POLICY BRIEF ON DOUBLE TAXATION AGREEMENTS

Table of Contents

Acknowledgements

The Centre for Trade Policy and Development (CTPD) would like to thank the following partner organisations: Action Aid International Zambia, The Joint Country Programme (Christian Aid, DanChurch Aid and Norwegian Church Aid) and NORAD for their financial and technical support rendered in the production of this document.

POLICY BRIEF ON DOUBLE TAXATION AGREEMENTS

Introduction

Countries' signing double taxation treaties (DTTs) is not new practice: the first double tax treaty on record was signed between Austria-Hungary and Prussia in 1899. Many countries, especially OECD member states, entered into DTTs between 1950 and the 1970s. DTTs have attained much more prominence and attention in the last 20 years, which saw the signature of 60% of the total current DTTs - 2976 treaties - by 2011 (UNCTAD). There has also been tremendous increase in signing of DTTs between developed and developing and transitioning countries/economies, which by 2008 accounted for more than 50% of the total DTTs signed, (UNCTAD, 2009). Many developing countries sign DTTs with the aim of increasing foreign direct investment (FDI), anticipating increased tax revenue base and job creation which are critically needed to ignite their economies for sustaining economic growth and development

One key motivation for developing and transitioning countries to conclude bilateral investment treaties (BITs) and double taxation treaties (DTTs) is to signal to investors that investments will be legally protected under international law in case of political turmoil, and to provide certainty that double taxation of foreign investors will be relieved.

Zambia registered the second highest FDI inflow of $1.981 billion and highest out flow in the COMESA region totalling to $1.150 billion out of the region total of $2. 266.9 billion. With increased FDI in Zambia, one would expect high employment and reduced poverty levels. However, poverty in Zambia is still a huge challenge; most of the population is still struggling to have a decent livelihood. Analysis by Zambia Food Security Research Project (FSRP) shows that the number of poor rural households in Zambia stood at 89.6%, while the national extreme poverty stands at 42.3%. Level of inequality also remains very high in Zambia, with the Gini coefficient of 0.57.

The key question for Zambia's policymakers is therefore, how we can ensure that tax treaties deliver both sustainable tax revenues and quality FDI for the benefit of poverty reduction?

What is Double Taxation?

Double taxation is the levying of taxes on the same income (or capital) of the same taxpayer in the same period. Generally the division is between economic double taxation (same income taxed twice e.g. profits then dividends, wages then VAT) and juridical double taxation (same income taxed in two different countries e.g. profits taxed in country of source and residence). DTAs are designed primarily to prevent juridical double taxation.

Why does double taxation arise?

Double taxation occurs when a taxpayer (particularly a multinational enterprise) pays tax on the same corporate income earned from economic activity twice, in different countries: once to the tax authorities of the foreign country which is host to the economic activity, and once to the tax authorities of the home country, in which the company is domiciled. By burdening economic activity in a foreign country twice, this (juridical) double taxation can represent an obstacle or barrier to foreign investment, thus distorting the efficient allocation of scarce financial resources across countries of the world(Eric Neumayer, (2009). Double taxation can arise:

(i) When a tax payer's income is taxed based on the residence or the citizenship of the taxpayer, and also taxed by another jurisdiction's tax authority based on where the income originates.

(ii) Another potential source of twofold taxation could be the fact that both countries claim either a certain taxpayer as a resident or that an income arises within its country.

(iii) It can also occur when two countries lay claim on one citizen through dual citizenship or lay claim on one income source.

What is a Double Taxation Treaty?

A double taxation treaty is an agreement between two (or more) countries to divide up taxing rights on cross-border income between them, primarily for the avoidance of double taxation. A tax treaty may be titled a Convention, Treaty or Agreement. Over 2,500 Double Taxation Conventions exist world-wide (see Easson 2000; Arnold, Sassevile, and Zolt 2002) and Zambia has signed 22 treaties which will discuss later in the paper.

There are, of course, a growing number of domestic mechanisms to relieve double taxation without 'source' countries giving up taxing rights through a double taxation agreement. In particular, most major capital-exporting countries, acting as headquarters of multinational enterprises and sources of FDI, now offer 'unilateral' tax credits for taxes borne on foreign income, irrespective of whether a double taxation agreement is in place. In addition, a growing number of wealthy countries now exempt foreign income from tax altogether, comprehensively preventing the possibility of much juridical double taxation. In practice, therefore, the advantage offered to foreign investors by double taxation treaties is not solely – or perhaps even mainly - the relief of double taxation, but the fact that the treaty can effectively set a ceiling on the taxes levied on cross-border income 'at source' by developing countries.

Why do Developing Countries like Zambia sign DTA treaties with Developed Countries?

The primary purpose of DTTs is to eliminate double taxation, which the OECD highlights being an important obstacle to FDI, (OECD, 2010a). As argued above, in practice the primary advantage of the treaty may be instead to mitigate uncertainty for the foreign investor as to how the overseas profits will be taxed, (Neumayer, 2007). DTAs may also act as a signal of a commitment to a favourable foreign investment environment (Christians, 2005). Taken together, if these attributes increase FDI, the developing countries that sign up may enjoy increased tax base and revenue, creation of employment, knowledge and technology spill overs, among others. However with some paradoxes sighted above one need to analyse if that is usually the case and why things sometimes happen differently.

Many developing countries that enter into DTAs often forego some tax revenues in anticipation of attracting more FDI. Net FDI flows between developed countries and developing countries are often largely unilateral in that, the outward FDI flowing from the developed country to the LDC far outweighs any inward FDI flows from the LDC to the developed country. Therefore, although the negotiated reduction in withholding tax rates applies equally to both contracting states, developing countries end up agreeing to a much greater reduction in potential tax revenue, sometimes not commensurate with the benefit derived from the FDI inflows, leading to net loss on the side of developing countries.

Do tax treaties increase foreign direct investment for countries like Zambia?

Evidence that tax treaties significantly attract new inward investment is mixed. In a recent set of studies showing positive and negative effects of tax treaties on both developing and developed countries, none found a positive impact on FDI into low-income countries as a result of tax treaties (Sauvant & Sachs, 2009). Where tax treaties signed by developing countries with other countries do increase investment from that country (Barthel et al 2009), it is unclear whether this is new investment, or simply treaty shopping: investment from other (non-treaty) countries that would have taken place anyway, simply structured via a jurisdiction to take advantage of the new treaty. Other studies have supported the finding that much of this ostensibly 'new' investment may simply be 'restructured' investment via the new treaty partner (Weyzig, 2012). Likewise studies by the OECD and the International Monetary Fund of the role of tax in investment decisions in developing countries have found that while tax advantages may tip the balance in favour of a marginal investment, it is very rarely amongst the top five, or even top ten, considerations for investment. Tax is unlikely to make or break an investment in the absence of more fundamental aspects of investment climate such as political stability, security, infrastructure, educated workforces and decent healthcare – the things that tax revenues pay for in the first place (OECD 2000, IMF 2014).

This ambiguous evidence doesn't mean that tax treaties can never be useful to attract FDI. But it does mean that it cannot be assumed or guaranteed: there isn't a body of empirical evidence to show that it is always the case. Policymakers need detailed knowledge of the potential investment flows in each case to reach a judgement.

Zambia's Current DTAs

Currently the Zambian government has in effect 22 Double Taxation agreements with the following countries

Country	Type of Agreement	Dividends (%) Qualifying companies	Interest (%)	Royalties etc. (%)	Management qualifying consultancy/companies technical fees	Date of Signature
Canada	Income and Capital	15%	15%	15%	Nil	16 February, 1984
China	Income	5%	10%	5%	15%	26 July, 2010
Denmark	Income and Capital	15%	10%	15%	15%	13 September, 1973
Finland	Income and Capital	5%	15%	5/15%	Nil	3 November, 1978
France	Income and Capital					5 November, 1963
Germany	Income and Capital	5%	10%	10%	Nil	13 May, 1973
India	Income and Capital	5%	10%	10%	nil	5 June, 1981
Ireland	Income and Capital	Nil	Nil	Nil	Nil	29 March, 1971
Italy	Income and Capital	5%	10%	10%	Nil	27 October, 1972
Japan	Income and Capital	Nil	10%	10%	Nil	19 February, 1970
Kenya	Income and Capital	Nil	Nil	Nil	Nil	27 August,1968
Mauritius	Income					26 January, 2011
Netherlands	Income and Capital	5%	10%	10%	Nil	19 December, 1977
Norway	Income and Capital	15%	10%	15%	15%	14 July, 1971
Poland	Income and Capital					19 May, 1995
South Africa	Income and Capital	15%	15%	15%	15%	22 May, 1956
Sweden	Income and Capital	5%	10%	10%	15%	18 March, 1974
Switzerland	Income and Capital	20%	-	-	-	30 May, 1961
Tanzania	Income and Capital	20%	20%	20%	20%	2 March, 1968
Uganda	Income and Capital	20%	20%	20%	15%	24 August, 1972
United Kingdom	Income and Capital	5%	10%	10%	Nil	22 March 1972 reviewed 2014

OECD and UN Models

There are two model treaties for DTTs often used in negotiations and drafting of DTTs between countries the OECD and United Nations models. The OECD model treaty is widely used in the drafting many DTTs across the globe despite promoting residence taxation, which benefits developed countries since it is mainly developed country investors who invest in developing countries, not the other way around. The UN model treaty, on the other hand, provides more room for source-based taxation, which is more beneficial to developing countries being capital net importers. Unfortunately the vast majority of DTTs concluded between developed and developing countries limit source-based taxation, which means that developing countries can only collect tax revenues from foreign investors to a limited extent in exchange for anticipation of increased FDI. For DTTs among developed countries this does not matter so much as FDI flows more or less equally in both directions un like when DTTs between developed and developing countries that creates almost one way traffic towards developed countries. DTTs if not well thought through may serve the 'cynical goal' of 'redistributing tax revenues from poorer to the richer signatory countries' Dagan (1999: 939)

Tax treaties: a fair slice of the pie?

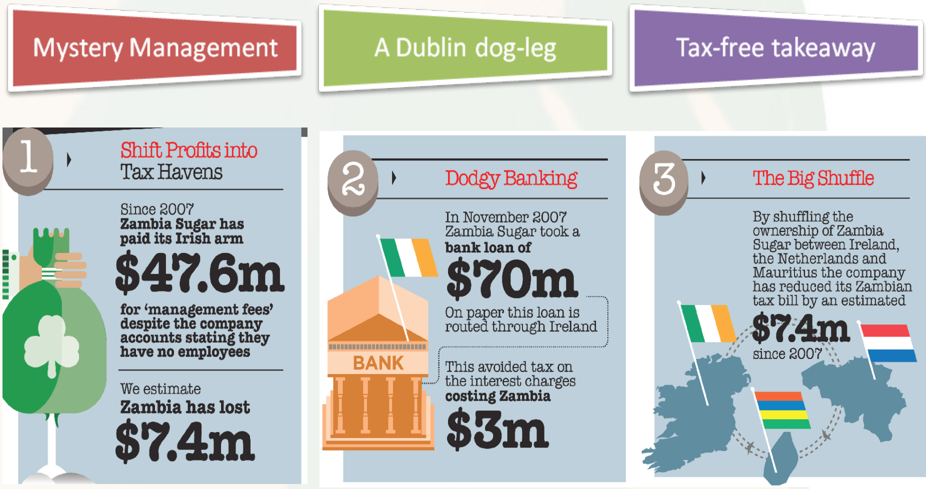
It may seem strange that Zambia can't always decide how much tax it levies on income generated in Zambia, due to DTTs signed with various countries. When an Irish company earns income from Zambia –for example by providing a service, or lending money to a Zambian company – both Zambia and Ireland will want, legitimately, to tax that income. The Zambia-Ireland tax treaty sets limits for how much a given piece of income can be taxed by the 'source country' of the income (usually Zambia), and by the 'residence country' of the income's recipient (usually Ireland). These limits over-rule any tax rate that a country may otherwise decide to apply to cross-border income. For example, Zambia generally levies a 15% withholding tax on interest payments made to non-residents. In its 2012/13 budget the Zambian government raised it to 20% but the Ireland-Zambia tax treaty, for instance, limits 'source country' tax on cross-border interest payments to zero. So regardless of what the Zambian parliament decides, Zambia is not permitted to levy tax on interest payments from Zambian to Ireland companies.

This seems fair at first sight. But the problem is that between developed and developing countries, cross border income generally flows predominantly in one direction, since developing countries like Zambia are mainly importers of investment and services. This means that taxable cross-border income generally flows outwards from Zambia to investors and companies based in wealthy countries or tax havens. Thus when a developed country or tax haven negotiates a tax treaty with a developing country like Zambia, it has a clear interest in trying to limit or even cancel the taxing rights of the 'source' country, which will generally reserve more taxing rights to itself. And as a potential source of investment for the developing country, the developed country will often have the economic and political muscle to get its way. The Ireland-Zambia tax treaty, signed over 40 years ago, is an unusually serious example of such imbalance. It is one of only two tax treaties that Zambia has signed that deny the right to tax any of the outflows of cross border income normally subject to withholding taxes.Not only does this tend to nakedly boost Irish revenues at the expense of Zambia – ironically for a country which is one of Ireland's nine long-term development partners – but it also allows multinational companies to 'treaty shop' (see below), using Ireland as a tax-free conduit for transactions between Zambia and other countries. While Ireland gives aid to the Zambian government with one hand, Zambian government revenues flow out again thanks to its Irish tax treaty.

The Case of Associated British Foods – Zambia Sugar PLC

Associated British Foods – the UK parent company of Zambia Sugar PLC - has used Ireland and the Netherlands to route income in order to take advantage of the Ireland-Zambia and Zambia-Netherlands tax treaties, avoiding source taxation in Zambia. The company used three main tactics to do this (see ActionAid - Sweet Nothings, 2013). These tactics have seen cross-border payments equivalent to over US$13.8million (Zambian Kwacha 62 Million) a year – redirected via sister companies in Ireland, Mauritius and the Netherlands. As a result, it is estimated that Zambia has lost withholding tax revenues of some US$17.7 million (ZK78 Million) since 2007, when ABF took over the Illovo sugar group.

How did Zambia Lose Revenue?



Getting the right DTA balance

Zambia Revenue Authorities have indicated the need to renegotiate several "outdated" tax treaties to "make source and residence more balanced". For example, a renegotiated UK-Zambia tax treaty, which since its colonial-era signature in 1955 has continued to restrict 'source country' taxing quite heavily, has just been signed awaiting ratification, though it does not in practice award greater taxing rights to Zambia than the older treaty. Rebalancing these treaties takes political will on both sides, and can be difficult even for much more powerful countries than Zambia. India, for example, haemorrhages an estimated US$600 million in revenue each year through loopholes in the crippling India-Mauritius tax treaty, and has been trying without success since 2006 to persuade Mauritius to renegotiate.Yet despite India's predominant economic power in the region, India's finance ministry continues to report "unwillingness on the part of Mauritius to cooperate" in addressing this problem.

A look at the renegotiated UK-Zambia Tax Treaty

The renegotiated UK-Zambia tax treaty establishes improved information-exchange/cross-border Tax Corporation and some limited improvements in anti-avoidance provisions. These are to be welcomed. There are few substantial improvements in terms of Zambia's taxing rights, however, and one significant reduction compared to the old treaty: a reduction of royalties withholding tax to 5% from 10% (Zambia raised its domestic ratefrom 15 to 20% in the 2012 budget specifically to "to help fund development programmes"). The rise of the UK as a low-tax jurisdiction for intellectual property (via the UK Patent Box since 2013) may make such a reduction significant for Zambia in the future. In general, the Zambian government has creditably 'held the line' in not reducing withholding tax rates further and defending its tax base. Nonetheless based on the UK's stated concern for Zambia's revenue-raising capacities, the UK should have offered Zambia a better deal with regards to taxing rights. Below is a comparative analysis of the renegotiated treaty to the 1967 treaty.

Aspect of treaty	**Assessment** *(green – good)* *(amber – partly good, partly bad)* *(red – bad)*	***Compared to previous UK-Zambia Treaty*** *(green – 2014 version is better)* *(amber – 2014 version is not significantly better or worse)* *(red – 2014 version is worse)*
Permanent Establishment (PE) definition (Art 5)	Includes 'services PE' for UK individuals and companies providing services in Zambia for more than 6 months a year. Includes mineral exploration structures as well as mines themselves.	Previous treaty's services PE only included entertainers, athletes and construction supervision (i.e. 2014 definition is stronger). Previous treaty did not include mineral exploitation structures (i.e. 2014 definition is stronger).
Attribution of business profits to PEs (Art 7.4)	Allows apportionment of profits to PEs i.e. does not insist on transfer pricing between a UK company and its branch in Zambia	Old version silent on this.
Attribution of business profits to PEs (Art 7.5)	Prevents attribution of profits to PEs engaged solely in purchasing goods	Old version didn't prevent this.
Dividends (Art 10)	Limits Zambian WHT to 5% (non-treaty rate is 15%), except income derived from immovable property by a tax-free investment vehicle (15%) (no higher rate for portfolio investment)	Limited Zambian WHT to 5% except portfolio investment (15%)
Interest (Art 11)	Limits Zambian WHT to 10% (non-treaty rate is 15%)	Limited Zambian WHT to 10%

Royalties (Art 12)	Limits Zambian WHT to 5% (non-treaty rate is 20%)	Limited Zambian WHT to 10% (i.e. new treaty restricts Zambia's taxing rights further))
Source taxation of other income e.g. services, management fees (Art 21)	Prevents Zambian WHT on 'other income' not dealt with in the treaty. (N.B. there are no specific articles allowing Zambian WHT on services or management fees, so this clause could prevent Zambian WHT on such services or management fees (non-treaty rate is 20% for management fees and consultancy fees). Services profits may still be taxed net in some circumstances under 'services PE'.	Prevented Zambian WHT on 'other income' not dealt with in the treaty.
Capital Gains (Art 13)	Allows Zambian taxation of gains made by UK companies from selling their stake in a Zambian company, but only if the Zambian company derives its profits from immovable property e.g. land or mines (better than OECD model, slightly weaker than UN model)	Did not allow Zambian taxation of gains made by UK companies from selling their stake in a Zambian company at all (i.e. new treaty is slightly better for Zambia, but still not as strong as UN model)
Taxes on capital (Art 22) e.g. property taxes	Allows Zambian taxation of immovable property (e.g. land) owned by UK individual/company, and movable property belonging to a PE of a UK company. No source taxation of any other forms of capital owned by UK individuals/ companies.	Old treaty silent on taxation of capital (i.e. no restriction on Zambian wealth/property taxes)
Anti-avoidance (various articles)	Includes 'beneficial owner' clauses in interest/royalties/dividends articles. Also includes specific anti-avoidance provision in interest/royalties/ dividends/other income articles.	No substantial anti-avoidance provisions.
Dealing with disputes (Art 25)	No mandatory arbitration in event of the UK and Zambian tax authorities failing to agree (mandatory arbitration is generally disadvantageous for smaller tax authorities)	No mandatory arbitration in event of the UK and Zambian tax authorities failing to agree (i.e. no change)

Exchange of information (Art 26)	Updates to be consistent with OECD and UN models. Allows information-exchange relevant to all taxes, not just those dealt in the treaty.	Only allows information-exchange relevant to taxes dealt with in the treaty.
Assistance in collection of taxes due (Art 27)	Allows cross-border assistance in recovery of taxes due	Did not explicitly allow (or deny) cross-border assistance in recovery of taxes due
Termination of the treaty (Art 30)	Cannot terminate for 5 years after entry into force	No restrictions on termination

REFLECTIONS

- The fore going of Zambia's right to tax MNCs when it enters into DTTs with developed countries that are based predominantly on 'residence taxation' clearly represents a substantial cost to developing countries, depriving them of resources that they would use to provide the much needed services to their citizens as well as contributing to unequal income distributions that governments stripped of financial resources will find difficult to address via transfer payments

- Responsible companies must regard paying their fair share of taxes as a core part of their social corporate responsibility and avoiding taking advantage of these old and unfair DTTs to avoid paying their due share of tax to the country where they generate their profits. It may be legal, but responsible companies should not exploit countries' resources, generating profits but reducing taxes through artificially taking advantage of DTTs through treaty shopping.

- Developing countries like Zambia should develop their own DTT model that suits their particular circumstances if they are to maximize benefit from such agreements. At a minimum, the UN model that emphasises taxation at the source of the income would be a more advantageous basis for negotiating tax treaties.

- The costs and benefits of individual new and revised tax treaties – in terms of tax revenues foregone and likely investment attracted - should be clearly assessed, and published, prior to treaty negotiations. Likewise tax treaties should be regularly reviewed, with the possibility of renegotiating harmful or outdated treaties.

- The inflow of FDI is not an end itself but means to increase employment and growth, as well as tax base and subsequently tax revenue. If DTTs do not deliver these fundamental benefits, they should be renegotiated. Obsession with increased FDI without being mindful of its impacts to the economy and social wellbeing of the people may easily lead to entering into constraining DTTs that are not very useful to the developing countries in both the short and long run.

- There's need to standardise and harmonize tax concessions included in the DTTs to be able to maximize benefit from them and avoid exploitation.

- Governments must close loopholes in national tax codes and tax treaties that allow the kinds of 'tax haven transactions' outlined in this brief. Donor and developed country governments have a particular responsibility to ensure that their own tax regimes and tax treaties do not make it easier for corporate profits to be siphoned out of developing countries.

- Responsible companies; stronger tax authorities; better tax laws; and, critically, public action and scrutiny – all have a part to play in protecting the revenues that Zambia andmany other countries need to resource their own futures.

BIBLIOGRAPHY

ActionAid-Sweet Nothings (2013)

Honourable Chikwanda Minister of Finanace and National Planning, Budget speech 2012/2013

Chipoto. A (2011); Factors Affecting Poverty Dynamics in Rural Zambia, working paper No. 55 Food Security Research Project, Lusaka, Zambia.

COMESA (2012); Investment Report 2011, COMESA

Doernberg (2004); International Taxation, West Academic United States of America

Easson. A (2000) 'Do we still need Tax Treaties?' Bulletin for International Fiscal Document 54, 619-25

Neumayer. E (2006); Do Double Taxation Treaties increase Foreign Direct Investments to Developing Countries?

OECD (2005); Model Tax Convention on Income and on Capital, Condensed Version". Paris: Organisation for Economic Co-operation and Development.

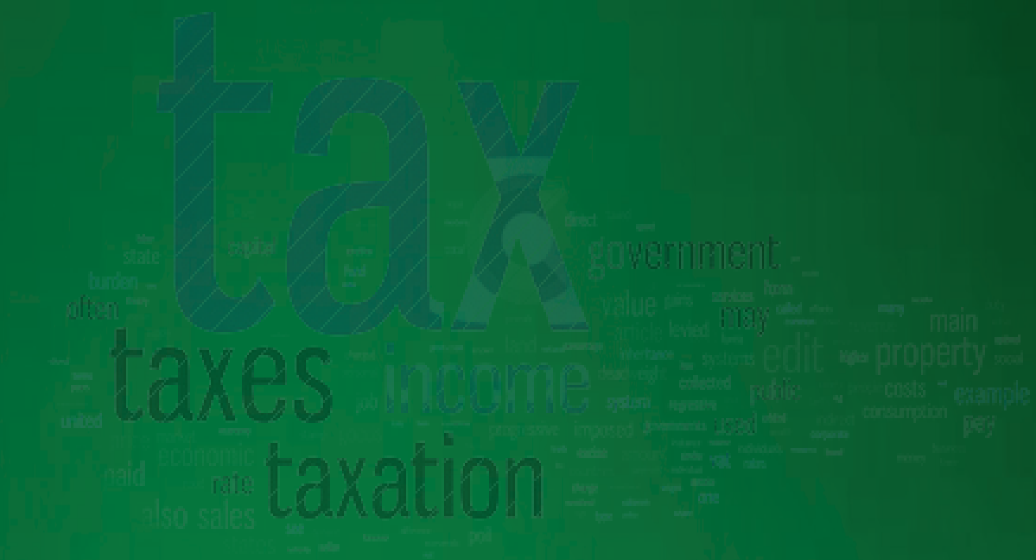
Dagan (1999); The Impact of Double Taxation Treaties on Cross Border Equity Flows, Valuations and Cost of Capital

United Nations Conference on Trade and Development (2001); World Investment Report 2001, Promoting Linkages

United Nations Conference on Trade and Development (2001); World Investment Report 2009, Transnational Corporations, Agriculture Production and Development.

World Bank (2012); Zambia Poverty Assessment, Stagnant Poverty and Inequality in a Natural Resource-Based economy

Zambia Fiscal Guide 2012/13 kpmg.com



Joint Zambia Programme