to non-portfolio investors (or foreign direct investment), can discourage cross-border investment. The concern appears to be exaggerated, however. There are examples of countries with relatively lower withholding tax rates and low foreign direct investment and countries with relatively higher rates and high levels of foreign direct investment (Figure 7). Investors in Africa are often seeking location-specific rents – that is, profits from resources such as mineral resources or agricultural resources that are only available in the jurisdiction. Mobile capital seeking returns

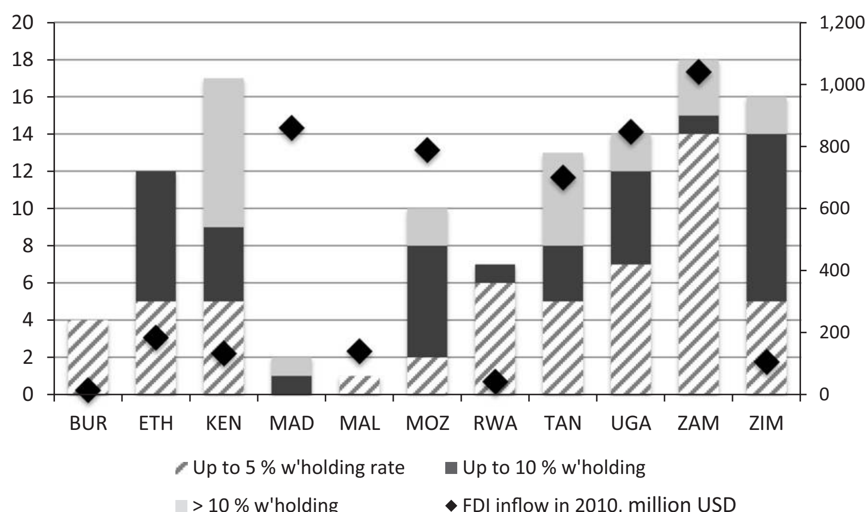

Figure 7. Withholding tax rates for non-portfolio dividends and foreign direct investment inflow.

from activities that could locate anywhere may be more sensitive to tax rates but it seems other factors are inducing or dissuading investment in African countries.

B. Interest

The maximum withholding tax rate on interest income prescribed by the OECD model treaty is 10 per cent; the UN model sets no standard rate but rather leaves the rate open to negotiations.

For the most part, the eleven countries analysed have accepted the maximum 10 per cent withholding tax rate set out in the OECD model (Figure 8). Only Ethiopia seems to have negotiated away more source taxing rights than necessary with half of its treaties (mainly with African or non-OECD countries) including a withholding tax rate which is lower than the 10 per cent rate anticipated by the OECD model treaty. Kenya and Tanzania, in contrast, were able to negotiate withholding tax rates higher than that set out in the OECD model in a majority of their treaties.

C. Royalties

One of the harshest limitations on taxing rights of the source country in the OECD model is that applied to royalty payments. Under the OECD model, the source state is not allowed to tax royalty payments at all; the residence state has an exclusive taxing right over income paid from a capital importing to a capital exporting nation. The UN model, again, leaves the withholding tax rate for royalties open to negotiations.

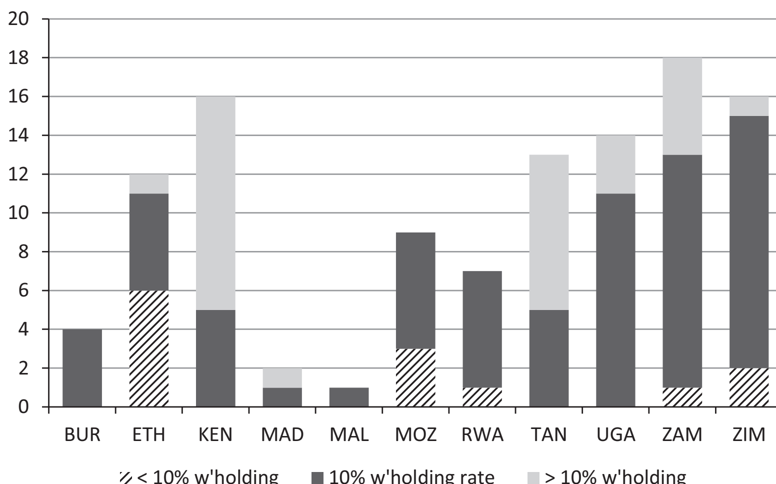

Figure 8. Withholding tax rates on interest payments.

A very limited number of treaties signed by the study's target countries have accepted the zero withholding tax limit prescribed by the OECD model.[38] The target countries were able to negotiate higher withholding tax rates in the vast majority of treaties they signed, although rates differ from treaty to treaty and the outcomes reveal different negotiating patterns (Figure 9). Kenya, Tanzania and Zambia have mainly negotiated withholding tax rates of 10 per cent or higher. Kenya and Tanzania, in particular, were able to extract higher tax rates in treaties with OECD countries, tending to use a 10 per cent rate in treaties with other African countries. Zambia succeeded in achieving withholding tax rates higher than 10 per cent in less than half of its treaties with OECD countries but it did gain higher rights in all its treaties with other African countries. Burundi, Mozambique and Rwanda have no treaties with the royalty withholding tax rate exceeding 10 per cent, and Zimbabwe has only one of sixteen treaties with a rate this high. The lowest rates under 10 per cent can mainly be found in the treaties either with other African or with non-OECD countries. The OECD, it seems, is more generous than neighbours and more willing to apply the UN treaty in some cases than are non-OECD countries.

VI. PROFITS FROM DEALINGS IN LAND

Of all the potential sources of income in a country, the most fundamental source must be the nation's land. Gains in the value of land can only be attributable to

38 These are the Kenya–Italy treaty (before it was amended by a protocol in 1997, the withholding tax rate was 15 per cent), the Mozambique–UAE treaty (but only for business royalties; cultural royalties may be taxed at a rate of up to 5 per cent), the Rwanda–Mauritius treaty, the Zambia–Finland treaty (but only cultural royalties must not be taxed in the source state), the Zambia–Ireland treaty and the Zimbabwe–DRC treaty.

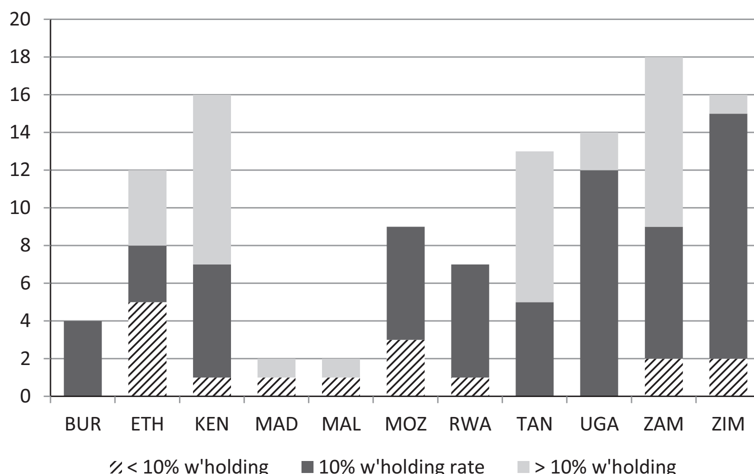

Figure 9. Withholding tax rates on royalties.

factors inside the country and not surprisingly, an assertion of taxing rights over gains realised by non-residents on the sale of property in a source country is a feature found in virtually all tax laws. Tax treaties preserve this right through an article that overrides other provisions in the treaties that might otherwise remove the source country's right to tax non-residents on gains from the sale of local property.

One technique used by investors to avoid the application of the immovable property article in tax treaties was to purchase land through interposed entities, most often a company. When a potential buyer appeared, the foreign investor would sell its shares in the interposed company that held title to the land rather than cause the interposed entity to sell the land. The use of 'land rich companies', as they are sometimes called in tax planning circles, could take the non-resident investor outside the immovable property article of the treaty and as a result outside the local tax net.

From the outset, the UN model treaty contained an anti-avoidance rule to prevent investors from circumventing the principal rule, extending the source country's right to tax gains from the sale of land to gains from the sale of interests in land rich companies (and other interposed entities such as partnerships, trusts and estates).[39] Until 2003, the OECD model had no similar rule but the practice of resource-rich OECD countries such as Australia and Canada eventually led to the inclusion of a similar rule in the OECD model. Most treaties by the target African group do not contain any saving rule for gains from the sale of interests in

39 Entities subject to the measure are defined as entities the property of which consists principally, that is, more than 50 per cent, of immovable property in the source country. The 50 per cent threshold was introduced in the course of a 2001 update to the UN model treaty and is laid down in article 13(4)(2) of the model.

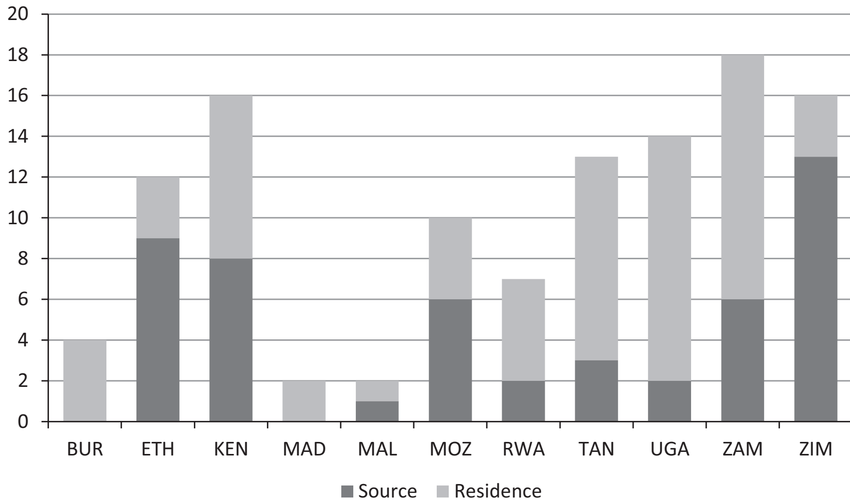

Figure 10. Source taxing rights on gains from the sale of shares in land-rich companies.

land-rich companies, however. Only Zimbabwe has this rule in most of its treaties, followed by Kenya which has the rule in half of its treaties (Figure 10).

VII. OTHER INCOME

Tax treaties are intended to be comprehensive in terms of their coverage, to provide certainty in respect of taxing rights over all possible income. To this end, they have a catch-all clause, the 'other income' article, that allocates taxing rights over all income not specifically dealt with elsewhere in the treaty. The other income article provides one of the sharpest dichotomies between the two model treaties with the OECD model reserving taxing rights over other income exclusively to the residence state of the investor, whereas the UN model, in contrast, allows the source state to retain all of its taxing rights over other income.

All of the African target countries apart from Madagascar, Zambia and Zimbabwe have secured taxing rights over other income in the majority of their treaties. Kenya, Tanzania and Uganda have relinquished their source taxing rights in a majority of their treaties with OECD countries, but retained them in their treaties with most African and non-OECD countries. A similar pattern in respect of the treaties with OECD countries can be observed in the treaty network of Zambia and Zimbabwe. Ethiopia, in contrast, was more successful in the negotiations with OECD countries but gave away more source taxing rights to non-OECD countries. Burundi, Mozambique and Rwanda are the countries which managed to keep their source taxing rights in most treaties with relatively equal treatment by OECD and non-OECD partners (Figure 11).

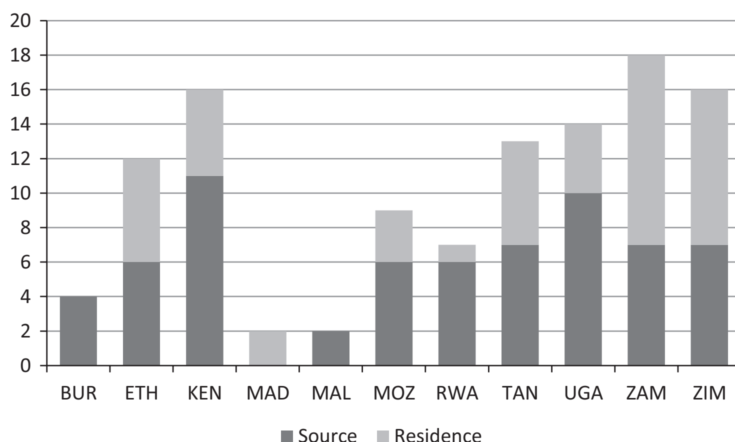

Figure 11. Source taxing rights on other income.

VIII. CONCLUSION

The jurisdictions reviewed in this study are found in the same part of Africa and have histories that share many features. The similarities in their backgrounds are not reflected in their networks of tax treaties with wide variations in the features of their treaties and sometimes significant differences in the extent to which they rely on OECD model treaty or UN model treaty precedents.

The extent to which jurisdictions choose to forgo taxing rights may depend on relative bargaining powers vis-à-vis treaty partners or domestic ideology regarding possible direct economic benefits from increased investment or indirect consequential benefits from enhanced relationships that might follow a retreat from taxing rights. As a general rule, larger and more economically advanced economies tend to retain more taxing rights in treaties than smaller, less advanced economies. Considered as a group, these African countries appear not to have been as successful as Asian countries in retaining taxing rights. Regional countries may find it beneficial to review each other's treaty policies and consider whether the revenue costs of less reliance on the UN model and more reliance on the OECD model might outweigh the perceived investment or ancillary benefits that they hope will flow from the transfer of taxing rights to capital exporting nations.

Regional countries might also wish to look at why OECD countries are often more generous in agreeing to greater retention of taxing rights by African countries than neighbouring African nations.