

International Fiscal Association - Africa Region

Tax Treaties in Africa

Topic 3: Abuse of Tax Treaties: Addressing Challenges and Promoting Fairness in International Taxation

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Abuse of Tax Treaties: Topics

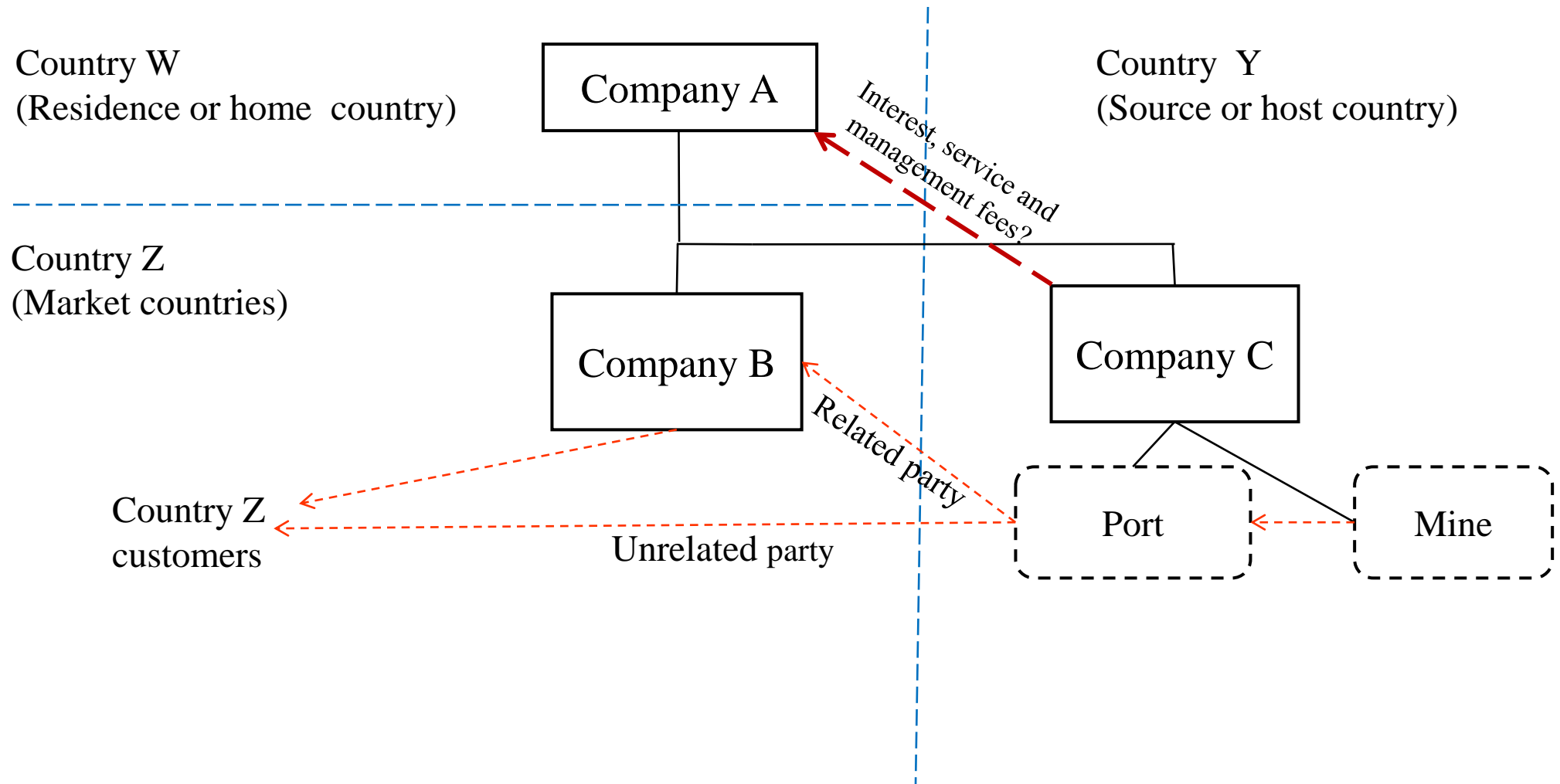
1. Understanding the Scope and Nature of Treaty Abuse
2. Legal and Policy Frameworks to Combat Treaty Abuse
3. Enhancing Administrative Capacity and Cooperation
4. Balancing Tax Competition and Fairness
5. Role of Civil Society and Public Awareness

Scope and Nature of Treaty Abuse: Background

- A MNE taxpayer's tax objective is to minimize its global effective tax rate, irrespective of the country to which tax is paid.
- Treaties are just one of a panoply of tools to reduce tax.
- Treaties are used in combination with deductible payments (interest, royalties, management fees), hybrid transactions (instrument and entity classifications), inconsistent permanent establishment (PE) and source rules, and offshore capital gains to avoid or reduce source taxation. Transfer pricing is the source of or increases the benefits.
- One of three answers every international problem: (i) use a hybrid, (ii) transfer pricing, (iii) write a derivative. Or in combination.

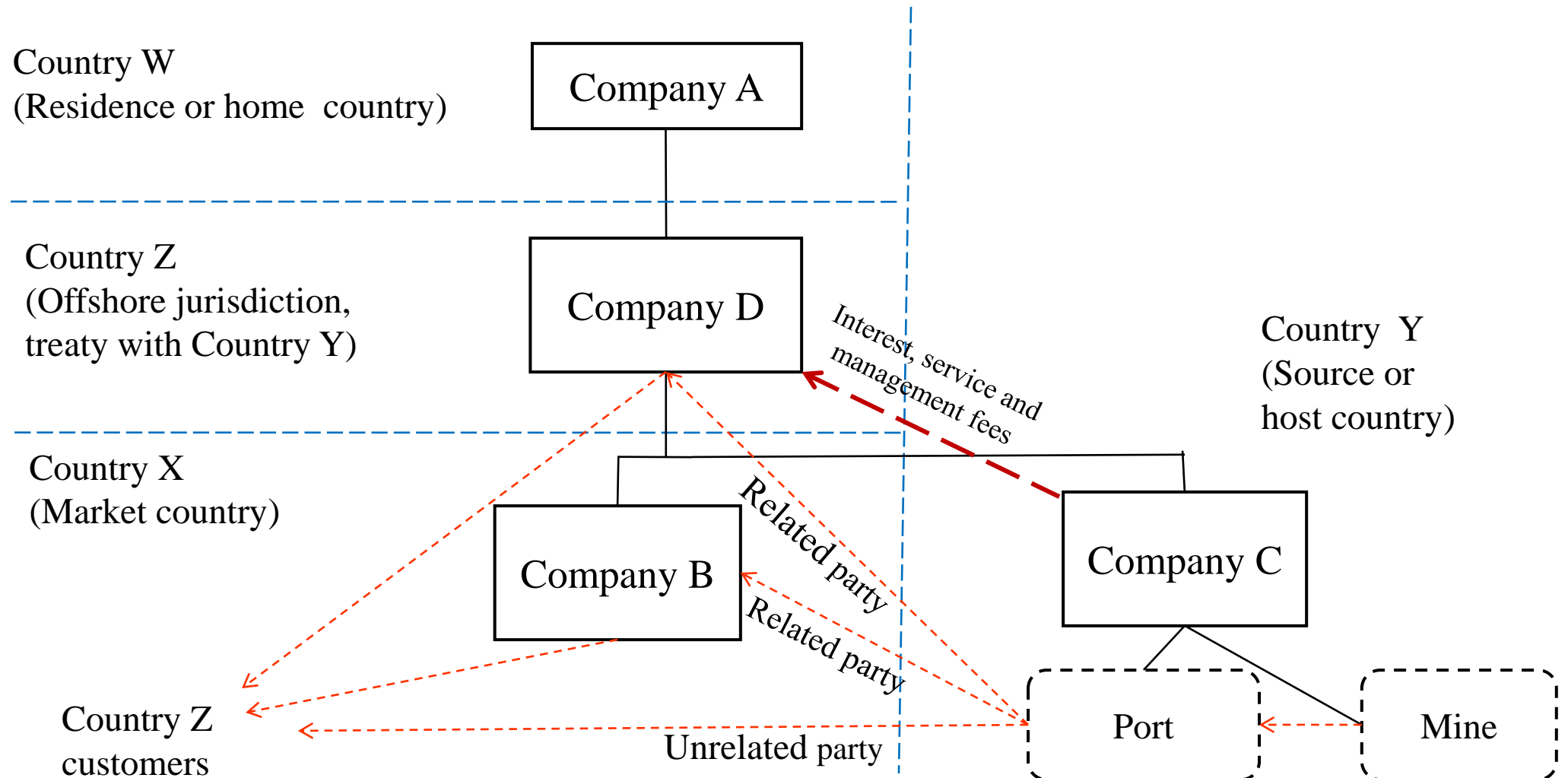
Scope and Nature of Treaty Abuse: Background

Example 1A - Base Case



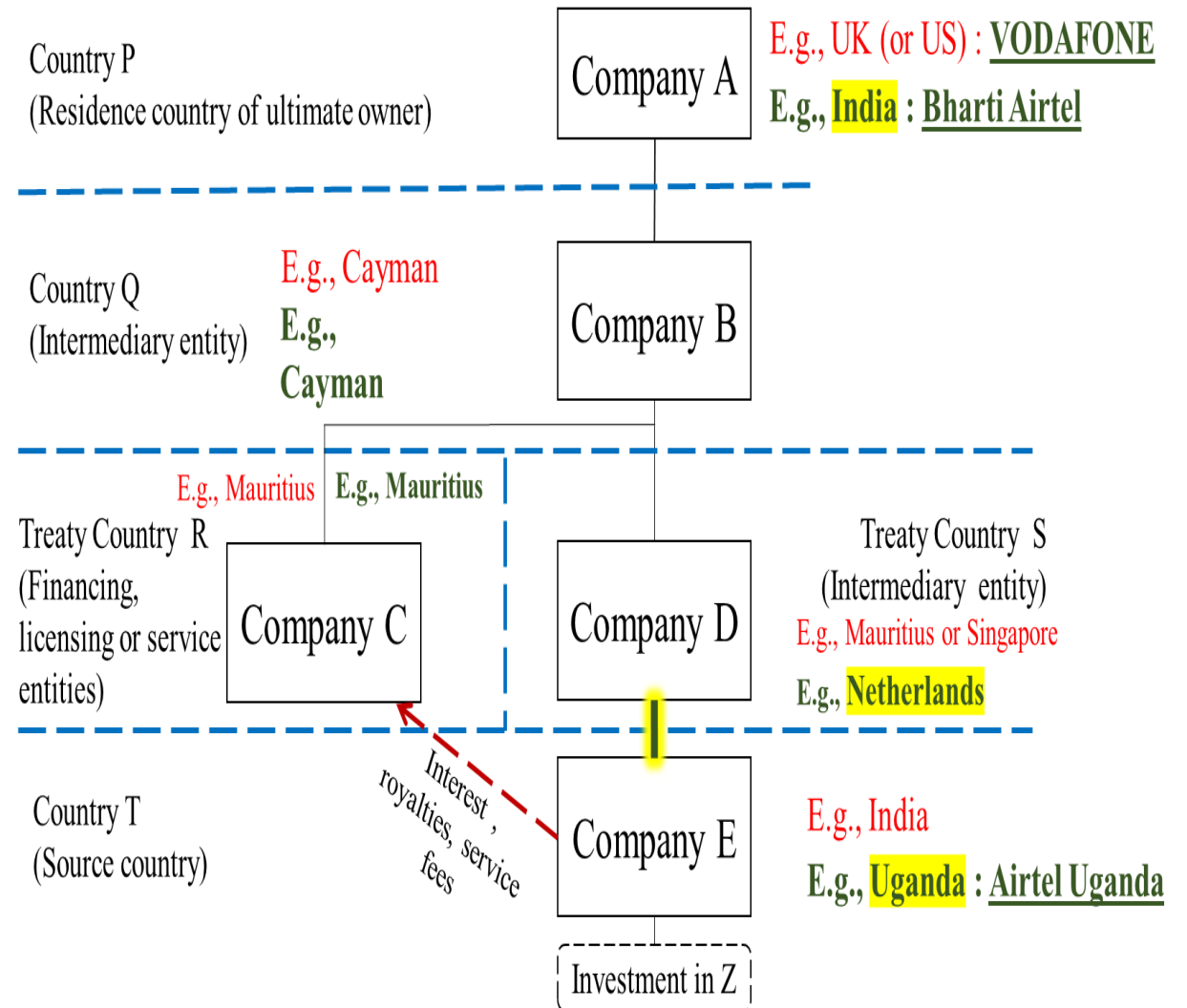
Scope and Nature of Treaty Abuse: Background

Example 1B – Offshore Treaty Company

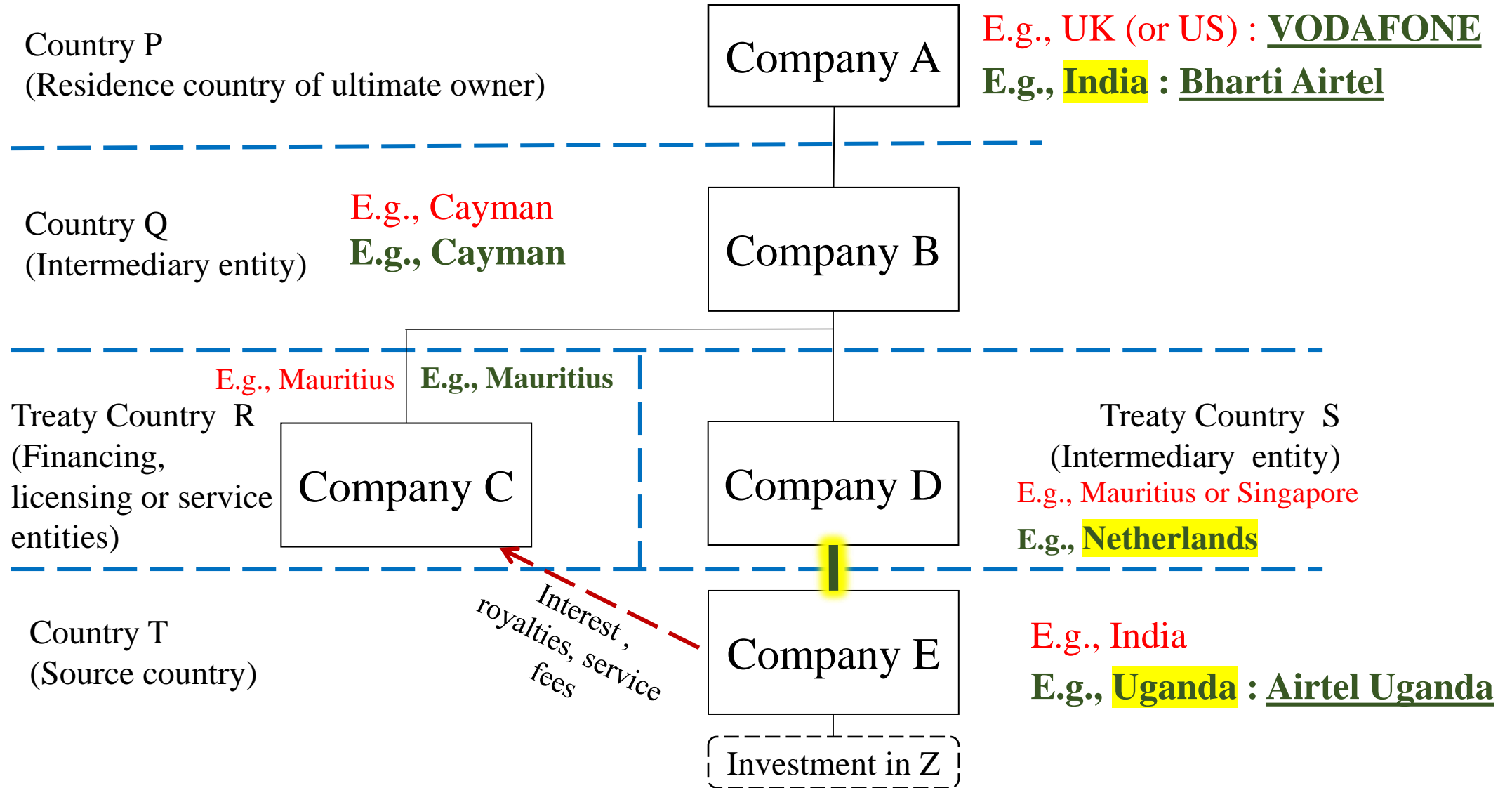


Scope and Nature of Treaty Abuse: Background

- Pre-BEPS and MLI it would be typical for a structure like the diagram to be used to make an equity direct investment financed with debt through a financing entity.
- Cash can be repatriated through principal repayment on intercompany debt.
- Base erosion is through interest, royalties and fees. Withholding taxes on interest and royalties are reduced by treaty. Fees depend on whether there is technical services article or PE.
- This structure permits multiple exit structures: A sells B; B sells D; D sells E.
- What effect Pillar 2?



Scope and Nature of Treaty Abuse: Background



Legal and Policy Frameworks to Combat Treaty Abuse: Country Best Practices

- Always consider treaties in and as a network. A country's treaty network only is as strong as its weakest treaty.
 - At least 4 countries involved in both examples above
- Identify aggressive tax treaties in a network:
 - Such as Mauritius and the Netherlands
- Systemic tax treaty network review must go beyond dividends:
 - Include interest, royalties, technical fees and combinations!
- Treaties lose revenue. Why have treaties? Rigorous cost benefit analysis is required.

Sources: **Hearson** (23 Sept 2014), **Oxfam** (1 Oct 2020), **Van 't Riet & Lejour** (1 Oct 2020), **Volkskrant** (27 Nov 2020), **ICTD WP 125** (Nov 2021)

Legal and Policy Frameworks to Combat Treaty Abuse: Possible Approaches

- Domestic law anti-abuse rules/doctrines
 - Relationship of domestic law anti-abuse rules to treaties
 - GAARs, business purpose and economic substance doctrines, substance over form, anti-conduit rules, and the like.
- What role for international law doctrines taking account of the object and purpose of tax conventions as well as the obligation to interpret treaties in good faith under Article 31 of the Vienna Convention on the Law of Treaties?

Legal and Policy Frameworks to Combat Treaty Abuse: Possible Approaches

- Treaties (with and without amendment under the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (or MLI) and treaty rules to prevent abuse:
 - Residence rules
 - Beneficial ownership condition
 - Limitation on benefits provisions:
 - Objective rules:
 - Testing persons; equivalent benefits tests.
 - Testing items of active business income
 - Principal purpose test (PPT) rules
- Dispute resolution mechanisms – arbitration or not?
- Competent authority rulings.