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# THE INTERACTIONS OF NATIONAL AND INTERNATIONAL TAX LAW AND THE KENYA - MAURITIUS TAX TREATY

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## ABSTRACT

*International tax rules and norms interact in complex ways with national law, mediated by the professional practices and techniques of lawyers and other tax advisers and practitioners. The current controversy over the proposed tax treaty between Kenya and Mauritius illustrates some of the features of these practices, as well as the policy issues at stake for both the fairness and effectiveness of taxation and the effects of tax treaties on international investment. A clearer understanding of these issues can greatly facilitate public debate on both the role of tax treaties and the current efforts to reform international tax rules.*

**Key words:** Anti avoidance tax rules, double taxation agreements, treaty shopping, Kenya, Mauritius, preferential tax regimes.

## 1. INTRODUCTION

The international tax system has been undergoing an unprecedented re-examination for over five years, since the launching in 2013 of the G20/OECD project on base erosion and profit shifting (BEPS). This is a complex process driven by economic and political considerations, and is also mediated by legal and normative practices. These involve interpretation and reinterpretation of legal texts, and the formulation of arguments, opinions, proposals and drafts for new texts.

This article will examine the role of law and lawyers in this process, by focusing on the controversy over the negotiation of the bilateral tax treaty between Kenya and Mauritius, which was the subject of a recent decision in the High Court of Kenya (TJN-Africa 2019). Tax treaties form the skeleton of the international tax system, and the challenge to this particular treaty raised some wide-ranging issues about how this system has been shaped. Consideration of this case will also illustrate the complex interactions of national and international law relating to taxation of multinational enterprises (MNEs), and the techniques and strategies deployed by advisers for MNEs, government officials and others involved in the international tax reform process.

I will begin in section 1 by outlining my approach to understanding how law works as a social process, focusing especially on the techniques of lawyers, particularly in its interpretation. This is important especially for corporate taxation, which is both a complex technical field and a site of economic and political contestation and power. Professionals such as lawyers are trained in specialised knowledge and skills, that they generally deploy on behalf of their clients. However, in my view they also have wider

social responsibilities. Unfortunately, lawyers' professional practices often create greater complexity and obscurity, and so restrict access to the debate to those with the resources to invest in the intellectual capital needed to master arcane concepts and language. So, the aim of this paper is to try to explain some of the technicalities as clearly as possible, to facilitate wider participation in this important public policy issue, as it has been framed in legal terms.

Section 2 of the paper will focus on the Kenya-Mauritius tax treaty case, in order to analyse the more general issues raised by tax treaties: the interaction between national taxation and the international obligations created by tax treaties, which are said to be justified by the need to attract foreign investment. This rationale has been challenged by critics such as Tax Justice Network-Africa (TJN-A), which brought the case, arguing that treaties result in significant losses of tax revenues, which do not seem counterbalanced by increased investment. A treaty with a jurisdiction such as Mauritius is particularly problematic, since such countries offer themselves as hubs for international investors (especially MNEs) from other countries, who can take advantage of 'treaty-shopping' to avoid tax. Section 3 will go on to discuss whether these dangers have been dealt with by the reforms resulting from the BEPS project.

### **1.1 A socio-legal perspective on legal interpretation**

My analysis adopts a 'contextual' or 'socio-legal' approach to law. This sees law as a social process involving particular techniques and practices carried out through a range of procedures and institutions. Most lawyers, and even non-lawyers, take a formalist or positivist view, which considers that law is simply applied or enforced. This assumes that legal texts have a clear or natural meaning, and that they result from and simply embody political decisions taken by governments, so that there is a sharp separation between law and politics.

However, law mediates social and political conflicts, its meaning is fluid and contested, and the debates over legal meaning form part of those conflicts. In a state based on the rule of law, political considerations affect both the formulation of legal measures and the processes of their implementation. Lawyers are involved everywhere, from the formulation of proposals and drafts of texts such as legislation or treaties, to the interpretation and application of these texts once issued as law. Indeed, this is a continuous and recursive process, because if a lawyer fails to persuade a government official or a judge to accept an interpretation that favours a client, the argument can always be pursued in another forum, including the legislature.

## **1.2 The indeterminacy of legal norms**

From this perspective, legal texts do not have a fixed, inherent meaning: their meaning is shaped by the social process of interpretation. To be sure, the fixation of a rule in a formal legal text narrows the scope of interpretation. However, even a written text remains inherently indeterminate. Although lawyers constantly battle over the meaning of legal rules, they usually prefer to think that the problem is lack of clarity or ambiguity due to poor drafting, and often assert that their interpretation is the correct one.

The inherent indeterminacy of law is due to three main reasons. First, as linguistic philosophers have shown, all language is given its meaning by the social context and practices. A word such as ‘house’ has a different meaning in an African village and a large cosmopolitan city. From a sociological perspective this means that specialised technical language such as that used by lawyers is given meaning through the professional practices of ‘cognitive communities’ of specialists (Picciotto 2015). Concepts that are central to tax law, such as ‘income’, have taken on complex connotations through decades of discussion by lawyers in many countries about their ramifications.

Secondly, in a liberal legal system legal rules are formulated in abstract terms, to apply to a general class of cases. Some are formulated as very general principles or standards, while others may be couched as more specific rules. Nevertheless, both are abstract norms specifying how legal subjects should behave in the future. This leaves considerable scope for interpreting how they should apply to specific actions or situations, whether by legal subjects themselves, their legal advisers, state officials responsible for enforcement, or ultimately by judges in the rare case that results in litigation concluding with a court decision. General principles are simpler and more flexible, applying to a wide range of specific situations, but they consequently leave more room for differing interpretations. They can work well if there is wide consensus about their implications, but they become hard to enforce if there is disagreement or a motivation to avoid their application. More specific rules or regulations leave less room for argument so can be easier to apply, but their lack of flexibility often makes them detailed and highly complex. They also can be avoided, by devising a method that does not contravene the specific action they prohibit while achieving the purpose they are intended to defeat.

Effective legislation can combine the two: for example, there is usually a general principle against dangerous driving on roads, and what is considered ‘dangerous’ can be interpreted flexibly according to road and traffic conditions; but there are usually also more specific regulations such as speed limits for particular roads, which are more rigid. Some areas of law become highly complex, because

disagreements and avoidance behaviour can undermine consensual interpretation of general principles, resulting in attempts to block loopholes through an increasing proliferation of specific rules. This has happened in many countries with tax law (Picciotto 2015). Hence, several commentators have argued that a combination of general principles and more detailed rules or regulations would be more effective also in tax law (Avery-Jones 1996, Braithwaite 2002).

Thirdly, legal rules are normative. This means that their interpretation is necessarily a teleological or purposive activity. To put forward an interpretation of a legal rule is to propose the desirability of one norm rather than another. Although lawyers often put forward their interpretations of legal rules as if that were the only and obvious way to understand them, they are always to some extent advancing a version that is in the interests of their client, or for some other purpose. For example, a judge who adopts a 'literalist' approach to interpretation is claiming faithfully to apply the intentions of the legislature. Yet such a stance also has a purpose or motive. For example, it may reflect a reluctance to accept an interpretation that could be considered controversial or unorthodox, or indicate that the judge is inviting the legislature to step in and amend the legal text. Technicism or formalism generally aims to depoliticise the issue under debate, while a purposive approach makes explicit the broader issues involved.

### **1.3 Legal pluralism**

In addition to the indeterminacy of particular legal texts, lawyers' techniques of interpretation involve navigating between a great variety of rules or norms. The formal law of the modern state includes several types of authoritative legal sources: the state constitution, primary and secondary legislation of the central state, by-laws issued by regional or local authorities, the decisions of tribunals and courts, and the regulations governing a variety of institutions or communities, such as school rules, corporate or industry codes of conduct, or the regulations of stock exchanges. Former colonies often continue to recognise both tribal 'customary law', and the 'received law' of the previous imperial mother country, which adds to the kaleidoscope of their sources of law.

Each set of rules has its scope of application, but they also interact. The validity of some may depend on their compliance with the higher authority of another: statutes are subject to the overarching standards of the constitution, and subsidiary legislation must be within the delegated powers of the primary statute. Court judgments add a parallel layer of authoritative norms or jurisprudence, while courts also refer to various sources as aids to interpretation.

International interactions add a further layer of complexity. Governments enter into international agreements or treaties, many of which require changes to domestic law, and this creates sometimes complex issues. This is particularly the case for tax treaties, since they are written to be directly applicable to legal persons, not just as obligations on states. They are supplemented by related legal texts such as Commentaries, and by semi-formal documents such as guidelines and official reports.

Managing and exploiting these interactions between national and international law has become an increasingly important field of legal practice, sometimes described as transnational law. Some aspects of the techniques involved will be illustrated in the case study discussed below.

#### **1.4 How law's body works**

I suggest that the legal process can be understood by analogy with the human body. Its skeleton consists of the formal legal texts, such as legislation, treaties, court decisions, codes and regulations. The actual shape or form of the body is given by the surrounding tissue, consisting of the interpretation of these texts in the vast corpus of legal commentaries, which gives them real meaning. Finally, the blood in the veins and the muscles giving the body life and movement is provided by the interpretive community, mainly lawyers of various kinds.

Great power is wielded in the processes of public policy formation by the professionals skilled in these techniques, particularly lawyers (Madsen 2006, Picciotto 2015). Especially where a market exists or can be created for such professional practices in a particular field, enormous investments pour into the refinement and dissemination of the concepts and norms of the field. These include educational programmes, training courses, publications, conferences and participation in debates and consultations. Since big business has the resources to employ the best professionals, often in large numbers, it is not surprising that these policy debates become dominated by the interests and perspective of corporate capital.

The general field of international tax concerns tax treaty rules and their interpretation. Within that wide field is the more specific specialisation of transfer pricing. This quickly became important from the 1980s, with an increasing proliferation of specialist courses and publications, and the creation of practice groups in the large global legal and corporate advice firms, as well as the emergence of smaller boutiques offering more specialist techniques such as micro-economic analysis. This field, like many others, is also inter-disciplinary, involving competition between professionals trained in law, accounting

and economics, as well as a blending of these perspectives. The ideas, language and techniques created in such a field of private practice tend to also pervade the public sector, due to the intermingling of personnel in professional interactions, and career paths through the ‘revolving door’ between the private and public sectors.

## **2. THE KENYA-MAURITIUS TAX TREATY CASE**

### **2.1 The aims of tax treaties**

Tax treaties create particularly complex interactions between national and international law, which provide fertile ground for lawyers. The power to tax is central to states and their governments, a key element in national sovereignty. The viability and effectiveness of a state largely depends on the creation of a tax system accepted as legitimate, and in modern fiscal states this rests on notions of fairness. Thus, the centrepiece of tax systems has become tax on income or profits, although governments also rely on a variety of other levies. Tax law is an important field of practice for lawyers, as well as other professionals such as accountants.

The scope of national taxes also needs to be coordinated between states, due to the growth of international economic activity, especially international investment. Even though a state’s power to enforce taxation is ultimately limited to its territory, it can be applied both to income earned there, and to persons resident in the state on their income from abroad. So, if a resident in state A has a business in state B, there could be double taxation of the income from the business -- though only if both states actually exercise their jurisdiction to tax it. Indeed, international business has complained of such double taxation since early last century.<sup>1</sup>

The possibility of international double taxation can be dealt with at national level, as it has been in most countries, including African states. Some, like Kenya, do not tax their residents on foreign income, even though this may encourage them to invest abroad to take advantage of lower foreign taxes.<sup>2</sup> Others, such as Uganda, that do tax residents on income from all sources, even from outside the country, grant a unilateral credit for foreign taxes paid on the same income.<sup>3</sup> Hence, neither Kenya nor Uganda need

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<sup>1</sup> For an outline of the development of the international tax system, from the perspective of developing countries, see Picciotto 2013.

<sup>2</sup> Kenya charges residents and non-residents only on income accrued in or derived from Kenya (Income Tax Act s. 3) and provides relief for international double taxation only under international arrangements (s.41).

<sup>3</sup> Uganda taxes residents on income ‘derived from all geographical sources’ (Income Tax Act s. 17.2) but grants a unilateral credit for income tax paid on foreign income declared (s. 81), as well as exempting foreign-source employment income from which tax has been withheld at source (s.80).

treaties to ensure that their own residents are not subject to international double taxation. Non-residents are only taxed on income considered to arise from activity in the country. Each country can decide how much it wishes to tax income from business conducted in that country, and this should depend on its need to attract foreign investment. Indeed, capital-importing countries frequently offer tax reductions or incentives with this aim. For example, Kenya has created export-processing zones, which provide tax exemptions for export-oriented production.<sup>4</sup>

Tax treaties aim to encourage international investment, essentially by restricting a host country's right to tax income from sources within the country (Brooks & Krever 2015). Their effect is to lock in the limitations that the partner states are willing to accept on their jurisdiction to tax, by restricting the changes they can make to taxes affecting foreign investors. These are significant limitations on national sovereignty but have been argued to be needed because making such commitments is necessary to encourage international investment (Lang & Owens 2014). It is easier for such treaties to be negotiated between states that are both exporters of capital, since both countries obtain symmetrical benefits for their investors in exchange for any tax foregone. For developing countries, which are mainly importers of capital, it is harder to justify entering into tax treaties. The spread of such treaties can perhaps be explained by the emergence of some complementarities in negotiating strategies since the 1970s. While important capital-exporting countries such as the UK pursued the aim of supporting investment abroad by their MNEs and reducing their overall effective tax rates, developing countries placed more importance on attracting investment and preserving their right to grant incentives than on ensuring effective taxation (Hearson 2017). Thus, tax treaties became aimed at facilitating international investment, largely disregarding their negative effects on ensuring fair and effective taxation.

However, commentators have pointed out that there is no clear evidence that tax treaties do in fact lead to increased investment (Brooks and Krever 2015, Beer and Loeprick 2018). The advice now from the International Monetary Fund is that:

*the benefits that a treaty could provide to such a country may actually be of relatively little value. ... What is clear is that countries should not enter treaties lightly— all too often this has been done largely as a political gesture—but with close and well-advised attention to the risks that may be created' (IMF 2014: 27-28).*

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<sup>4</sup> An export processing zone enterprise (i.e. one licensed under the Export Processing Zones Act 1990, s. 23, to produce only for export) is exempt from tax for 10 years (Income Tax Act Schedule 3), but is subject to a rate of corporate tax of 25% for the following 10 years (if it is still in existence); during the period of exemption period it is deemed to be a non-resident and is governed by ITA Schedule 11.

It is important to bear in mind that treaties do not impose taxes, nor are they needed to do so - the right to tax stems from national law. Tax treaties are particularly powerful for two reasons. First, they limit the power of states to tax foreign investors. These limitations are directed mainly at source taxation, that is to say they limit the sovereignty of host states to tax MNEs rather than their states of residence. Secondly, these treaties are generally incorporated directly into national law, creating enforceable legal rights. In effect, they create a special tax regime within national law for MNEs, giving tax advantages to non-residents. Being binding on the state, they provide protection for non-residents from future taxation, unless the treaty is renegotiated. For this reason, legal advisers for MNEs are very active in lobbying around the negotiation of tax treaties, including on their content.

## **2.2 Tax treaties and national law**

In most countries it is the executive branch of government that is responsible for the state's international affairs, including the negotiation of international agreements.<sup>5</sup> Governments usually prefer to keep negotiations confidential, though there may be private meetings and consultations with interested persons. However, tax treaties are worded so as to create rights directly for legal persons.<sup>6</sup> For this to be effective, they must be incorporated into national law, which usually requires the approval of parliament. Various methods are used by states to align their domestic law to their international obligations. Since the executive is also usually responsible for initiating domestic legislation, it is responsible for ensuring that national law is in line with international obligations.

Some countries adopt a 'dualist' approach, separating international and national law. Thus, in the UK's unwritten constitution, treaties do not create rights or obligations in domestic law unless they are formally incorporated. This means that before the UK ratifies a treaty that requires any change to domestic law, the executive must obtain the agreement of parliament for those changes. In the case of tax treaties, UK tax legislation has ensured that this occurs automatically once a treaty has been tabled in and approved

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<sup>5</sup> In international law a legally binding agreement between states is usually referred to as a treaty, although the term 'convention' can also be used (particularly for a multilateral agreement). The international law governing treaties has been stated in the Vienna Convention on the Law of Treaties (VCLT), which is a multilateral agreement, but is generally considered to be a statement of generally accepted rules of international law. It defines a treaty as 'an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation'. There are also international agreements that are not considered to bind the state, such as agreements between governments, branches of government, or public bodies; these are sometimes described as memorandums of understanding (MOUs), and their legal status is unclear (see Picciotto 2011: 21-22, 53-55, Shelton 2000).

<sup>6</sup> This is not usually the case even for treaties on economic matters, e.g. trade agreements, or those governing intellectual property rights.

by parliament.<sup>7</sup> Uganda's 1995 Constitution makes the relationship clearer: its article 123 gives the executive (the President) the power to negotiate treaties, while stating that parliament must create laws governing their ratification. However, Uganda's parliament has ceded to the Cabinet the right to ratify most treaties, requiring only that ratified treaties must be laid before parliament 'as soon as possible'.<sup>8</sup> Once ratified, the Uganda Income Tax Act provides that an international agreement shall take effect as if it were part of that Act (s.88). It goes further and specifies (s.88.2) that the provisions of such an agreement will override the Act and other statutes if they are inconsistent, although with the important exception of its anti-avoidance provisions. (This is discussed in section 3.2 below).

Other countries adopt a 'monist' approach, that automatically incorporates international obligations into national law. Thus, the US Constitution article VI.2 states that the constitution, laws made under it, and treaties 'shall be the supreme law of the land'. This puts national and international law on an equal footing.<sup>9</sup> However, the US Constitution also requires international agreements to receive the 'advice and consent' of the Senate, by a two-thirds majority.<sup>10</sup>

Kenya's Constitution of 2010 also provides that both general international law and 'any treaty or convention ratified by Kenya' shall 'form part of the law of Kenya' (s.2). In addition, the Income Tax Act includes a provision (s.41) giving effect to any international double taxation arrangement published by the Minister of Finance, and requiring such an arrangement to be laid before parliament without delay. Like Uganda, treaty provisions are stated to override other domestic laws, except for the anti-abuse provision (s.41.5).

The Kenya Constitution does not explicitly give the parliament any role in approving treaties. It does, however, include 'participation of the people' in its statement of national values and principles of governance (article 10). Furthermore, article 201 lays down principles of public finance, and specifies 'openness and accountability including public participation in financial matters'. In addition, article

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<sup>7</sup> Taxation (International and Other Provisions) Act (TIOPA) 2010 ch. 1 s. 2.

<sup>8</sup> Under the Ratification of Treaties Act 1998 treaties can be ratified by the Cabinet, except that a resolution of Parliament is needed for those relating to armistice, neutrality or peace, or when the Attorney-General certifies in writing that they would entail a constitutional amendment.

<sup>9</sup> Some countries go further and give superior status to international law. Notably, article 55 of the Constitution of France of 1958 states that treaties or agreements once properly ratified and published prevail over domestic legislation, provided that they are respected by the other party.

<sup>10</sup> This acts as a brake on the power to negotiate treaties; however, the US developed a category of 'executive agreements' that can be concluded by the executive without the Senate's consent, although they do not take effect in domestic law unless incorporated by legislation.

210.1 specifies that ‘No tax or licensing fee may be imposed, waived or varied except as provided by legislation’. Hence, although it does not spell out a procedure for involving parliament in the treaty-making process, a good argument can be made that such participation is necessary. This is especially so for treaties that will directly change domestic law, particularly on taxation.

Parliament itself has, indeed, enacted such procedural requirements, in the Treaty Making and Ratification Act (TMRA) of 2012. This lays down detailed requirements that the executive branch must follow in the whole treaty-making process, including evaluation of desirability of the treaty, and procedures for ratification. The Cabinet Secretary is required to present an explanatory memorandum as specified by the Act (s.7), and if ratification is agreed by the Cabinet must again submit a memorandum to the Speaker of the National Assembly (s.8). Approval is required by one or both of the Houses of Parliament, depending on the content. Furthermore,

*The relevant parliamentary committee shall, during its consideration of the Treaty, ensure public participation in the ratification process in accordance with laid down parliamentary procedures. (Section 8.3).*

The Clerk of the National Assembly has issued a Factsheet outlining the arrangements for such participation in the legislative or other business of parliament, especially the budget-making process (Kenya National Assembly 2017).

### **2.3 The TJN-Africa complaint and court case**

A tax treaty between Kenya and Mauritius was signed in Port-Louis in May 2012 and published in the Mauritius government gazette a month later.<sup>11</sup> It seems to have been published by a Legal Notice in a supplement of the Kenya government gazette two years later, on 23 May 2014.<sup>12</sup> On 3 October 2014 a petition was filed in the Kenya High Court by Tax Justice Network Africa (TJNA), a civil society organisation. The petition asked the Court to order the Cabinet Secretary for Finance to withdraw the notice of the treaty and submit it to parliament in accordance with the TMRA 2012, and with articles 10 and 201 of the Constitution. Responses were filed by the Kenya Revenue Authority (Large Taxpayers’ Office) in January 2015, and by the Treasury in November 2015. Submissions by the parties were

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<sup>11</sup> See <http://internationaltaxtreaty.com/download/mauritius/dtc/Mauritius-Kenya-DTC-May-2012.pdf>

<sup>12</sup> Although described as Supplements to the Kenya Gazette, Legal Notices are published separately, on an individual basis, and accessible on the Kenya Law website. This one is available at [http://kenyalaw.org/kl/fileadmin/pdfdownloads/LegalNotices/2014/LN59\\_2014.pdf](http://kenyalaw.org/kl/fileadmin/pdfdownloads/LegalNotices/2014/LN59_2014.pdf).

completed by April 2016. The Court finally published its judgment on 5 March 2019.<sup>13</sup> This found a middle ground in the legal dispute between the parties. Although it rejected the arguments presented by the petitioner, it invalidated the treaty on the grounds that it had not been laid before parliament within 7 days as required by the Statutory Instruments Act 2013, s.11.

The court decision brought the treaty into the public spotlight, achieving the petitioner's political aims. The treaty's initial publication by Mauritius in 2012 had been reported in the specialist international tax press.<sup>14</sup> When it was gazetted in Kenya in May 2014 professional advisers in Kenya and Mauritius quickly noted it, and issued advisory notes aimed at clients, some reporting that it had come into force,<sup>15</sup> although its status was not clear. The government submissions in the case later claimed that ratification had been approved by the Cabinet in either August or October 2013 (para. 18), but it seems that the two governments did not exchange the notifications required under article 28 of the treaty for its entry into force. The court case put this issue into abeyance. Following the decision, TJN-A quickly proclaimed its victory in a press release.<sup>16</sup> A month after the Court decision, on 10 April 2019, the specialist tax press picked up an announcement by the government of Mauritius that a tax treaty had again been signed (with five other treaties) during a visit by President Uhuru Kenyatta to Port-Louis.<sup>17</sup>

The High Court decision has created a dilemma for the Kenya government, although the judges did not accept TJN-A's arguments, thus avoiding a direct confrontation with the executive. Can it rely on the judgment and proceed to ratify the treaty without complying with the procedure specified in the TMRA? To comply with the judgment it must at least lay the treaty before parliament, but can it risk doing so without submitting an explanatory memorandum and opening it up to a full scrutiny, including public participation, as specified in the TMRA? For that matter, what is the status of the other half-dozen tax treaties signed and gazetted since 2010 (Mutava 2019, Waris 2017, 10)? These issues will undoubtedly be further debated, and renewed litigation is likely, perhaps going up to the Kenya Supreme Court. At the time of writing, the treaty signed in April 2019 has not been published by either country, though

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<sup>13</sup> *TJN-A v. Treasury et al* (2019); citations to paragraph numbers below refer to this text.

<sup>14</sup> *Tax Notes International*, a key source for tax professionals, republished it on 3 December 2012.

<sup>15</sup> See for example the report by Axis, that describes itself as 'a leading Mauritius-based independent trust company providing a full spectrum of fiduciary and corporate services to an international client base' <https://www.axis.mu/uploads/DTA-%20Mauritius%20&%20Kenya.pdf>.

<sup>16</sup> Available at <https://taxjusticeafrica.net/wp-content/uploads/2019/04/PRESS-RELEASE-COURT-DECLARES-KENYA-MAURITIUS-DTA-UNCONSTITUTIONAL-2.pdf> The press release was criticised as misleading in a case-note of the judgment in a tax law journal published in the UK (Ogembo 2019).

<sup>17</sup> The announcement is here <http://www.govmu.org/English/News/Pages/Signature-of-six-agreements-Mauritius-and-Kenya-enhance-cooperation-in-several-fields.aspx>, and the report in MNE Tax, is here <https://mnetax.com/kenya-and-mauritius-sign-new-tax-treaty-following-court-nullification-of-earlier-agreement-33414>.

authoritative sources suggest that it is the same as that signed in 2012.

On the face of the decision, the reasons given for rejecting the arguments presented for TJN-A seem weak. The judgment turned on a narrow interpretation of s.3 of the TRAM:

3. (1) *This Act applies to treaties which are concluded by Kenya after the commencement of this Act.*  
(2) *This Act shall apply to—*  
(a) *multilateral treaties;*  
(b) *bilateral treaties which deal with—*  
(i) *the security of Kenya, its sovereignty, independence, unity or territorial integrity;*  
(ii) *the rights and duties of citizens of Kenya;*  
(iii) *the status of Kenya under international law and the maintenance or support of such status;*  
(iv) *the relationship between Kenya and any international organisation or similar body; and*  
(v) *the environment and natural resources.*  
...  
(4) *Notwithstanding subsection (2)(b), the Government may enter into bilateral agreements—*  
(a) *necessary for matters relating to government business; or*  
(b) *relating to technical, administrative or executive matters.'*

The Court found that this article makes a distinction between ‘treaties’, to which the requirements of the Act apply under 3.2, and ‘international agreements’, which are excluded by article 3.4.

*‘If the intention was for the two provisions to mean the same then there would be no need to distinguish the two by the use of “Treaty” and “Agreement”’. (Para. 35).*

Since the Kenya and Mauritius governments had described the document they signed as an ‘agreement’, the court held that it was exempted from the procedural requirements of the TRAM by the exception in s.3.4. This implies also that the provisions in the Constitution do not apply to ‘international agreements’, particularly article 2.6, that declares that a ‘treaty or convention ratified by Kenya shall form part of the law of Kenya’.

This interpretation places a lot of weight on the choice of words in both the TRAM and the Constitution. The petitioner’s legal argument had pointed out that the word ‘treaty’ is generally used interchangeably with the term ‘international agreement’, and that the OECD recognises that tax agreements, sometimes described as conventions, are treaties within the meaning of the VCLT. Indeed, the VCLT itself defines a treaty as ‘an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation’ [italics added]. Further, although this was not discussed in the Court’s judgment, article 41 of the Income Tax Act, which incorporates tax agreements into domestic law, refers

to ‘arrangements’. It is not clear whether this term would be interpreted to include a document described as an international agreement, like the Kenya-Mauritius treaty.

It seems more important in interpreting the TRAM to consider its purposes in requiring parliamentary scrutiny and public participation prior to ratification of treaties, as well as the possible reasons for making the exclusions in s.3.4. As outlined above, tax treaties are directly incorporated into domestic law, in Kenya as elsewhere, and it seems hard to justify the view that this should occur without adequate parliamentary scrutiny. It seems likely that the exclusions in s.3.4 were aimed at the type of inter-governmental agreements classified in the US as ‘executive agreements’, and that do not result in changes to domestic law. As the petitioner pointed out, the TRAM in s.3.2.b.ii specifically includes bilateral treaties which deal with ‘the rights and duties of citizens of Kenya’. Since ratification of the treaty would result in its direct incorporation into domestic law, there would clearly be a direct legal effect on all residents of Kenya, including citizens. The division of powers embodied in the Kenyan constitution clearly gives a central role in the legislative process to parliament, so it seems appropriate for a treaty that would have direct legal effect to be scrutinised by the parliament. Indeed, it could be argued that parliament should be consulted earlier, as by the time negotiations are concluded it would be presented with a *fait accompli* (Mutava 2019).

By invoking the Statutory Instruments Act the Court at least conceded that parliament should be notified, but it implied that substantial evaluation was not necessary. Indeed, it accepted the government’s argument that the Constitution’s standards of integrity, transparency and accountability for governance were satisfied by the involvement of several departments, particularly the Kenya Revenue Authority in approving the treaty. In a striking turn of phrase the Court opined ‘Accountability in today’s democracy must be different from ancient Athenian democracy of direct participation of the people’ (para. 37). With respect to the learned judge (as lawyers say when disagreeing with an authoritative interpretation), the TRAM lays down what seems a modest and workable set of procedures for scrutiny and debate, falling well short of Athenian direct democracy. Parliaments in other countries have debated the policy issues raised by tax treaties; notably in September 2019 the parliament of Ireland had an extensive debate on the development implications of Ireland’s proposed tax treaty with Ghana.<sup>18</sup>

The petitioner also presented a number of criticisms of the contents of the treaty, which were countered by the government. The court seems to have been confused, perhaps understandably, by these arguments. The judgment commented that it had not been made clear which constitutional rights were allegedly

violated by the treaty (para. 34), and also that the petition lacked ‘specifics in terms of figures’ and other details of the possible losses to Kenya (para. 38). However, the petition did not ask the Court to decide on the substantive question of whether the treaty is good for Kenya. That is clearly not the role of a court. The criticisms were relevant as evidence that the treaty involves important issues for Kenya that merit wider debate, especially through the parliament.

#### **2.4 What is the benefit for Kenya of the Mauritius treaty?**

The aim of this treaty is to encourage international investment between Kenya and Mauritius. On both occasions when it was signed, it was part of a package including an investment protection and promotion agreement. However, as outlined in s.2.1 above, Kenya does not need a treaty to ensure that its residents are not subject to international double taxation on income from foreign investment, since in any case it does not claim to tax such income. The treaty would limit Kenya’s taxation of residents of Mauritius on income derived from Kenya, and lock in these commitments as long as the treaty remains in force. The treaties negotiated by Mauritius, including this one, also include other advantages for investors using companies resident in Mauritius. In particular, gains from the sales of shares in such companies are taxable only in Mauritius, which does not have a capital gains tax. At the time the treaty was first signed Kenya did not have capital gains tax, but one was introduced from 1 January 2015. Clearly, the treaty’s restrictions would mean both an immediate and continuing loss of tax revenues for Kenya, and a loss of tax sovereignty for the future. The justification for the treaty is that this could be offset by the additional economic activity that might result by stimulating investment from residents of Mauritius.

Who are the residents of Mauritius who might be attracted to invest in Kenya? Mauritius is a small island, with a population of some 1.3m people. Since independence in 1968 it has grown from a low-income agriculture-based economy to a middle-income country. This has been achieved largely by developing ‘offshore’ financial and professional services, aimed at non-residents. Essentially it has offered itself as a conduit country, a channel for investments from elsewhere. It launched its offshore business centre with its Banking Act of 1988 and the Offshore Business Activities Act 1992 (FSI 2018).<sup>19</sup>

A key element of this is the tax advantages it has offered to MNEs. The corporate income tax rate in

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<sup>18</sup> See [https://www.oireachtas.ie/en/debates/debate/select\\_committee\\_on\\_finance\\_public\\_expenditure\\_and\\_reform\\_and\\_taoiseach/2018-09-20/3/](https://www.oireachtas.ie/en/debates/debate/select_committee_on_finance_public_expenditure_and_reform_and_taoiseach/2018-09-20/3/)

<sup>19</sup> For a discussion of the role of offshore financial centres in the management of ‘global wealth chains’, focusing on Africa and including discussion of Mauritius, see Waris and Seabrooke 2017.

Mauritius is 15%, but this could be reduced to a maximum of 3% under its Global Business Licence (GBL) regime. Mauritius has a complex legal framework for the formation and taxation of corporate entities, including both companies and sociétés (which for tax purposes includes limited partnerships and limited liability partnerships).<sup>20</sup> Overlaid on this is the GBL regime, which governs offshore business, i.e. business done outside Mauritius. Until 2019 there were two categories of GBL: a GBL 2 company was licensed to do business only outside Mauritius, so was considered non-resident and not subject to tax. A GBL 1 company was licensed to carry out a number of activities considered to produce income from Mauritius, including providing ICT services, assets management, consultancy services, operational headquarters, financial services, insurance, logistics and marketing. Although a GBL 1 company was considered resident and hence income from these activities would be taxable in Mauritius, generous tax credits were allowed, especially a deemed foreign tax credit on 80% of its foreign source income, that brought the effective tax rate down to a maximum of 3%.<sup>21</sup>

This regime makes Mauritius the type of tax haven described as a conduit or treaty hub (FSI 2018, Beer and Loepriek 2019). A key technique for tax avoidance by MNEs is ‘treaty-shopping’ to take advantage of treaty hubs such as Mauritius. They can simply form intermediary entities in such jurisdictions either to own assets (such as intellectual property rights, or loans), or perform services (such as those permitted in Mauritius for GBL 1 companies) for other affiliates in the MNE group. The interest, royalties or fees they charge for these activities are deductible from gross income, so reducing the taxable income of the operating affiliates, while being taxed at a maximum of 3% in Mauritius. Since Mauritius does not apply withholding taxes to payments (such as dividends) from those Mauritian-resident entities, this income can simply flow through Mauritius almost entirely untaxed. Also, gains from the sale of a business owned through a holding company in Mauritius would be protected from capital gains tax.

The conduit system relies on the network of tax treaties negotiated by Mauritius especially since the 1990s, including 15 with countries in sub-Saharan Africa (beginning with Zimbabwe in 1992). These aim to enhance the attractiveness of Mauritius as a hub by restricting taxation at source, allowing tax-deductible payments for fees, royalties and interest to flow through Mauritius. Kenya applies withholding taxes on a wide range of payments to a non-resident, including management and professional fees, royalties and interest (Income Tax Act s.34). The proposed treaty with Kenya would only allow taxation

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<sup>20</sup> The relevant statutes, which interact in various ways, include the Income Tax Act 1995, the Foreign Tax Credit Regulations 1996, the Companies Act 2001 and the Financial Services Act 2007, all of which have been regularly amended.

<sup>21</sup> Income Tax (Foreign Tax Credit) Regulations 1996;

of services provided in Kenya by entities resident in Mauritius if they are provided through a permanent establishment in Kenya. It would also limit withholding taxes on royalties and interest to 10%.

Hence, the treaty would result in significant reduction of tax payable in Kenya by MNEs willing to route their investments through Mauritius. A recent study for the World Bank has estimated that revenue losses to countries in sub-Saharan Africa from concluding a treaty with Mauritius range between 15% and 25% of corporate income tax revenues. Furthermore, it found that concluding a treaty with Mauritius did not increase foreign direct investment (Beer and Loeprick 2018, 21).

These are significant losses for its African neighbours, but what has Mauritius gained? It could be argued that Mauritius is justified in offering low or zero tax rates to foreign investors to stimulate its own economy, and undoubtedly the regime adopted has helped to generate a boom in Mauritius. At year-end 2017 there were 11,495 GBL 1 companies, and 10, 083 GBL 2 (Mauritius FSC 2018, 7). Thirty of the 100 largest US MNEs have affiliates in Mauritius (FSI 2018). However, the benefits to Mauritius from the activities supposedly carried out there due to these tax exemptions are relatively modest, since the companies mostly exist only on paper. Most of the employment is in ancillary services, such as company formation and support, accounting and legal services. Employment in non-bank financial services was only 7,428 people in 2017, although the nominal assets of GBL companies amounted to US\$697 billion (Mauritius FSC 2018, 13-15). Even these small gains are obviously of some benefit to a small country, but they do not seem to provide a good foundation for sustainable development.

Any benefits to Mauritius are also highly disproportionate to the damage they cause to other countries. Essentially, this amounts to providing facilities that enable an MNE to avoid tax in countries such as Kenya where they have substantial activities, in exchange for the creation of a few relatively well-paid professional service jobs in Mauritius. This can fairly be described as a beggar-thy-neighbour policy. Yet by signing this treaty Kenya would be accepting or even colluding in this policy.

The evidence therefore seems to support the arguments of TJN-A that the treaty would likely result in significant tax losses to Kenya, without stimulating additional investments. The court petition specifically mentioned that article 21 of the treaty would preclude Kenya from taxing income paid to Mauritius residents for services (TJN-A v Kenya 2019, para. 3c), which would be a major source of tax losses. In addition, article 22 would allow Mauritius to grant the generous tax credit regime that reduces the effective tax rate to almost zero.

The response to this point from the Kenya Revenue Authority was that the same article was included in the treaties concluded by Mauritius with other African countries. Yet, the World Bank study estimates that these treaties resulted in a 15-25% fall in corporate tax revenues. There seems no reason for Kenya to do the same, especially as that study also showed that the treaties do not seem to have stimulated additional investment. The response from the Kenya Treasury argued that the treaty had been ‘cleverly crafted’, to allow taxation of services and management fees in article 5.3.b, instead of by withholding taxes (TJN-A 2018, para. 5.c). However, article 5.3.b only applies if those services are furnished through employees in Kenya continuously for more than 6 months. It has long been clear that it is easy for such services to be delivered by employees based anywhere, who only need to visit their clients occasionally. The growth of internet-based communications makes this even easier. That is why many countries, including Kenya, have preferred to apply withholding taxes.

### **3. CAN THE PROBLEMS WITH THE TREATY BE RECTIFIED?**

In the period since the Kenya-Mauritius treaty was first signed in 2012 major efforts have been underway through the BEPS project to plug the loopholes in international tax rules (Picciotto 2017, ch. 1). The project at first involved only OECD and G20 countries, until the final few months when some developing countries, including Kenya, were invited to join. In 2016 the OECD created an Inclusive Framework for BEPS (IF), which is open to all countries willing to accept the commitments agreed in the reports from the first phase issued in 2015. The IF now has 129 members, including both Kenya and Mauritius. Members of the IF may also participate in the processes of supervising implementation of the commitments, and in the continuing work.<sup>22</sup>

Tackling the role of conduits and treaty hubs was a major element in the BEPS project, and two of the four commitments that resulted are directly relevant to the Kenya-Mauritius treaty.<sup>23</sup> The monitoring of compliance with all the minimum commitments is done by processes of ‘peer review’ through the IF, coordinated by the OECD secretariat.

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<sup>22</sup> The main work is now under Action 1, ‘Addressing the Tax Challenges of Digitalisation of the Economy’. Since it has been agreed that digitalisation affects the whole economy, and has greatly exacerbated the defects of the existing rules, it is clear that much more far-reaching reforms are still needed. For a short account of the latest discussions see <https://www.ictd.ac/blog/new-stage-change-international-tax/>.

<sup>23</sup> Details, including the main reports and documents, are available at <https://www.oecd.org/tax/beps/beps-actions.htm>.

### **3.1 Revising treaties to include anti-abuse provisions**

One commitment is that all treaties should include effective anti-abuse provisions. This has two components: (a) an express statement (generally in the preamble) that the treaty's purposes include preventing non-taxation, and (b) one of three methods of dealing with treaty shopping. The three possible provisions are either (i) a principal purpose test (PPT); (ii) a PPT combined with a standard-form simplified limitation of benefits provision; or (iii) a tailor-made detailed limitation of benefits provision combined with an anti-conduit rule. To facilitate fulfilment of these commitments and rapid amendment of the large number of existing treaties, suitable provisions for the first two options were included in the multilateral convention for implementation of treaty-related BEPS measures, usually described as the multilateral instrument (MLI).<sup>24</sup>

The best and easiest way for a country to include the approved anti-abuse provisions in its tax treaties is to join the MLI, as well as listing all existing treaties as covered by it. However, countries are allowed to comply by agreeing suitable amending instruments bilaterally with their treaty partners, and this is necessary for adoption of the third option, since the provisions need to be tailor-made. This alternative was agreed by the BEPS negotiators essentially to accommodate the USA, which considers the PPT to be too subjective. The MLI has now been signed by 87 jurisdictions, but not the USA. The MLI has added considerable complexity to the treaty system, although without it the process of amending over 2,500 treaties would have been far more complex as well as much slower. The complexity is due to the decision to design the MLI with a maximum of flexibility, so that parties can choose which treaties to list as covered agreements and which provisions to apply in them. The OECD has created tools to facilitate monitoring of its implementation in actual treaties. It is to be hoped that in time the MLI's coverage will expand, in both members and treaty provisions covered, so that it becomes a de facto minimum standard for tax treaties.

Mauritius was initially reluctant to join the MLI, and indicated that it would emulate the US and negotiate bilaterally with its treaty partners to amend its treaties to include a detailed limitation of benefits provision. Following pressure from the OECD it fell into line, and signed the MLI on 5 July 2017; but it listed only 23 of its 43 existing treaties as covered, and announced that it would discuss amendment of the others bilaterally with its treaty partners. Most of its treaties with African states were excluded. Following

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<sup>24</sup> For full details see <https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm> , and for an explanation and analysis see BEPS Monitoring Group 2017.

further pressure, it filed an amended list on 10 October 2018 covering all its 43 treaties except for those with Cape Verde and India. The Indian treaty had already been revised in bilateral negotiations.

The Kenya-Mauritius treaty is not covered by the MLI, since the MLI only covers treaties in force, and in any case Kenya has not yet signed the MLI. However, both Kenya and Mauritius, as members of the Inclusive Framework, are expected to comply with the commitment that new treaties meet the anti-abuse standards. The treaty signed in 2012 does not comply, as it does not include either element of the anti-abuse commitment. It remains to be seen whether the version signed in 2019 is different.

### **3.2 Provisions against treaty abuse and treaty shopping**

Would inclusion of these anti-abuse provisions, especially the PPT, remedy the defects in the treaty? The text provided in the MLI for inclusion in the preamble of treaties is as follows:

*'Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)'*

The PPT provision is:

*'Notwithstanding the provisions of this Agreement, a benefit under this Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Agreement.'*

This provision is clearly aimed at sham arrangements created by non-residents of the state concerned in order to obtain the benefit of the treaty, i.e. treaty-shopping. Its terms are very broad, leaving considerable scope for interpretation. It is not obvious that such a provision could be used to deny treaty benefits to the type of service companies granted GBL status in Mauritius. The GBL system has been established in Mauritius for some 25 years, so it would be implausible for Kenya to claim to be surprised if MNEs with operations in Kenya create service hubs for them in Mauritius. Indeed, it is likely that some MNEs with operations in Kenya already have service hubs in Mauritius, so it would be hard to argue that they formed the entity in Mauritius for the purposes of obtaining the benefits of the treaty. If it is Kenya's intention to disallow residency status for Mauritian companies with a GBL licence by including the PPT provision, this should be clearly stated during the negotiations and before conclusion of the treaty.

Another possibility could be for Kenya to apply its own domestic anti-treaty-shopping rule. As discussed in s.2.1 above, arrangements with other countries providing relief from double taxation are automatically incorporated into Kenya law under s.41.1 of the Income Tax Act, which states that treaties override other provisions of that Act and other laws. However, that is ‘subject to s.41.5’. Section 41.5 states that any tax exemption or reduction provided by such an arrangement shall not be available to a resident of the other state ‘if fifty per cent or more of the underlying ownership of that person is held by an individual or individuals who are not residents’ of that other state. This is subject to a proviso in s.41.6 that s.41.5 does not apply if the entity is listed on a stock exchange in that other state.

This provision could allow Kenya to deny the exemptions and reductions of taxes to companies resident in Mauritius under the treaty unless they are at least 50% owned by residents of Mauritius, or quoted on the Mauritius stock exchange. This is a clear and simple rule, and easy to administer. Intermediary service companies such as those set up by MNEs in Mauritius with a GBL licence are generally owned by the parent or other entities in the MNE group, and not separately listed on any exchange.

However, the use of this provision may also entail some legal uncertainty. This has been the experience in neighbouring Uganda, which has a very similar provision (Uganda Income Tax Act s.88.5). In 2011 the Uganda Revenue Authority applied capital gains tax to the gains on the acquisition of Celtel Uganda by Bharti Airtel, due to Bharti’s purchase of Zain Africa (the ultimate parent of Celtel) from Zain International. This was an indirect transfer of assets, since both Zain and Bharti are companies formed in the Netherlands, and they objected that Uganda did not have the right to tax the transaction under Uganda’s tax treaty with the Netherlands. Although the Uganda Court of Appeal upheld the URA’s jurisdiction to make the assessment (Zain International 2014), the companies have taken the issue up as an international tax dispute under Uganda’s tax treaty with the Netherlands.

The URA’s case hinges on the view that the treaty does not override Uganda’s domestic anti-avoidance provision (s.88.5). This seems easy to justify, as s.88.5 quite clearly states that its provisions prevail over a treaty. Nevertheless, the URA was put under strong pressure by tax advisers representing Zain, arguing that Uganda’s obligation to comply with its international agreements should override domestic law.<sup>25</sup> They argued that the obligation under international law to respect and comply with treaties (‘pacta sunt servanda’) binds the state and all its organs, including government agencies (such as revenue authorities)

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<sup>25</sup> Personal communication. This argument has also been made by some commentators, see e.g. Warambo 2017.

and courts. Certainly, even in countries with a dualist approach to the relationship between international and domestic law, courts have accepted that domestic legislation should as far as possible be interpreted to comply with treaties and other obligations under international law. Conversely however, even in countries which take a standard monist view, such as the USA, a statute may override earlier treaties, since treaties are considered to have the same status as domestic legislation.<sup>26</sup> However, in both Kenya and Uganda treaties are incorporated into domestic law by a legislative provision that in the very same section clearly states that this is subject to the domestic anti-abuse provision. In my view, this argument would be likely to prevail in the national courts.

This perhaps explains why the company preferred to pursue its claim through international procedures under the treaty. The details of this claim are confidential, like all international tax disputes pursued through the mutual agreement procedure of tax treaties (Picciotto 2016). The Zain case involves a considerable sum, around 5% of total government revenue, as well as raising important issues of principle. Like other conflicts over tax involving large MNEs, the debate over the legal position may become subsumed into a wider political negotiation between the company and the government.

This exemplifies the strategic use of legal techniques to take advantage of the interactions of national and international law (discussed in section 1.2 above). MNEs are often able to persuade governments to conclude tax treaties, by arguing that they are important to attract foreign investment. Such arguments are likely to be attractive especially in ministries of Finance, and with Prime Ministers or Presidents, who like to be seen signing international agreements with a grand announcement that they will benefit the country. Revenue authorities will usually be more cautious, aware of the tax losses that are likely to result, although until recently they have not been much involved in treaty negotiations. This is now changing as several African countries have been reviewing their procedures and policies on tax treaties. Regrettably, however, these reviews have been held in secret, and governments seem reluctant to publish a statement of their policy. Although Kenya has apparently conducted such a review, nothing has yet been published.

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<sup>26</sup> See Picciotto 1992, ch. 11.2; as mentioned above, some countries, such as France, give treaties a superior status to domestic law. The issue has been discussed at length in the report *Tax Treaty Override* produced by the OECD in 1989 (Annex R8 of the Full version of the OECD model convention), following the complaints of the treaty partners of the US about treaty overrides created by the US tax reform of 1986. This report recommended that countries should avoid legislation that would intentionally and clearly override tax treaties, and that where treaties cause problems, the treaties partners should promptly hold consultations, which could be facilitated through OECD Working Party 1.

Revenue authorities may be reassured if anti-abuse provisions are included, either in the treaty or in domestic law, or even better in both. However, as can be seen by the Zain case, this opens up legal avenues that MNEs' lawyers can pursue more easily than can national revenue authorities. Unsurprisingly, MNEs have been pressing for strengthening of international tax dispute procedures, particularly the inclusion of mandatory binding arbitration. This would establish a deadline for resolution of MAP cases, after which they must be submitted to binding arbitration. Developing countries are understandably reluctant to accept this procedure, which would place great pressure on their tax authorities to accept an external decision on issues that often involve substantial tax revenues (Picciotto 2016).

While inclusion of anti-abuse provisions can be a useful safeguard, their inclusion should not be used to lure developing countries into entering into treaties that are not beneficial for them.

### **3.3 Curbing preferential tax regimes**

The second BEPS commitment that is relevant to the Kenya-Mauritius treaty concerns preferential tax regimes, sometimes described as harmful tax practices. This also has two elements: the automatic exchange of tax rulings, and the phasing out of preferential tax regimes that are considered harmful to other states. Both Kenya and Mauritius have some potentially harmful regimes, since both have special economic zones (SEZs); and the Mauritius GBL regime can even more clearly be described as a harmful preferential regime.

The evaluation of these regimes is being done by the Forum on Harmful Tax Practices (FHTP) set up by the OECD. The scrutiny of preferential tax regimes aims to identify regimes that 'have the potential to unfairly impact the tax base of other jurisdictions'. These measures began as political initiatives against 'harmful tax competition', resulting in standards formulated in an OECD report of 1998 (OECD 1998), and a Code of Conduct on similar lines agreed by EU states (EU Council 1999). OECD practice was explained in Application Notes (OECD 2004), and was then revamped in the 2015 BEPS Action 5 report (OECD 1995). The EU Code was applied initially to EU member states and their dependencies and associated states. It was extended to non-EU states in 2016, by its inclusion in the standards for 'good tax governance' that the EU began to apply in determining which countries to include in a list of 'non-cooperative jurisdictions'.<sup>27</sup> Although the OECD standards and the EU Code are not formally legally binding, they are norms, and can be considered to be a type of 'soft law'. This technique has become

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<sup>27</sup> See <https://www.consilium.europa.eu/en/council-eu/preparatory-bodies/code-conduct-group/>

ubiquitous in global governance (Picciotto 2011, ch. 2.3.2), applied through interpretive practices similarly to ‘hard’ or formally binding law.

The evaluations by the FHTP are done through a ‘peer review’ of each country’s measures, though with much less transparency than other peer review procedures. The OECD has published only summary reports, listing the regimes that have been or are being evaluated, and the outcomes of the reviews. The reports have no discussion of how the criteria are interpreted, nor are any reasons given for the decisions taken. The OECD defends this secrecy as necessary to protect the process from business lobbying. However, business representatives are generally well-informed especially due to their close contacts with the authorities in the jurisdictions that offer preferential tax regimes. (Indeed, they often help devise those regimes). The opacity of the process greatly hinders a wider knowledge and understanding, and shields it from any effective public debate. This is further exacerbated by the technical complexity of the regimes (such as the GBL scheme in Mauritius). Due to political pressure through the EU Parliament, the EU procedures have become more transparent since 2017. Some key documents are published, although the process is still shrouded in obscure technical language.

Since the 2015 report, the OECD has issued a Progress Report on Preferential Regimes in October 2017 (OECD 2017), and an Update in January 2019 (OECD 2019). The 2017 report explained that regimes are brought to the attention of the FHTP primarily through each jurisdiction self-identifying the regimes that it offers, although this is supplemented by the ability of a peer jurisdiction to alert the FHTP. The procedure adopted was explained as follows:

*‘12. The review process involves each jurisdiction which offers a relevant regime completing a standardised self-review questionnaire and submitting the relevant legislation to the FHTP. Each regime is then discussed at the periodic meetings of delegates of the FHTP, which includes a dialogue with the jurisdiction in order to provide any clarifying information. Decisions are reached on a consensus basis, although it is possible where necessary to use a “consensus minus one” basis of decision making in relation to the peer review process.’ (OECD 2017, p.14).*

Thus, the evaluation is somewhat like a meeting of Alcoholics Anonymous, since it is done collectively by representatives of countries most of which have their own incentive regimes. While one might hope that they would encourage each other to be more virtuous and genuinely give up harmful practices, it is perhaps more likely that they will interpret the rules leniently, and learn from each other how to revise their regimes to merely mitigate the worst features. Furthermore, if a regime is found not harmful it becomes legitimate, encouraging other states to emulate it. This occurred in the 2013-15 period of the

BEPS project, when the main focus was ‘patent box’ regimes particularly the one introduced by the UK in 2012. Although patent box schemes have been criticised as undesirable, the Action 5 report (OECD 2015) could only agree a new ‘nexus’ test, requiring the income benefiting from the low tax rate to be related to the expenditure on research resulting in the relevant patents. The result was a generalisation of such regimes, as UK and other countries amended their schemes, while other countries (such as Ireland and Switzerland) adopted similar ones. Hence, while such a process may act as a discipline to restrict the worst excesses, it is likely also to lead to a generalisation of practices that are found acceptable.

In 2017 the Kenya Special Economic Zone regime was reported as under review, while a year later it was stated to be Not Operational. As regards Mauritius, in 2017 the GBL 1 and GBL 2 regimes were listed as ‘In the process of being amended’, and its Global Headquarters Administration Regime was listed as ‘Not harmful’. The listing for Mauritius in the 2019 report was as follows:

Regime	Status
Freeport zone	Amended (out of scope)
Captive insurance	Amended (out of scope)
Global Business Licence 1 (IP and non-IP)	Abolished
Global Business Licence 2 (IP and non-IP)	Abolished
Partial exemption system	Not harmful
Banks holding a banking license under the Banking Act 2004 (Segment B banking)	Abolished
Banks holding a banking license under the Banking Act 2004	Not harmful

This outcome was reported in November 2018 by the Financial Services Commission of Mauritius by a press release (Mauritius FSC 2018) announcing ‘OECD latest report on Peer Review Results on Preferential Regimes–Mauritius Tax Regimes NOT HARMFUL’.

To escape being found harmful, Mauritius made amendments to its GBL regime in 2018 taking effect from 2019, although with transitional periods to the end of June 2021.<sup>29</sup> There will be a single type

<sup>28</sup> Many countries encourage investment in research and development (R&D) through tax allowances, but patent boxes allow a low tax rate on income deemed to be attributable to patented inventions; this requires complex rules that are hard to administer, as the connection is hard to verify, especially when coupled with the need to show a nexus between R&D expenditure and the income (Sullivan 2015); furthermore, the tax revenue losses far exceed the possible benefits, for example on its introduction it was estimated that the UK patent box would cost around £1 billion p.a., around a third of the UK budget for science research (Evers et al. 2015).

<sup>29</sup> Finance (Miscellaneous Provisions) Act 2018, especially s.29 amending the Financial Services Act.

of GBL, though holders of GBL 1 licences can automatically become holders of the new GBL. The GBL 2 category has been replaced by a new type of ‘authorised company’, which will be owned by non-residents, and controlled and managed from outside Mauritius. Such a company would not be tax-resident in Mauritius, so would be subject to tax only on Mauritius-source income, and this will now exclude buying and selling of goods that do not physically land in Mauritius. This seems aimed at providing a preferential tax regime for international commodity trading and procurement.

The new GBL will be for a company controlled by non-residents that proposes to conduct business mainly outside Mauritius; confusingly however, it must carry out its core income-generating activities ‘in, or from Mauritius’. It must also do so by employing ‘a reasonable number of suitably qualified persons’ and having ‘a minimum level of expenditure, which is proportionate to its level of activities’, and employ at least two local directors ‘of sufficient calibre to exercise independence of mind and judgement’. In lieu of the deemed foreign tax credit there will be an exemption for 80% of certain types of foreign source income, particularly investment management and investment advisory activities conducted in and from within Mauritius, and ship and aircraft leasing (EY 2018, Council of the EU 2019). This produces the same result as the previous deemed credit, an effective tax rate of 3%.

Clearly, Mauritius intends to continue to offer a very low tax rate for companies formed there to do business outside Mauritius. The GBL companies are resident in Mauritius, but they are licensed for business aimed at customers outside Mauritius.<sup>30</sup> This seems acceptable according to the interpretation adopted of the concept of ring-fencing adopted earlier (OECD 2004, pp. 24-27), that it:

*‘does not prevent a country from providing a preferential tax rate to encourage an activity in a particular sector of its economy even if the preference involves geographically mobile activities. There is a distinction between a preferential regime and one that is ringfenced. A preferential regime will be considered to be ring-fenced only where it excludes resident taxpayers from the benefits of the regime or where the enterprise qualifying for the regime does not have access to the domestic market.’ (OECD 2004, p. 20).<sup>31</sup>*

The changes introduced by Mauritius in 2018 were cleverly designed to escape this definition. This was done essentially by specifying that GBL companies are resident in Mauritius, and licensed to conduct

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<sup>30</sup> Hence the confusing requirement that GBL companies should conduct their business principally outside Mauritius, although their core income generating activities should be done in Mauritius.

<sup>31</sup> These are similar to the criteria in the EU Code: ‘1. whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or 2. whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base’ (Council of the EU 1998, p.5). However, the EU has specified that they must be interpreted both de facto and de jure (Council of the EU 2018, p.117).

business ‘in and from Mauritius’, although for overseas clients. Furthermore, the low tax rate results from provide exemptions that are also available to companies licensed for domestic business, such as dividends and such foreign source income. This seems to have satisfied the FHTP, although the EU asked for further commitments ‘at the highest political level’ (Council of the EU 2019, p. 14). As regards the ring-fencing criteria, the EU applied a slightly more stringent ‘de facto’ test, that requires evidence that the tax preferences do not disproportionately benefit companies doing business outside Mauritius. Since the revised GBL regime is new, it seems that this aspect will be monitored. The EU also took a stricter view of the ‘substance’ test, especially as regards ‘outsourcing’ of functions (Council of the EU 2019, pp. 17-18). Mauritius has responded with a commitment to introduce further changes to come into full compliance by the end of 2019.<sup>32</sup>

The weak interpretation of the ring-fencing test was adopted by OECD countries a decade before the BEPS project. It allows countries to offer tax incentives, including a reduced tax rate, to attract mobile activities by introducing other distinctions, particularly as to the source of income. This might be justified on the grounds that countries should not be prevented from offering incentives to attract real activities, even if they are mobile. This is presumably why export processing zones have generally been accepted as not harmful, sometimes with some amendments.

However, such schemes often aim at services: the GBL covers various kinds of financial, business management and global treasury activities, and headquarters administration.<sup>33</sup> Developing countries have long considered that services should be taxable by the country where they are delivered, not where the provider is resident. This issue has become increasingly important as it has become harder to identify the true location of service providers. The lax measures against preferential regimes encouraged competition among OECD countries, including Belgium, Ireland, Luxembourg, Netherlands, Switzerland and the UK, to offer low tax regimes for activities such as treasury operations, fund management, commodity trading, intellectual property management and headquarters functions, often notionally done by companies employing few or no people. The remedy suggested in 2004 was to apply the rules on transfer pricing to ensure that income was appropriately attributed to the entities supposedly performing the functions (OECD 2004, ch. IV). However, these rules have become ineffective due to the entrenchment of interpretations of tax treaty rules on allocation of income of MNEs based on the so-called arm’s length

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<sup>32</sup> Letter of 4 February, Document 6097/19 Add 1, available at <https://data.consilium.europa.eu/doc/document/ST-6097-2019-ADD-1/en/pdf>

<sup>33</sup> Mauritius Financial Services Act, 2nd Schedule.

principle. These allow MNEs' operating companies to be attributed only 'routine' profits, while high levels of income can be allocated to low-taxed subsidiaries supposedly fulfilling high-value functions or bearing risks (Durst 2019, ch.3).

The BEPS project was supposed to rectify these problems, by realigning income with activities and value creation. However, it rejected any reconsideration of the arm's length principle, instead approving detailed revisions to the Transfer Pricing Guidelines that made them even more complex and difficult to apply (Picciotto 2018). For the evaluation of preferential regimes, a new 'substantial activity' requirement was added (OECD 2015, ch. 4.III). However, it did not specify any quantifiable way of measuring the substance required, only a discussion of the 'core income-generating activities' that could be involved with various types of services.

The weakness of this approach can be seen in its application to the changes made to the Mauritius regime, which have been accepted by the FHTP as sufficient to avoid it being labelled harmful. These only introduce formal legal requirements that a GBL company should perform its core income-generating activities 'in or from Mauritius', by employing 'a reasonable number of suitably qualified persons' and having 'a minimum level of expenditure, which is proportionate to its level of activities'. GBL companies will no doubt employ a handful of professionally qualified staff to satisfy these requirements, but could still continue to attribute high levels of income to these supposedly high-value activities. This is a recipe for conflicts and disputes over transfer pricing.

Thus, Mauritius will continue to position itself as a suitable hub for MNEs with affiliates in African countries, by offering low tax rates for income that under conventional interpretations of current rules can be attributable to companies formed there. While this might create some relatively highly-paid services jobs in Mauritius, the operating companies in other countries could be treated as performing only routine functions and so earn relatively low levels of profit. Many of those involved in the BEPS project have now acknowledged the inadequacy of the reforms agreed so far, and there are continuing attempts to find improved solutions (Picciotto 2019). In the meantime it is important for countries such as Kenya to protect their own tax base. Regrettably, the Mauritius treaty would have the opposite effect.

#### **4. CONCLUSION**

Here I will briefly give my general conclusions based on the analysis given above, though no doubt others will have their own interpretations and opinions.

The reforms resulting from the BEPS process do not seem to suggest any reason to change the advice given by the IMF in 2014, cited above, that countries should be very cautious about entering into tax treaties, should not do so as political gesture, and should closely examine the risks that may be created. It is clearly important in democratic countries for such an examination to take place as a public debate facilitated by the parliament. If Kenya's executive continues to be reluctant to allow this, then parliament itself should do so, and failing that the courts have a sound constitutional basis for ensuring such debate takes place.

More widely, the arguments for entering into tax treaties seem to be weak, especially for capital-importing developing countries. Problems of potential double taxation can adequately be dealt with in a state's own internal laws, as is usually the case. Many states, especially developing countries such as Kenya, do not claim the right to tax their own residents on foreign-source income or, like Uganda, provide a unilateral foreign tax credit.

The main effect of tax treaties for such countries is to bind the state to provide incentives, by refraining from taxing income at source, in order to attract investment from non-residents. Like all tax incentives, these should be carefully evaluated, with estimates of potential revenue losses as well as possible effects on investment. The protections from tax in treaties are even more problematic than other incentives, since they discriminate in favour of non-residents. Sustainable development must depend on encouraging and stimulating the local economy and a country's own entrepreneurs. While it is important that local business should be competitive, and for a country to be open to foreign know-how and capital, those are not good reasons to discriminate in favour of foreign investment to the detriment of local business.

Binding international commitments should not be entered into lightly, because they restrict the state's sovereignty to design its own policies. Tax treaties are particularly restrictive because, as explained in section 2 above, their provisions are generally incorporated directly into domestic law. This in effect creates a special tax regime applicable in domestic law benefiting foreign investors. The interactions thus created further exacerbate the complexity of tax law, making it more difficult to administer. Tax

authorities are at a particular disadvantage in navigating these complexities, because the MNEs which dominate international investment have considerably greater resources. Conversely, the unfamiliarity of tax officials with international rules may lead them to take decisions that companies consider arbitrary or unreasonable. The main beneficiaries are the expanding legions of international tax advisers.

Capital-importing countries should be especially wary about treaties with countries that act as treaty hubs. This includes not only those like Mauritius that are openly conduits, but also countries that have historically been capital-exporting, such as the Netherlands, Switzerland and the UK. Since the 1970s they have expanded their network of tax treaties, mainly with the aim of supporting overseas investment by ‘their’ MNEs. They have also combined this policy with the introduction of measures to attract MNEs to locate their headquarters and services hubs in those countries. The attempts to curb this competition to offer preferential regimes for such mobile activities have been largely ineffectual, and indeed have led to their normalisation. It is hard to blame a small country like Mauritius for trying to join in this game, but there seems to be no reason for countries such as Kenya to accept this. Indeed, countries that already have treaties with treaty-hubs such as Mauritius, especially African states, should reconsider them. It seems that some are already doing so, with the recent report that the government of Senegal has decided to cancel its treaty with Mauritius, claiming that it has caused a loss of some 150b CFAFr (\$260m USD) over 17 years (Diarra 2019).

Finally, this seems a good moment for developing countries to conduct a thorough re-evaluation of their tax treaty policies. The first phase of the BEPS project has made some first steps towards reform of international tax rules, but it is clear that these are temporary palliatives. The continuing work, although conducted under the rubric of Addressing the Tax Challenges of Digitalisation of the Economy, has a much wider scope. The Programme of Work agreed by the IF in May 2019 includes potentially radical changes to two basic elements, the threshold for taxable presence (permanent establishment) and criteria for allocation of income of MNEs (pillar 1), as well as a global minimum tax (pillar 2). These could be much more effective than the previous BEPS recommendations, but their introduction could be hindered by problems of compatibility with treaty obligations. Many developing countries are fortunate in not having an extensive network of treaties, although even one can provide a convenient conduit for any foreign investors from anywhere. The best advice at this point in time seems to be to call a halt to any negotiations and reconsider tax treaty policies.

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