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

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GLOBAL GOVERNANCE PROGRAMME

*Choosing between the UN and OECD Tax Policy Models:
an African Case Study*

VERONIKA DAURER AND RICHARD KREVER

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Abstract

Almost all the world's tax treaties are based on precedents found in an OECD model tax convention or a UN model tax convention. Both model divide taxing rights on cross-border investment and business activities. The OECD model shifts taxing rights to capital exporting treaty partners while the UN treaty allows capital importing countries to retain more taxing rights. This paper examines the use of OECD and UN precedents in the tax treaties of a group of 11 East African countries. It is difficult to see a link between reduced taxation by the capital importing countries and increased foreign investment. While there are variations within the group, as a group the African countries may have conceded more taxing rights to capital exporting nations than counterparts in Asia.

Keywords

Tax treaties, OECD model, permanent establishment.

1. Introduction

Most of the world's income tax systems impose tax on the world-wide 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 world-wide incomes. In the absence of any agreement between the source country and the residence country from which a cross-border investor or business is carried out, 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 the tax rate imposed in the source country and that imposed in the residence country.

Wealthier countries, particularly OECD nations, very often enter into treaties with each other to divide 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 as each jurisdiction will sacrifice to the other taxing rights of profits from cross-border investment and business. If one party to a treaty is a capital importing nation, the treaty will shift overall taxing rights (and tax revenue) from the poorer country to the richer country (Easson, 2000). Many African 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 (Sauvant and Saches, 2009; Baistrocchi, 2008) or enhance the jurisdiction's attractiveness as an investment location by acting as a "badge of international economic respectability" (Rosenbloom, 1982), increasing "international economic recognition" (Dagan, 2000). 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 (cite someone – Easson, 2000: 623).

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 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. A comparison of 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 11 East African countries. It compares the policy outcomes in treaties with African countries – not necessarily within the group –, between members of the group and relatively wealthy OECD countries, and between members of the

group and other countries that are not members of the OECD. It also looks at the treaty outcomes in respect of taxing rights over some types of profits found 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.

The substantive findings part of this paper charts all tax treaties entered into by the 11 target nations post independence.¹ All but one of the treaties are bilateral treaties between two countries. The bilateral treaties comprise 92 treaties between individual countries in the target group and single country partners outside the group² and three bilateral tax treaties between countries within the 11 member target group.³ In addition to these 95 bilateral treaties, there is one multilateral treaty applying to five members of the group.⁴ The multi-lateral treaty in effect operates as 10 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.⁵ 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 51 of the 105 treaties entered into by these countries signed with OECD countries and a further 20 with non-OECD, non-African countries, leaving less than one-third of the total treaties with other African countries. 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.

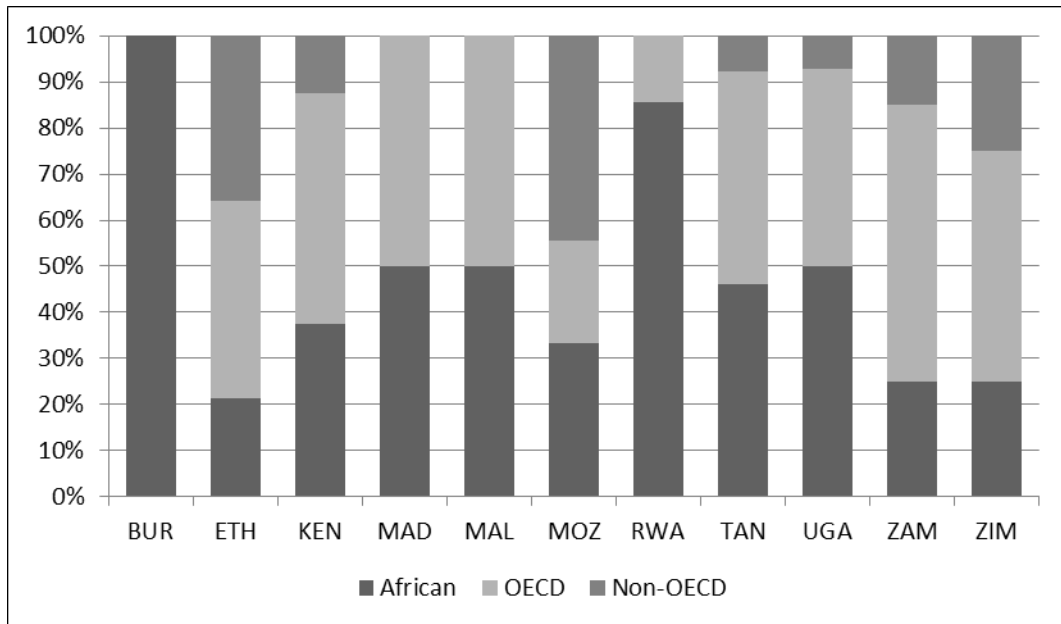
¹ Not all of them are already in effect (as of 1 January 2012).

² Of the 92 treaties, two are between the same countries: Tanzania and India. The second treaty, however, has not yet entered into effect.

³ These are between Zambia and Kenya, Zambia and Tanzania, and Zambia and Uganda.

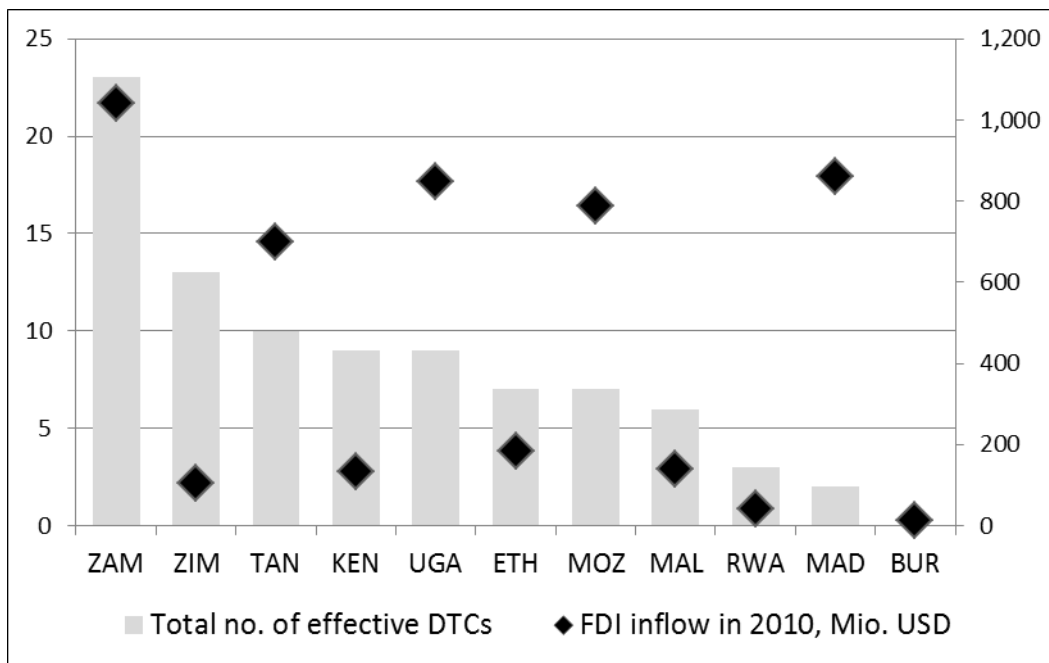
⁴ The signatories to the multi-lateral treaty are Kenya, Tanzania, Uganda, Burundi and Rwanda. This treaty, signed in 2010 and not in effect yet, replaced a 1997 treaty between Kenya, Tanzania and Uganda which never came into force.

⁵ 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.



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 the table below 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.

Fig. Relation between FDI inflows and number of tax treaties⁶



⁶ 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.

2. 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 the World War I. Although a limited number of jurisdictions had imposed income taxes prior to the war, the number grew with adoptions to finance war expenditures and the combination of an increasing number of countries adopting income taxation, war-time and post-war rises in tax rates 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 a report from four prominent economists to investigate the issue (League of Nations, 1923). The 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 (Brooks, 2007).

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 (Graetz and O’Hear, 1997), supporting neither the source nor the residence principle completely, though the bias was towards greater taxing rights for capital exporting nations (Wang, 1945). The initial draft treaties developed by the technical experts proved incompatible with the tax systems of most nations, leading to further revisions (Debatin, 1980) but some key design principles remained in subsequent drafts prepared prior to the outbreak of the Second World War. 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 allocation 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 being a fixed place of business (Carroll, 1968), 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 the war 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 (Wang, 1945). Sometimes viewed as the predecessor for a model treaty developed by the United Nations almost four decades later (Lennard, 2008), the Mexico model can be seen as “the first attempt by the developing countries to write a model treaty reflecting their particular problems” (UN, 2003).

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 were organized, 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 (Debatin, 1980), 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 program. The London Model became a de facto model for tax treaty negotiations between developed countries for nearly 20 years (Carroll, 1968).

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, as the OECD, released a new model in 1963, based for the most part on the London Model (Lennard, 2008) and, like that precedent, a model that 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 might at first sound, however. The model was explicitly intended for use between OECD Members – countries sharing similar levels of industrialization 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 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 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 adoption of a model with a bias towards taxing rights for capital exporting (residence) countries must favour the country at 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" (Van der Bruggen, 2002).

Nevertheless, as decolonisation proceeded in the second half of the 20th 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 (Brooks, 2007) prompted the Secretary-General of the United Nations, on the basis of a resolution of the UN's Economic and Social Council (UN, 1967) 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 10 coming from developed nations and 10 from less developed countries (Brooks, 2009). 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 (Surry, 1980). 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 (Krabbe, 2000), the UN is regarded as a "blueprint of matters to be considered in bilateral negotiations" (Surrey, 1980, 77). Provisions from the UN model are found in a number of tax treaties (McIntyre, 2005) 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 (Wijnen and Magenta, 1997). However, the

study reported in the present paper suggests the penetration of the UN treaty is inconsistent at least in part of Africa.

3. 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 its face 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 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.⁷

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. However, until recently the UN treaty had a broader definition of interests in land.

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

⁷ The exception is found in Article 17 of the treaties.

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 provides 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.

Tax treaty measures on interest, dividends and royalties set a cap or maximum withholding tax rate that the source country may impose on these types of income. The lower the rate, 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 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 tax on the foreign source income, it must provide residents with a credit for the tax imposed by the source country.

4. Business Profits

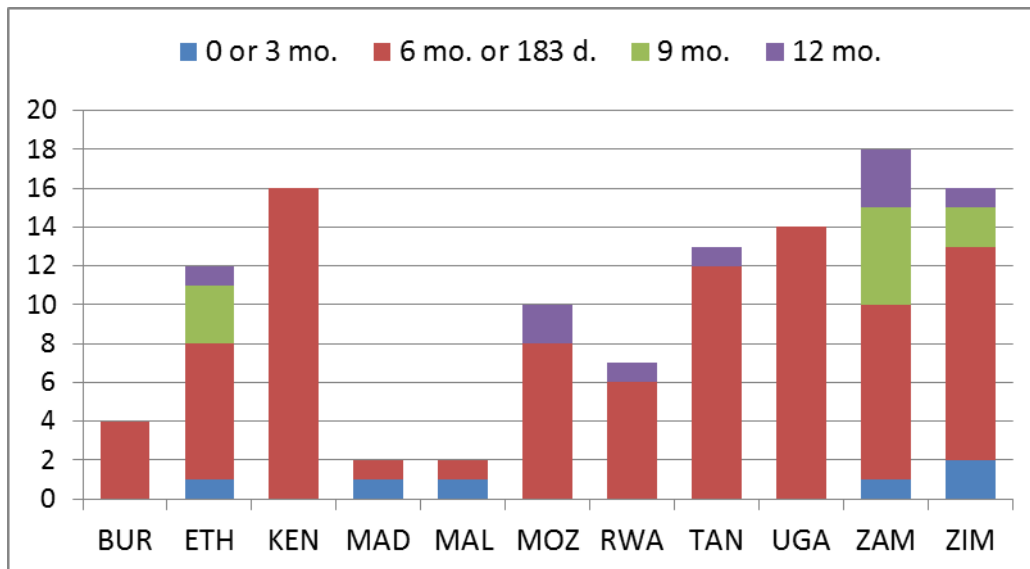
The most significant and one of the most severe treaty restrictions on a capital importing country’s right to tax income sourced in the country is the removal of all taxing rights over business profits unless the profits are attributable to a “permanent establishment” in the source country. As originally 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 (van Raad, 2010, p. 125), with many decades of application, the tangible location elements of the definition attract relatively little controversy.⁸ 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 whether other types of presence in the country 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, over a significantly broader range of business activities. The points of difference arise in respect of four issues – when a building site or construction or installation project will constitute a permanent establishment, if an assembly project or supervisory activity can give rise to a permanent establishment, whether the provision of services through employees amounts to a permanent establishment, and whether activities carried on directly by the foreign owner of a permanent establishment should be attributed to the permanent establishment.

⁸ 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, 2010).

4.1 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 for a set period.⁹ 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 12 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.

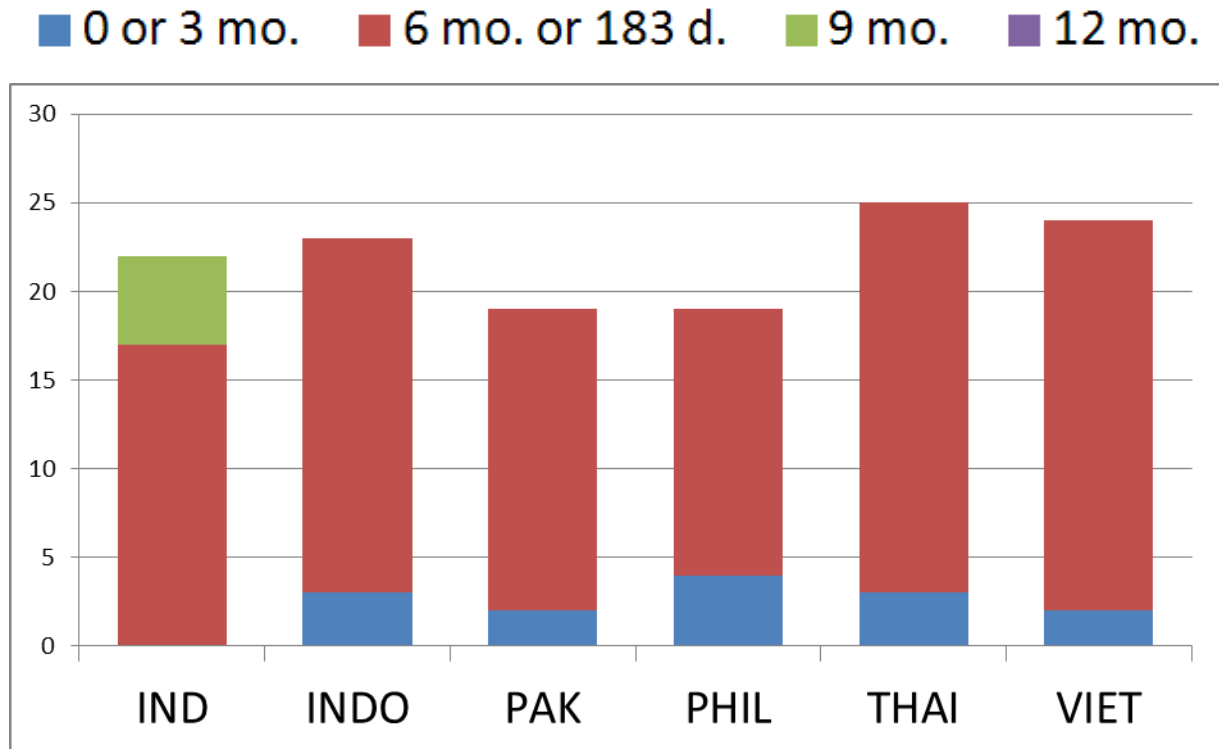
As will be seen, the African target countries have accepted the more restrictive allocation of taxing rights under the OECD model in respect of rights to tax many types of income. But in the case of income from building sites or construction or installation projects, the vast majority of target country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



The 11 target countries are almost evenly divided in terms of adopting the UN model (or a shorter period) in all treaties and 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 12 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 treaty between Ethiopia and Tunisia), all the treaties with other African nations use UN or a shorter threshold. Generally, treaties with non-African, non-OECD countries fall between the OECD partner treaties and the African partner treaties in terms of the distribution of treaties using the UN or shorter thresholds and those with longer thresholds treaties.

⁹ Article 5(3).

It appears African nations, when negotiating with partners from outside Africa, may have less bargaining power than counterpart countries in Asia. All but one of the sample group of six representative Asian nations (India, Indonesia, Pakistan, Philippines, Thailand and Viet Nam) 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.



4.2 Services permanent establishment

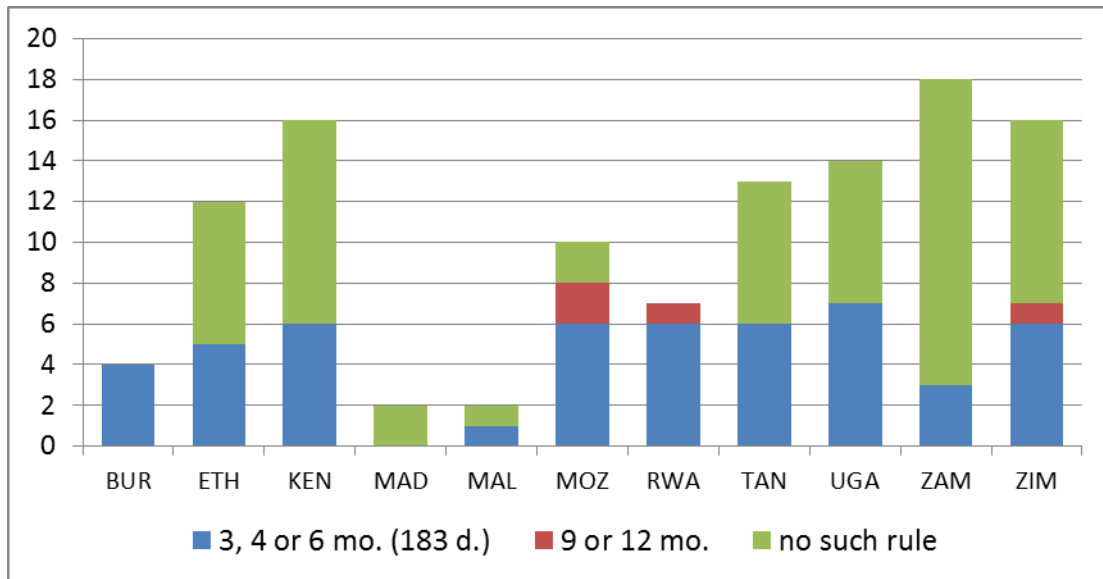
In contrast with the relatively strong position the target African nations hold on retaining taxing rights over profits from shorter-term building and construction sites, the target countries have been relaxed in their adoption of the UN model treaty rule that deems some types of service provision in the source country to amount to a permanent establishment. Under the UN model,¹⁰ 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 12-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 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 and thus bypass the rule denying source countries any right to tax business income unless the income is derived through a permanent establishment.

More than a half of the treaties signed by the target countries follow the OECD model and contain no “services permanent establishment” provision. Only Burundi follows the UN model in all of its treaties; Madagascar used the OECD model exclusively. However, all of Burundi’s treaties are with

¹⁰ Article 5(3)(b).

African nations (in the form of one multi-lateral treaty); Madagascar has one treaty with an OECD partner and one with an African partner.

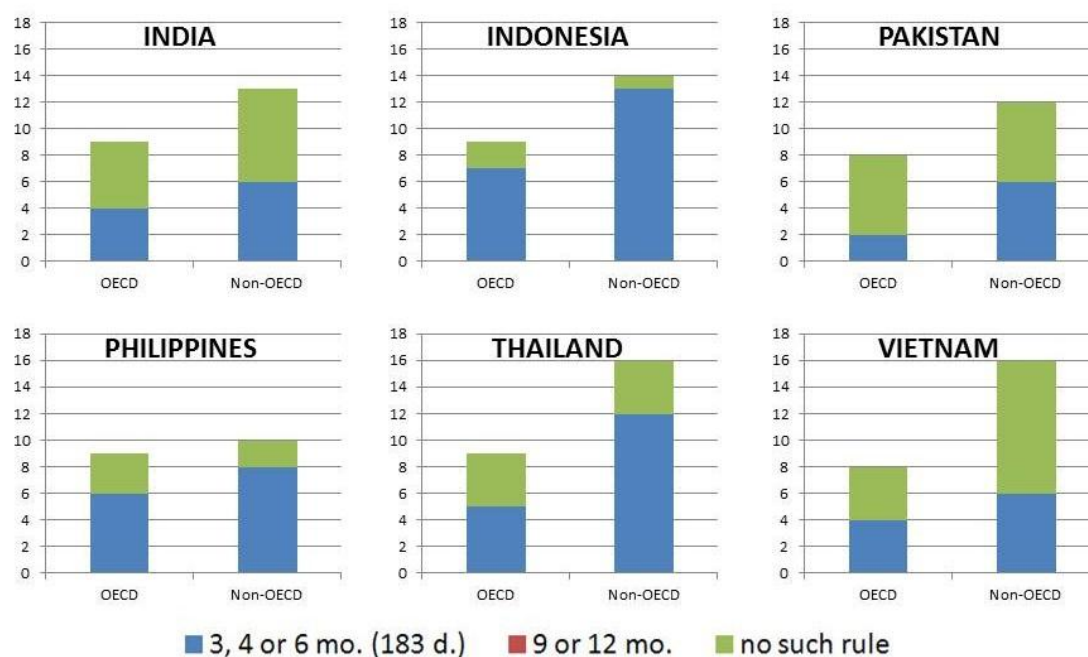
Fig. Service permanent establishment provisions



The division between OECD and UN model precedents is even starker if treaties with OECD members are compared with treaties with non-members (including African partners). African countries have been able to add service permanent establishments to only 13 of their 51 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% of its treaties with OECD partners, and Zambia, which signed away the rights in 80% of its OECD treaties. Ethiopia and 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.

In contrast, the comparative Asian group have negotiated UN Model service permanent establishment recognition insertions in almost half their treaties with OECD members. Once again, it seems Asian developing countries have been able to extra greater concessions from OECD treaty partners.

Fig. Asian Comparison: Service PE – regional breakdown



5. 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 payer 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.

5.1 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 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 under the local tax

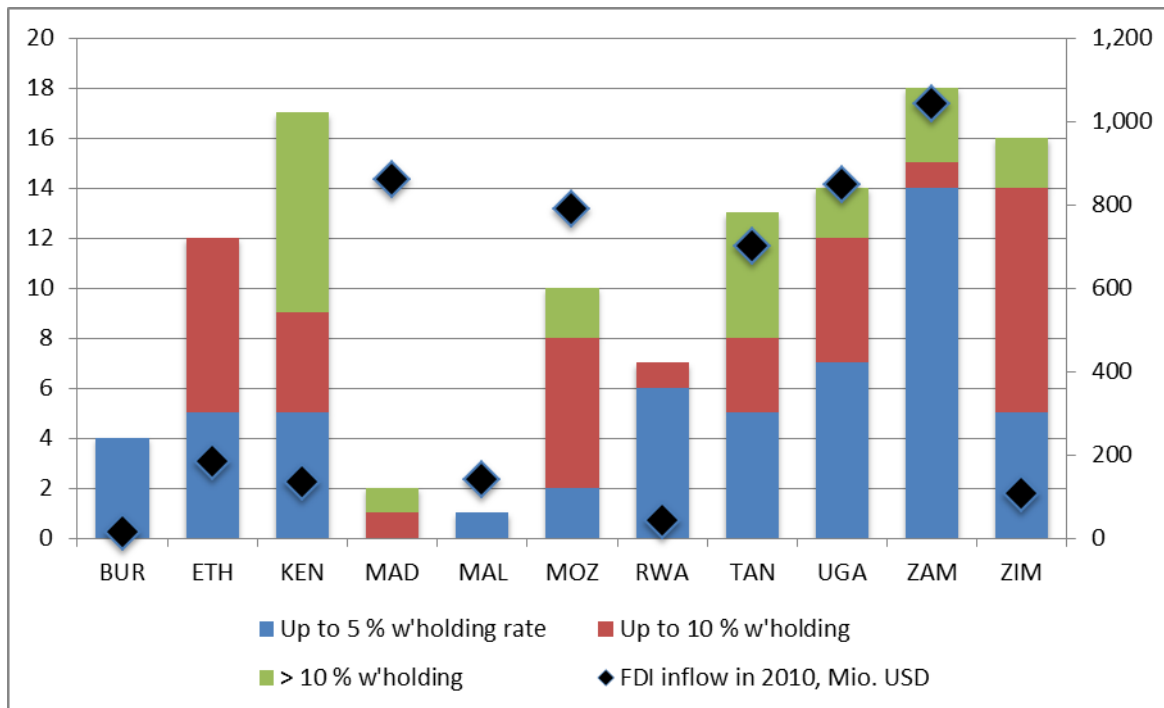
laws. If the business is owned through a locally incorporated subsidiary, the profits are potentially subject to two layers of tax – once when the local company earns the business profits and again when they are distributed to the foreign shareholders.

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% 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% or greater interests in a company.

In the majority of their treaties, the target countries do not adopt a corresponding differentiation: Burundi in none of its treaties, Kenya, Mozambique and Rwanda in a small number of their treaties but only making use of the OECD style 25 % threshold. The only country which makes a difference between portfolio and non-portfolio dividends in all but two of its treaties is Zimbabwe. Again, however, it mainly relies on the OECD model for this purpose. Hardly any of the 11 country’s treaties make use of the UN model’s 10 % threshold. This might be due to the fact that in this case the UN model might be not so beneficial for developing countries after all because a lower threshold means that a share in a company is qualified more easily as a non-portfolio investment which is usually linked with a lower source tax rate. The withholding tax rate for portfolio dividends in the OECD model is 15 % and for non-portfolio dividends 5 %. In contrast, the UN model leaves it open to the negotiating parties to settle for a rate.

Fig. Withholding tax rates for non-portfolio dividends and FDI inflow



Even though the UN model leaves the withholding tax rate for dividends open, for the purpose of non-portfolio dividends many of the target countries have stuck to the 5 % rate of the OECD model or even lower rates repeatedly. Burundi, Rwanda and Zambia are a good example for this. Also half of Uganda's treaties contain a rate of up to 5 %. Ethiopia, Kenya, Madagascar, Mozambique, Tanzania and Zimbabwe, on the other hand, were successful in negotiating higher withholding tax rates in the majority of their treaties. The treaties in which the rate exceeds 10 % are all, except for a treaty between Kenya and India, treaties with OECD countries. Also in Ethiopia's and Zimbabwe's treaties the higher withholding tax rates tend to be in the treaties concluded with OECD countries. For Zambia, however, a different pattern can be observed: the majority of the OECD treaties contain a lower rate.

It is often argued that higher withholding tax rates, especially on non-portfolio dividends (or foreign direct investment), would impede investment activity in a country. Comparing the figures for the target countries, however, does not reveal a clear pattern which would proof this assumption. Tanzania and Mozambique, for example have rather high withholding taxes but nearly as much FDI inflow as Zambia, which has many more treaties with lower rates. Burundi and Rwanda have low withholding tax rates but do not seem to attract much less FDI than Zimbabwe which has rather high withholding taxes.

The withholding tax rate for portfolio dividends set forth in the OECD model is 15 %. The treaties of Burundi, Ethiopia and Rwanda are dominated by withholding tax rates which are lower than 15 %. Mozambique, Uganda and Zambia pretty equally include either the OECD style rate or a lower one. In Uganda and Zambia the higher rates are mainly included in treaties with OECD countries and the lower ones with non-OECD or other African countries. Kenya, Tanzania and Zimbabwe have been more successful in negotiating withholding tax rates higher than 15 % in more than half of their treaties. Here again, the higher rates are found in the treaties signed with OECD countries. [We didn't prepare a comparison with the Asian countries' withholding tax rates!]

5.2 Interest

Similar to the dividend article, the UN model does not provide a limitation on withholding taxes but leaves it open to negotiations. Following the OECD model, the source state has to restrict its taxing rights to a maximum of 10 %.

Fig. Withholding tax rates on interest payments

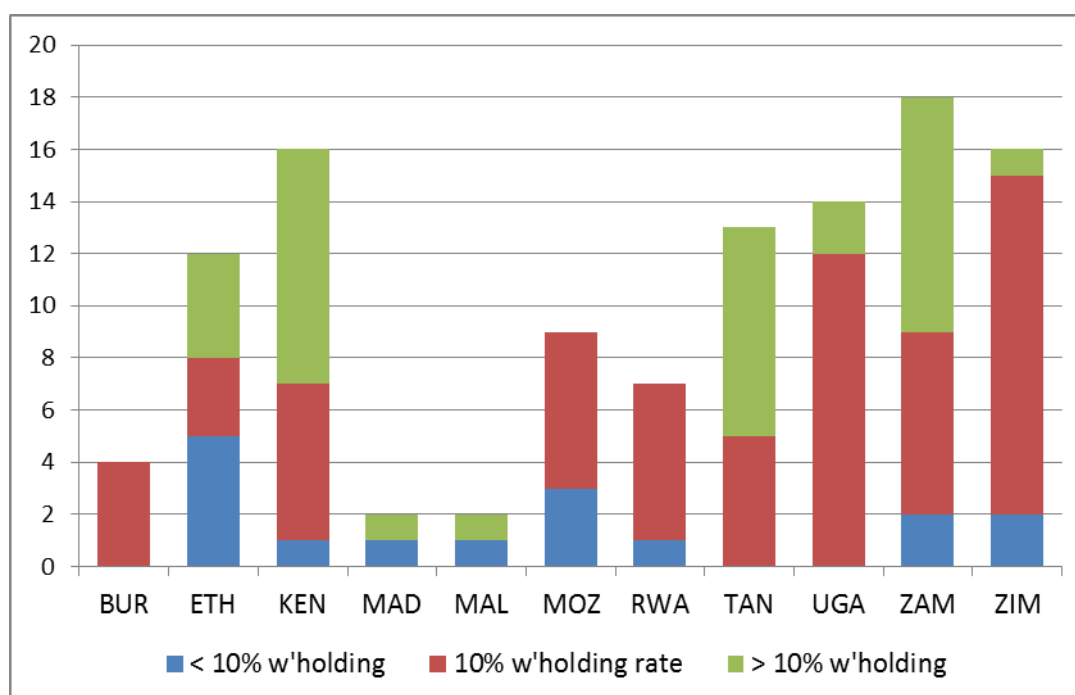


The graph reveals that the 11 countries analysed have mainly adopted the 10 % withholding tax rate of the OECD model. Only Ethiopia seems to have negotiated away more source taxing rights than necessary with half of its treaties (mainly with African or non-OECD countries) including a withholding tax rate which is lower than 10 %. Kenya and Tanzania, in contrast, were more successful in adopting higher tax rates than in the OECD model.

5.3 Royalties

One of the harshest limitations of taxing rights of the source country in the OECD model is the one for royalty payments. Following the OECD model, the source state is not allowed to tax royalty payments at all; the residence state has an exclusive taxing right. The UN model, again, leaves the withholding tax rate for royalties open to negotiations.

Fig. Withholding tax rates on royalties



A zero withholding tax rate is only set forth in a limited number of treaties of the target countries.¹¹ In all other treaties the countries were able to negotiate higher withholding tax rates. The exact rate, however, differs from treaty to treaty and there seems to be different approaches by the target countries. Kenya, Tanzania, and Zambia have mainly negotiated withholding tax rates of 10 % or higher. In Kenya's and Tanzania's treaties the higher tax rates can be found in the ones signed with OECD countries and the 10 % rates in the ones with other African countries; Zambia has only managed to include withholding tax rates higher than 10 % in less than half of its treaties with OECD countries but in all its treaties with other African countries. Burundi, Mozambique, Rwanda and Zimbabwe have a majority of treaties where a 10 % rate is included and a few treaties with even lower rates. The lowest rates under 10 % can mainly be found in the treaties either with other African or with non-OECD countries. In the treaties of Ethiopia, Madagascar and Malawi a mix of rates can be found.

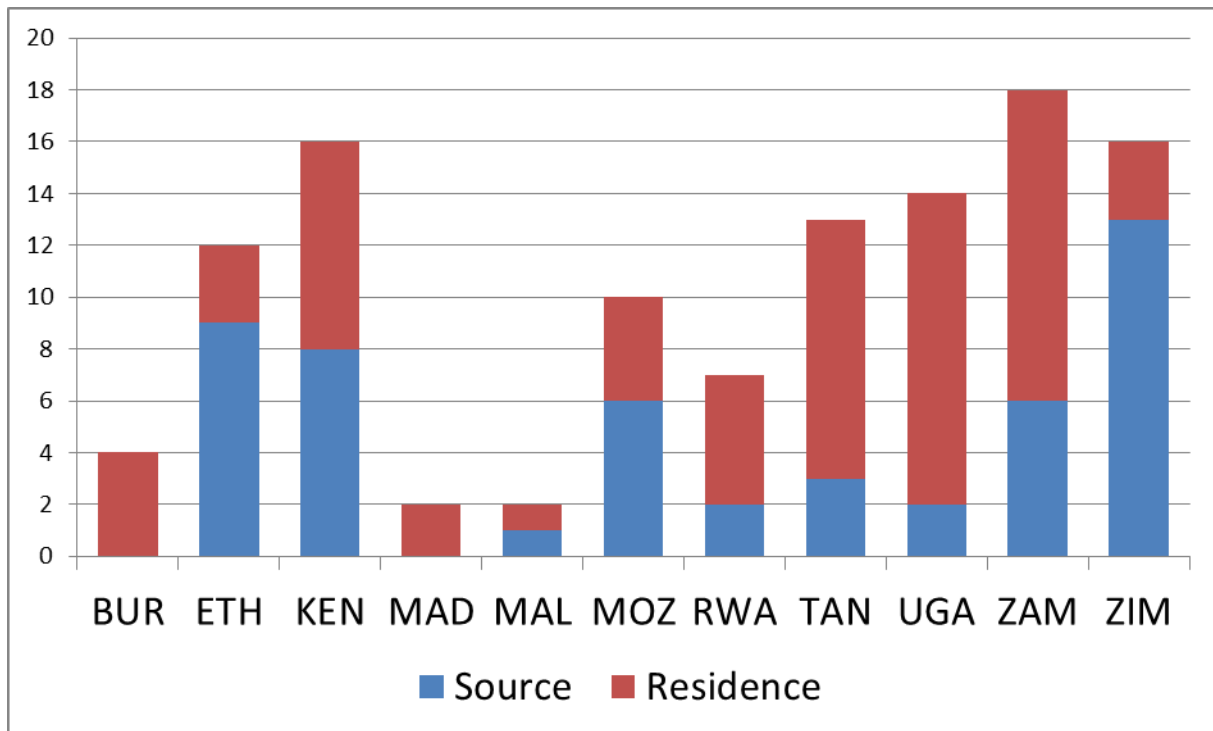
6. Profits from dealings in land

Following Art. 13 Para. 4 UN Model, income from the disposal of shares in land-rich companies may be taxed in the source state, i.e. the state in which the immovable property is situated. Land-rich companies include not only companies but also partnerships, trusts and estates the property of which consists principally, i.e. more than 50 %, ¹² of immovable property. An interesting fact is that in 2003 the OECD has introduced a similar paragraph in its Art. 13 – a rare case where the OECD followed the UN and not the other way around. The wording of Art. 13 Para. 4 OECD Model, however, differs from the UN Model's equivalent.

¹¹ These are the Kenya-Italy treaty (before it was amended by a protocol in 1997 the withholding tax rate was 15 %), the Mozambique-UAE treaty (but only for business royalties, cultural royalties may be taxed with up to 5 %), 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.

¹² The 50 % threshold was introduced in the course of the 2001 update and is laid down in Art. 13 Para. 4 Subpara. 2 UN Model.

Fig. Source taxing rights on income from the alienation of shares in land-rich companies

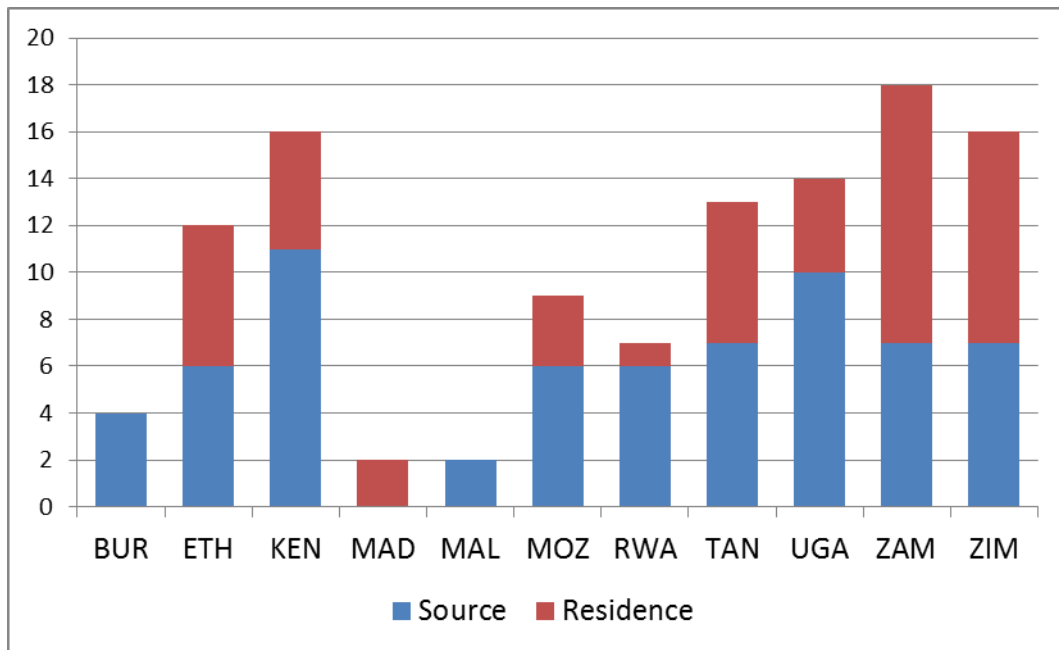


The source taxing right for income from the alienation of shares in land-rich companies can be constituted by including an OECD or UN model style rule or by including different rules which lead to a similar result, e.g. treating the selling of shares as alienation of immovable capital. For the purpose of the table above, no difference was made between these rules. Moreover, such treaties where the alienation of shares in general may be taxed in the source state, i.e., where the company the shares of which are sold is resident, are taken into account.

7. Other income

Tax treaties are structured in a way that all possible income is covered. For this purpose usually they have a catch-them-all clause, which encompasses all income which cannot be categorized under the other allocation rules. Whereas the OECD model allocates the taxing rights in respect of this “other income” exclusively to the residence state, the UN model sets forth that other income arising in the source state may also be taxed there.

Fig. Source taxing rights on other income



All of the African target countries, except for Madagascar, Zambia and Zimbabwe, could in at least half of their treaties secure taxing rights at source for other income. Kenya, Tanzania and Uganda have given away 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, even vis-à-vis OECD countries.

8. 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 forego 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.

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