

Double taxation agreement between Kenya and Mauritius

Submission to the High Court of Kenya

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1. I have been asked by Tax Justice Network - Africa (TJNA) to comment on the replying affidavit dated 2nd November 2015 and submitted by the Attorney General's office ("the affidavit") in response to TJNA's petition number 494 of 2014, regarding the double taxation agreement between Kenya and Mauritius.
2. Paragraphs 4, 5 and 7 of the affidavit suggest that reduced withholding tax rates within the double taxation agreement will attract investment into Kenya. I have studied the academic literature on the relationship between double taxation agreements and foreign direct investment at length, and can confirm that there is no firm evidence base for this assertion. While some studies have found that treaties increase the flow of investment into signatories, others have found no effect or even that treaties reduce the flow of investment. Few of the academic studies are based on data that have a reliable coverage of developing countries, and most are unable to control for the distorting impact of 'treaty shopping' on investment data. A list of the academic studies reviewed is given in an annex to this document.
3. Notwithstanding the uncertain evidence base, there is another reason why the lower rates in this double taxation agreement may not attract investment into Kenya. Mauritius is not in its own right a large source of outward investment, and so it is likely that the main effect of lower rates in this treaty will be to provide an avenue for multinational investors from other countries to pay withholding taxes at a lower rate than envisioned for them in Kenya's statutory rates or any treaty between Kenya and their country of residence.
4. Paragraphs 9 and 10 suggest that the provisions of Article 5(3)(b) and Article 5(7) of the agreement will permit Kenya to tax services despite the omission of a specific article permitting Kenya to impose withholding taxes on management, technical service and consultancy fees. This is only partially correct, and the confidence of the assertion in article 10 is unjustified. Without the aforementioned article, Kenya will be able to tax services provided by Mauritius-resident companies whose presence in Kenya meets the permanent establishment threshold described in Article 5. Kenyan law, however, permits a withholding tax to be levied on all companies and individuals who provide such services even if they do not meet this test. The treaty will prevent Kenya from levying this tax on Mauritian residents. The main effect will be that Mauritius-resident companies and individuals who provide management, technical and consultancy services in Kenya but are not present in the country for the minimum length of time prescribed in the provisions of Article 5 will not be taxed in Kenya.
5. It has been suggested to me in interviews with Kenya Revenue Authority and Treasury officials that Article 21 of the agreement, which covers income not expressly mentioned elsewhere in the agreement, might allow Kenya to impose the aforementioned withholding tax. This view, however, is not shared by many international commentators on the legal interpretation of double taxation treaties. This precisely why the United Nations Committee

of Experts on International Cooperation in Tax Matters has recently decided to add a provision permitting the imposition of withholding taxes on technical service fees into its model tax convention.

6. The introduction of capital gains tax in Kenya is undermined by the Kenya-Mauritius agreement, because it provides a route for foreign investors to structure their investments to avoid it. It may also be possible for domestic investors to engage in 'round tripping' to achieve the same effect, despite anti-abuse rules in Kenyan domestic law, because the capacity of such rules to override international double taxation agreements is uncertain. As paragraphs 12 and 13 note, Capital Gains Tax had not been imposed in Kenya when the agreement was negotiated. But because a major effect of double taxation agreements is to constrain current and future governments' tax policies, it is negotiators' responsibility to anticipate potential future changes to the tax system of their country, as well as taking into account its existing features.
7. According to paragraph 15, tax sparing is the "core and essence" of double taxation agreements, but this is not correct, and only a minority of double taxation agreements include such provisions. Indeed, since an OECD report in 1998 entitled *Tax Sparing: a reconsideration*, the practice has been largely discredited in double taxation agreements signed by OECD members because it provides opportunities for tax 'treaty shopping', and creates an incentive to repatriate profits rather than reinvesting them in developing countries.
8. The affidavit discusses at length the correct procedure for ratification of double taxation agreements in Kenya. I cannot comment on the interpretation of the Kenyan constitution, but I would observe that double taxation agreements are ratified by the legislature of almost all developed countries, and an increasing number of developing countries. Examples include the UK, US, Thailand and South Africa. Given that double taxation agreements place restrictions on the fiscal resources available to the state under present and future governments, this seems to me the only appropriate way to ensure effective scrutiny in a parliamentary democracy such as Kenya.

London, 9th December 2015

Annex: academic studies on the relationship between double taxation treaties and foreign investment

Barthel, Fabian, Matthias Busse, and Eric Neumayer. "The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence From Large Dyadic Panel Data." *Contemporary Economic Policy* 28, no. 3 (December 30, 2009): 366–77. doi:10.1111/j.1465-7287.2009.00185.x.

Blonigen, B A, and R B Davies. "The Effects of Bilateral Tax Treaties on USFDI Activity." *International Tax and Public Finance* 11 (2004). doi:10.1023/b:itax.0000036693.32618.00.

Blonigen, Bruce A., Lindsay Oldenski, and Nicholas Sly. "The Differential Effects of Bilateral Tax Treaties." *American Economic Journal: Economic Policy* 6 (2014): 1–18. doi:10.1257/pol.6.2.1.

Coupé, Tom, Irina Orlova, and Alexandre Skiba. "The Effect of Tax and Investment Treaties on Bilateral FDI Flows to Transition Economies *." In *The Effect of Treaties on Foreign Direct Investment*, edited by Karl P Sauvant and Lisa E Sachs, 687–713. Oxford University Press, 2009. doi:10.1093/acprof:oso/9780195388534.003.0024.

Davies, R B. "Tax Treaties and Foreign Direct Investment: Potential versus Performance." *International Tax and Public Finance* 11 (2004): 775–802. doi:10.1023/b:itax.0000045331.76700.40.

Davies, RB, PJ Norbäck, and A Tekinoru. "The Effect of Tax Treaties on Multinational Firms: New Evidence from Microdata." *The World Economy* 32 (2009). doi:10.1111/j.1467-9701.2009.01158.x.

Egger, Peter, Mario Larch, Michael Pfaffermayr, and Hannes Winner. "The Impact of Endogenous Tax Treaties on Foreign Direct Investment: Theory and Evidence." *Canadian Journal of Economics-Revue Canadienne D Economique* 39 (2006). doi:10.1111/j.1540-5982.2006.00375.x.

Egger, Peter, and Valeria Merlo. "Statutory Corporate Tax Rates and Double-Taxation Treaties as Determinants of Multinational Firm Activity." *Finanzarchiv* 67 (2011). doi:10.1628/001522111x588754.

Kumas, Abdullah, and Daniel L Millimet. "It's All in the Timing: Assessing the Impact of Bilateral Tax Treaties on U.S. FDI Activity." In *The Effect of Treaties on Foreign Direct Investment*. New York: Oxford University Press, 2009. doi:10.1093/acprof:oso/9780195388534.003.0022.

Lejour, Arjan. *The Foreign Investment Effects of Tax Treaties*. CPB Discussion Paper, 2014.

Louie, Henry J, and Donald J Rousslang. "Host-Country Governance, Tax Treaties and US Direct Investment Abroad." *International Tax and Public Finance* 15, no. 3 (2008): 256–73. doi:10.1007/s10797-007-9020-5.

Neumayer, Eric. "Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?" *Journal of Development Studies* 43, no. 8 (November 2007): 1501–19. doi:10.1080/00220380701611535.