TAX JUSTICE NETWORK AFRICA

EATGN

THE GOOD, THE BAD AND THE UGLY

An Examination of Kenya's Double Taxation Agreements with Portugal and Turkey

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Block 3, 106 Brookside Drive Westlands
P. O. Box 25112-00100 Nairobi-Kenya

Contacts
Email: info@taxjusticeafrica.net
Tel: +254 728279368
Website: www.taxjusticeafrica.net

Jaflo Limited, Block 3 Brookside Drive Westlands

Contacts
Email: info@eataxgovernance.net / coordinator@eataxgovernance.net
Tel: (254) 20 24 73373, (254) 728 279 368
Website: www.eataxgovernance.net

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INTRODUCTION

Increased globalization has resulted in increased cross-border trade. Since tax laws tend to be jurisdictional with each country's laws applying to its jurisdiction, cross-border trade often results in double taxation from both the country where the person resides and where they have sourced their income, therefore, resulting in the income being taxed twice. Consequently, countries have seen a need to find ways of assigning rights between the two countries, for example through tax treaties. These treaties are agreements through which two countries agree to assign and restrict taxing rights on economic activities that span two countries.[1]

Tax treaties are meant to serve the core function of encouraging cross-border trade by the elimination of double taxation likely to be caused by such trade. Since taxation is a significant expense for companies.

Tax treaties are meant to serve the core function of encouraging cross-border trade by the elimination of double taxation likely to be caused by such trade. Since taxation is a significant expense for companies, it would be prudent for countries, which want to promote cross-border trade, to enter into double tax treaties that will ensure countries share the tax on that income rather than taxing the same income twice by both countries. Bilateral tax treaties are, therefore, vastly common the world over. Kenya presently has about 14 double tax treaties, currently in force, and more than 30 other treaties in various stages of negotiation or conclusion.[2]

However, while treaties are officially aimed at eliminating double taxation, they can also have the unintended consequence of double non-taxation[3]. This is because treaties can very easily be used as tools for aggressive tax planning that result in massive tax avoidance.

In most cases, the jurisdictions that suffer loss of taxes – as a result of tax avoidance – are the developing countries that are capital importing countries and also market jurisdictions, where the income of these companies will be earned (source countries). Due to the fact that developing countries represent a large untapped market with new consumers, market jurisdictions will continue to suffer loss of taxes.

Earlier this year, the National Treasury of Kenya made public the draft treaties that Kenya had completed negotiating with the Republic of Turkey and another with the Portuguese Republic. TJNA has a keen interest in ensuring such tax treaties which are signed by Kenya with more industrialised and developed countries do not result in an inequitable loss of tax revenue in Kenya. One way to ensure that this is achieved is through transparency and ensuring that there is public input. The Constitution of Kenya indeed requires that Parliament shall *"...facilitate public participation and involvement in the legislative and other business of Parliament and its committees.*[4]*"*

These issues were litigated by TJNA when objecting to the ratification of the Kenya-Mauritius double tax treaty in the case of **Tax Justice Network - Africa v Cabinet Secretary for National Treasury & 2 others [2019] eKLR.**[5] While the court did not pronounce itself on the issue of revenue loss risk, it did determine that the tax treaty between Kenya and Mauritius was void as it was not laid before Parliament for deliberation before being enacted into law.

The National Treasury briefly requested for comments and views from the public on the two draft tax treaties prior to tabling the same before parliament. The parliamentary approval process will, to a certain extent, give a level of public participation due to representation of the people by the members of parliament. It is yet to be seen to

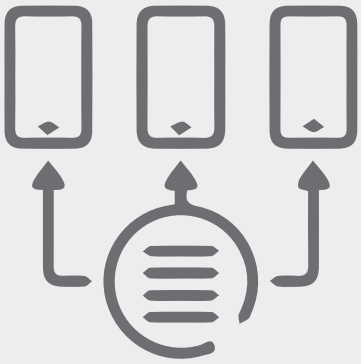
1. Hearson, M. and Kangave, J. (2016). *A Review of Uganda's Tax Treaties and Recommendations for Action.* [online] Brighton: Institute of Development Studies. Available at: http://ictd.ac/research/themes/index.php?option=com_udownload&view=document&id=105 [Accessed 27 Jul. 2017].
2. Kenya National Treasury Website: https://www.treasury.go.ke/agreements/
3. Trepelkov, A., Tonino, H., &Halka, D. (2017). *United Nations handbook on selected issues in protecting the tax base of developing countries.* New York: United Nations.
4. Article 118(1)(b) of the Constitution of Kenya, 2010
5. Citation: Petition No.494 of 2014

what extent the views received from the public participation exercise will be taken on board, and whether they influenced changes in the content of the two draft treaties. Where the public or parliament feels strongly that certain positions must be amended in the draft treaties, the representatives from either country mandated to negotiate the treaties must again sit down and discuss the proposed changes, agree to them and have their competent authority sign against the amended draft.

This report reviews both treaties from the angle of Kenya as the jurisdiction where foreign companies intend to invest (also known as the 'capital importing' jurisdiction) and where there is likely to be a large untapped market ('market jurisdiction' or 'source country'). It has been split into three main parts dubbed, 'the good, the bad and the ugly'.

The good is what is considered to be favourable and equitable to Kenya and which is in line with what has been proposed by the UN Model Tax Treaty.[6] On the surface, the good segments of the treaties determine that Kenya, as a capital importing and market jurisdiction will have taxing rights over income that is earned in Kenya.

Meanwhile, the bad and the ugly represent provisions that in their very nature will result in reduced tax revenue for Kenya and which may lead to the possibility of or provide avenues for aggressive tax planning by multi-national enterprises. The two drafts containing a more detailed discussion on all the provisions that can be improved and the proposals for amendment of these provisions to ensure equity in taxation and minimal opportunities for tax planning, avoidance and evasion are annexed to this document.



The bad and the ugly represent provisions that in their very nature will result in reduced tax revenue for Kenya and which may lead to the possibility of or provide avenues for aggressive tax planning by multi-national enterprises.

THE GOOD

Services Permanent Establishment (PE)

The Turkey draft contains a provision in Article 5 on the creation of a services permanent establishment. Briefly, a permanent establishment (PE) means a fixed place of business through which the business of an enterprise is wholly, or partly, carried on. Consequently, for instance, where a company resident in Turkey establishes a PE in Kenya, the presence of the PE determines the right that Kenya has to tax the profits of that Turkish company, but only to the extent that these profits are attributable to the PE in Kenya.

The negotiations on the thresholds of determining that a PE exists can be very prolonged. The capital importing jurisdictions will hope to get a low PE threshold so that they can have taxing rights over the PE's income as quickly as possible. The jurisdiction of the non-resident company will want a higher threshold so that they retain the taxing rights for as long as possible.

The provision of a services PE is advantageous to the capital importing country. Its effect is to broaden the definition of a PE in the treaty to include instances where a non-resident performs a service in the source state for a specified period of time, even where the services are not provided through a fixed state of business. As such, services provided by employees or other personnel engaged by the entity will be taken into account in determining whether a PE has been created.

6. The United Nations Model Double Taxation Convention between Developed and Developing Countries ('UN Model Tax Treaty') is one of the more popular models that constitute the basis for bilateral tax agreements. The UN Model Tax Treaty is preferred by most developing countries as it tends to propose allocation of more taxing rights for the source countries.

Accordingly, if a Turkish entity engaged independent contractors to perform services in Kenya, the number of days on which those independent contractors furnish services is counted, along with services provided by employees, in determining whether the 6 months (within any twelve months' period) threshold has been met, in order to determine that the entity has created a PE in Kenya.

Fees from Technical Services

The Portugal draft provides a separate article for taxation of fees from technical services in line with the proposals by the UN Model Tax Treaty. Fees for technical services encompass any payment in consideration of any service of a managerial, technical or consultancy nature, unless the payment is made to an employee. Other payments that may also fall out of this definition include payment for teaching in or by an educational institution and payments by an individual for services for personal use.

The provision of a separate article for taxation of fees from technical services was introduced in the 2017 UN Model Tax Treaty. Before its introduction, developing countries had for a while claimed that fees charged for various services were a major basis for profit shifting. Since payments made for receipt of these services are deductible in the source country, they reduce the taxable profits of the entity paying them.

The difficulty in taxing such income in the source country was due to the fact that a PE had to be formed in order for that income to be taxed in the source country. However, the threshold of creating a PE under Article 5 could easily be circumvented owing to the nature of services being provided without having a fixed place of business. Alternatively, the service could be provided in a very short period of time and would, therefore, not be covered under the threshold of the Service PE, discussed above.

Subsequently, countries were left to fall back on the article on taxation of other income which generally provides for taxation of such other income not expressly provided for under the treaty in the country of residence. As a consequence, this meant that the source country automatically lost out on the taxation of such income. Even in cases where the article on other income provided for a residual taxing right in the source country, as per the UN Model Tax Treaty Article 22 on other income in paragraph 3, even then, it is difficult to implement this provision in taxation of such fees.[7]

All things considered, this article providing for taxation on fees for technical services will allow Kenya to tax income from technical services earned by a non-resident Portuguese entity, once payment is made, through a withholding tax levied on the gross payments. This will apply even where there is no PE in place. This provision would, in most cases and where a reasonable rate is applied, result in a more efficient manner of collecting tax than the services PE provision discussed above.

If a Turkish entity engaged independent contractors to perform services in Kenya, the number of days on which those independent contractors furnish services is counted, along with services provided by employees, in determining whether the 6 months (within any twelve months' period) threshold has been met, in order to determine that the entity has created a PE in Kenya.

THE BAD

Title of the Treaty

The title and preamble form part of the double taxation agreement and constitute a general statement of the object and purpose of the treaty. They, therefore, play

7. See for example Tax Appeals Tribunal case McKinsey and Company Inc. Africa Proprietary Ltd Vs KRA (Apr. 2021)

an important role in the interpretation of the provisions of the Agreement. It is generally understood that the principal purpose of the tax treaty is to enhance bilateral trade between the contracting states by eliminating double taxation. Treaties have, however, been subject to abuse and have been used for tax planning and tax avoidance.

The title to the Turkey draft agreement, however, only makes reference to the avoidance of double taxation and the prevention of fiscal evasion, without making any direct reference to the Agreement's purpose of the prevention of tax avoidance. The UN Model Tax Treaty proposes the inclusion of an explicit statement to the effect that the contracting states do not intend that the provisions of the treaty will create opportunities for non-taxation or reduced taxation through tax evasion and avoidance. Including such a definitive statement in the preamble creates an all-encompassing General Anti-Avoidance Rule (GAAR) that can be applied to disallow any kind of transaction that is intended for tax avoidance or evasion.

The UN Model Tax Treaty proposes the inclusion of an explicit statement to the effect that the contracting states do not intend that the provisions of the treaty will create opportunities for non-taxation.

Determination of Residence for Persons other Than Individuals

Paragraph 3 of the article on residents provides for the manner in which the residence of a person, other than an individual, is to be determined in cases where paragraph 1 cannot be applied, and it is not clear where the entity's place of residence is situated. In both treaties, the paragraph states that the residence shall be determined based on the place where the effective management of that person is situated.

The reason that residence is important is because the place of residence of an entity has the primary right of taxation, or residual right of taxation, unless otherwise stated by the treaty.

A company or person may try to manipulate the place of residence in order to appear to be resident in a low tax jurisdiction, for example, through incorporating the company in that low tax jurisdiction or establishing that jurisdiction as its place of effective management.

Alternatively, a company may ensure to have its place of effective management in a particular country simply to take advantage of its treaty networks and enjoy favourable rates under a tax treaty.

The term 'place of effective management' is not defined in the Portugal draft. It should also be noted that the Kenyan Income Tax Act (ITA) also does not provide a definition of this term. Generally, the place of effective management is located where the daily management of the company is carried out and the major decisions are taken, for example, where the meetings of the company's board of directors habitually take place.

The paragraph as is drafted may lead to tax avoidance cases. As such, entities with dual residence will deliberately ensure that location of their senior management offices or the place where company board meetings are held is in a particular jurisdiction. This is done in order to make that jurisdiction the place of effective management and hence constitute it as the place of residence of that entity.

By allowing the place of effective management test, it is indeed possible that an enterprise which is not resident in Portugal but seeks to obtain the benefit of the treaty may manipulate its senior management operations to ensure that the effective management occurs in Portugal in order to obtain the benefit of the treaty.

Entities with dual residence will deliberately ensure that location of their senior management offices or the place where company board meetings are held is in a particular jurisdiction.

With regard to the Turkey draft, it should be noted that the definition provided in Article 3 of the term *'place of effective management'* is very specific covering important aspects, such as determination of the place that plays a leading part in the management of a company from an economic and functional point of view, and where the key management and commercial decisions are to be made. However, there is still a possibility of all these functions being at different jurisdictions and still leaves room for a lot of debate on the place of jurisdiction with the possibility for tax avoidance.

The UN Model Tax Treaty having noted this possibility of avoidance recommends that the determination of this tie breaker on a case-by-case basis takes into account various factors, such as where the person's headquarters are located or where the board meetings are held or where its accounting records are kept etc. Furthermore, where the place of residence of the entity cannot be determined, then the entity shall not be entitled to any relief or exemption under the agreement.

Where the place of residence of the entity cannot be determined, then the entity shall not be entitled to any relief or exemption under the agreement.

Taxation on Dividends

Paragraph 2 of the article on dividends in the Portugal draft provides for a reduced tax rate of 7.5% for dividends paid if the beneficial owner is a company that holds at least 10% of the capital of the company paying the dividend. Meanwhile, the Turkey draft proposes a rate of 7.5% where the beneficial owner holds at least 25% of the capital of the company paying the dividend.

In our view, the minimum portfolio rate percent of 10% proposed in the Portugal draft is quite low – even lower than the domestic rate of 12.5% – and is not in accordance with the rates provided by Kenya in its other DTAs.

With regard to the Turkey draft, the provision does not provide a time threshold within which such shares must be held.

Where this is not provided, it may easily be argued that one would obtain the benefit of the reduced rate even when they have held the 25% shareholding for any period during that financial year. Without giving a minimum timeframe in which the 25% shareholding is to be held, this provision is likely to be abused by non-resident shareholders who may increase their shareholdings just before dividends are paid in order to obtain the concessional tax rate.

THE UGLY

Determination of Persons Covered

In Article 1, both the Turkey and Portugal drafts provide that the Treaty is to apply only to persons who are resident of one or both contracting states. As drafted, the article fails to take into account the developments captured in the UN Model Tax Treaty relating to payments that are made to entities that are partly, or wholly, fiscally transparent such as partnerships[8] or trusts. This also applies to payments that have a different character in the two contracting states, for instance, where one state considers a payment as interest while the other considers it to be dividend. Such a difference in treatment of classification is known as a mismatch which can easily result in double non-taxation of that particular income.

The effect of a mismatch in relation to partnerships may be illustrated as follows: where a partnership owned by Portuguese partners is registered in Kenya, Kenya may

8 Under the Kenya Income Tax Act, Partnerships and Trusts are considered tax transparent. In Portugal some categories of commercial partnerships have legal personality and are not tax transparent leading to the possibility of mis-match.

not tax the partnership since Kenya considers that a partnership is tax transparent and as such can only tax the partners. However, Kenya will also be unable to tax the partners since they are resident in Portugal and are taxable in Portugal according to the tax treaty.

Portugal, on the other hand, may consider that a partnership is a taxable entity which should have been taxed in its place of registration in Kenya and, therefore, does not tax the partnership or the partners who are resident in Portugal. This scenario will result in the income of the partnership and the partners not being taxable in either contracting state.

In order to deal with these mismatch situations, the more recently negotiated treaties ensure to include a paragraph that specifically states that if – under the laws of a contracting state – the entity or arrangement (such as partnerships) is a taxable entity, then the entity may qualify as a resident of that contracting state and, therefore, be entitled to benefits of the treaty.

However, if the entity is treated as tax transparent under the laws of the residence state, and accordingly, the partners or owners are taxed on the entity's income, then the provisions of the treaty should be applied at the level of the partners and not the level of the entity. (UN Model Commentary)

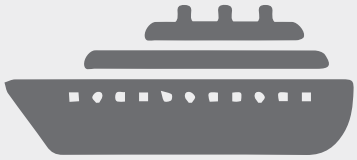
Failure to include this provision creates a very ripe opportunity for tax avoidance as investors will form partnerships or other tax transparent entities and take advantage of the mismatch to achieve double non-taxation in their place of residence and the source country.

Taxation on Income from Shipping and Air Transport (Portugal)

The Portugal draft provides an interesting proposal on taxation of income from international shipping and air transport. Paragraph 2 of the applicable article provides that the profits derived from the operation of ships in international traffic in the other contracting state shall be deemed to be an amount not exceeding 5% of the amount received by the enterprise on account of carriage of passengers or freight embarked in that other state. Further, it states that the tax chargeable shall be reduced by an amount equal to fifty percent thereof.

The provision in the preceding paragraph is problematic particularly when read together with Kenya's Income Tax Act. Section 9(1) of the Income Tax Act provides that Kenya may tax the gross amounts received by a non-resident ship owner, charterer or air transport operator on account of carriage of passengers who embark or cargo or mail which is embarked in Kenya, other than those embarked in the process of transhipment. The Third Schedule of the Act then provides that in respect of gains or profits from the business of a ship owner which is chargeable to tax under section 9(1) of the Act, the tax payable will be 2.5% of the gross amount received.

Applying the provisions of the UN Model Tax Treaty to the Income Tax Act means that Kenya will be permitted to only tax an amount not exceeding 5% of the gross income at the rate of 1.25% (being 50% of the tax chargeable). The amount of tax payable under the Portugal draft treaty will, therefore, be a very small fraction of the tax that would be payable without the treaty as the Income Tax Act already grants some concession on this income.



Profits derived from the operation of ships in international traffic in the other contracting state shall be deemed to be an amount not exceeding 5% of the amount received by the enterprise.

The Portugal draft provides an interesting proposal on taxation of income from international shipping and air transport.

This provision limits the application of the amount of income that may be subject to tax. It should be noted that Kenya's ports connect the landlocked East African countries to the rest of the world. A provision that limits taxation to such an extent will likely deny Kenya income from shipping lines resident in Portugal.

Capital Gains Tax on Alienation of Shares

The article on taxation of capital gains in the Portugal draft has omitted a key paragraph that covers taxation of a gain on the alienation of shares and comparable interests of entities other than those principally owning immovable property.

Take for instance, a telecommunications company in Kenya that had substantial valuable assets such as licenses and other IP and is 100% owned by a non- resident company. This non- resident company is also owned 100% by another company resident in Portugal. In the event of the transfer of shares in the Portuguese company, resulting indirectly in transfer of interest in the Kenyan company, there will be an indirect transfer of capital assets in Kenya and ideally this transaction should be subject to capital gains tax in Kenya.

The UN Model Tax Treaty proposes the inclusion of a paragraph covering this type of disposal on interest as it was seen to be important that a contracting state should be able to tax a gain on the alienation of shares of a company resident in that state, whether the alienation occurs within or outside that state. This provision would allow taxation of that gain on any number of shares (or percentage of interest) as long as the shareholding is substantial at any time during the 12-month period preceding the alienation. Consequently, even if a substantial shareholding is alienated through a number of transfers of smaller shareholdings, the taxing right granted by the paragraph will still apply if the shares transferred were alienated at any time during the 12-month period.[9]

In the event of the transfer of shares in the Portuguese company, resulting indirectly in transfer of interest in the Kenyan company, there will be an indirect transfer of capital assets in Kenya and ideally this transaction should be subject to capital gains tax in Kenya.

9. Para. 9-10 UN Model Tax Treaty: Commentary on Article 13 (2017).

Case Study of Vodafone in India

Vodafone International Holdings (VIH), a Dutch Company procured 100% shares in CGP Investments (Holding) Ltd, a company situated in the Cayman Islands, from Hutchison Telecommunications International Ltd (HTIL) in the year 2007. CGP, through different organizations and actions controlled 67% of Hutchison Essar Limited (HEL), an Indian Company. Vodafone got command over CGP and its downstream subsidiaries including HEL, through the acquisition. HEL had acquired telecom licenses to give cell communication in various circles in India starting from November 1994.

The Indian Tax Authorities sought tax in connection to the above transaction as the transaction of transfer of shares in CGP had an impact of indirect transfer of assets in India.

The question put forward to the court for determination was whether the transfer of shares between two foreign companies, resulting in extinguishment of controlling interest in the Indian Company held by a foreign company, amounted to transfer of capital assets in India and whether such a transaction is chargeable to tax in India. The Bombay High Court held that the transaction amounted to transfer of capital assets and is chargeable to tax in India.

This decision was overturned in the Supreme Court which was of the view that tax should be levied on the basis of the source, which is the location where the sale takes place and not where the product is derived or purchased from. Since the sale took place outside India the source of revenue is outside India.

Were the transfer of shares between two foreign companies amounted to transfer of capital assets in India and is such a transaction chargeable to tax in India?

The Effect of the Most Favoured Nation Clause in the Tax Treaty between Kenya and France

Kenya entered into a tax treaty with France in December, 2007. Article 28 of the treaty makes a provision for a Most Favoured Nation (MFN) clause. The MFN provides that in the event that Kenya negotiates a subsequent treaty with any other OECD country and in that subsequent treaty provides for lower rates or for exemption on taxes chargeable for dividend, interest or royalties, then the same must automatically apply to the Kenya - France treaty. Since Portugal is a member of the OECD, then Kenya must be careful to consider the rates it negotiates in the Portugal Treaty vis-a-vis the France Treaty.

MFN provisions, such as these, are problematic for a number of reasons. Particularly, when the MFN provision is one sided and allows France to benefit from treaty negotiations between Kenya and another OECD country, without regard for the special situations or circumstances that lead to a certain result in a treaty with another party.

In the draft treaty with Portugal, the tax rates applicable are: dividend - 7.5% or 10%; royalties - 10; interest - 12% and fees from technical services - 10%. The France tax treaty has the following rates: dividend - 10%; interest - 12% and royalties - 10%.

As per the MFN provisions, the lower rate of 10% on interest will automatically apply to France instead of the negotiated 12%. Until the provisions of the MFN are removed from the Kenya - France treaty, Kenya must keep in mind the rates it applies with other OECD members as it has a direct bearing on the France treaty.

Treaties can have some uses, the risk of them being exploited by multinationals seeking to avoid payment of their full share of tax is also very acute.

CONCLUSION

The debate on whether tax treaties are beneficial continues to rage. While the treaties can have some uses, the risk of them being exploited by multinationals seeking to avoid payment of their full share of tax is also very acute. When this happens, it is the source countries that lose the most revenue. Governments should, therefore, be cautious of these loopholes and possible risks to revenue and ensure that these are eliminated as much as possible.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WHITE PAPERS ON DOUBLE TAXATION AGREEMENTS

1.0 Introduction

1.1. An analysis of the draft Double Tax Agreements (DTAs) between the Government of the Republic of Kenya and the Governments of the Republic of Portugal and Turkey was undertaken.

1.2. The analysis of the draft DTAs covered the following areas:

1.2.1. Comparison of the provisions of the two DTAs against the standard provisions in the OECD Model, the UN Model as well as the ATAF Model Conventions and the identification of any differences or variations of the DTAs against the standard provisions of the Model Conventions.

1.2.2. Analysis of the implications of these variations in terms of revenue implications for Kenya.

1.2.3. Shedding light on any loopholes in the DTAs, whether or not they are caused by the variations from the Model Conventions, which can result in tax avoidance or evasion in Kenya.

1.2.4. Examination of select DTAs that Portugal and Turkey have concluded in the recent past, particularly with developing countries in order to try and establish an international tax policy.

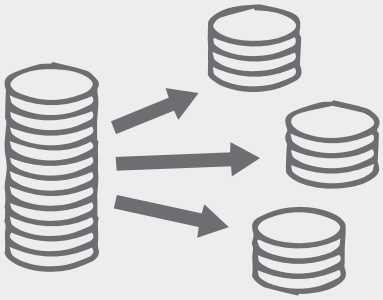
1.2.5. Examination of select DTAs that Kenya has concluded with developing countries in the recent past and compare with the provisions of the two DTAs to ensure that an international tax policy that is reasonable to Kenya is being uniformly applied.

1.2.6. Review of other provisions contained in the DTA such as the preamble or the protocols to the DTAs that may have an adverse effect on equitable distribution of taxes between the contracting states.

1.2.7. Proposals for amendment of these provisions to ensure equity in taxation and minimal opportunities for tax planning, avoidance and evasion.

1.3. The findings of the analysis were as shown in the next section:

Shedding light on any loopholes in the DTAs which can result in tax avoidance or evasion in Kenya.



Equitable distribution of taxes between the contracting states.

DOUBLE TAX AGREEMENT BETWEEN THE GOVERNMENT OF THE REPUBLIC OF KENYA AND THE GOVERNMENT OF THE REPUBLIC OF PORTUGAL

2.0 Article 1: Persons Covered

2.1. The Article states that the agreement is to apply only to persons who are resident of one or both contracting states.

2.2. It fails to take into account the developments captured in Article 1, paragraph 2, of both the 2017 UN and OECD Models relating to payments that are made to entities that are partly, or wholly, fiscally transparent such as partnerships[10] or trusts, or in relation to payments that have a different character in the two contracting states (hybrid instruments). For instance, where one state considers a payment as interest while the other considers it to be dividend. Such a difference in treatment of classification is known as a mismatch which can easily result in double non-taxation of that particular income.

The effect of a mismatch in relation to partnerships.

2.3. The effect of a mismatch in relation to partnerships is illustrated below:

Where a partnership owned by Portuguese partners is registered in Kenya, Kenya may not tax the partnership since Kenya considers that a partnership is fiscally transparent and as such can only tax the partners. However, Kenya will also be unable to tax the partners since they are resident in Portugal and are taxable in Portugal according to the DTA. Portugal, on the other hand, may consider that a partnership is a taxable entity which should have been taxed in its place of registration in Kenya and, therefore, does not tax the partnership or the partners who are resident in Portugal. This scenario will result in the income of the partnership and the partners not being taxable in either contracting state.

2.4. The draft agreement also fails to take into account paragraph 3 of both the 2017 UN and OECD Models. This paragraph confirms the principle that the agreement does not restrict a contracting state's right to tax its own residents, except where this is intended, and lists the provisions with respect to which that principle is not applicable.

Proposed Amendment(s)

2.5. In line with the OECD Model 2017 and the UN Model 2017, we would recommend that the article be amended as follows:

1. ***This Agreement shall apply to persons who are residents of one or both of the Contracting States.***
2. ***For the purposes of this Agreement, income derived by or through an entity or arrangement that is treated as wholly, or partly, fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State, but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.***
3. ***This Agreement shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under [Paragraph 3 of Article 7], Paragraph 2 of Article 9 and Articles 20, 21, 22, 24, 25 and 26 and 31.***

10. Under the Kenya Income Tax Act, Partnerships and Trusts are considered tax transparent. In Portugal some categories of commercial partnerships have legal personality and are not tax transparent leading to the possibility of mismatch.

3.0 Article 3: General Definitions

3.1. The term 'international traffic' has been defined as '*any transport by ship or aircraft operated by an enterprise which has its place of effective management in a contracting state, except when the ship or aircraft is operated solely between places in the other Contracting State, and the enterprise operating the ship or aircraft is not an enterprise of that State'* (emphasis added).

3.2. The term 'place of effective management' is not defined in the draft agreement. It should also be noted that the Kenya Income Tax Act (ITA) also does not provide a definition of this term. Generally, the place of effective management is located where the daily management of the company is carried out and the major decisions are taken (for example, where the meetings of the company's board of directors habitually take place).

3.3. The definition of international traffic to cover transport by enterprises whose place of effective management is in a contracting state opens avenues for tax planning. It is indeed possible that an enterprise which is not resident in Portugal but seeks to obtain the benefit of the agreement may manipulate its senior management operations to ensure that the effective management occurs in Portugal in order to obtain the benefit of the agreement.

The ship or aircraft is operated solely between places in a Contracting State and the enterprise operating the ship.

- **Proposed Amendment(s)**

3.4. In line with the OECD Model 2017 and the UN Model 2017, we would recommend that the definition of international traffic be amended to read as follows:

- ***Any transport by ship or aircraft ~~operated by an enterprise which has its place of effective management in of a contracting state,~~ except when the ship or aircraft is operated solely between places in a Contracting State and the enterprise operating the ship or aircraft is not an enterprise of that State'.***

4.0 Article 4: Resident

4.1. Paragraph 3 of the Article provides for the manner in which the residence of a person, other than an individual, is to be determined in cases where paragraph 1 cannot be applied. It states that the residence shall be determined based on the place where the effective management of that person is situated.

4.2. The paragraph as drafted may lead to tax avoidance cases. As such, entities with dual residence will deliberately ensure that location of their senior management offices or the place where company board meetings are held is in a particular jurisdiction. This is done in order to make that jurisdiction the place of effective management and hence constitute it as the place of residence of that entity.

4.3. The 2017 UN and OECD Models having noted this possibility of avoidance recommend that the determination of this tie breaker on a case-by-case basis, taking into account various factors, such as where the person's headquarters are located or where the board meetings are held or where its accounting records are kept and so on.

4.4. Further, the two models propose that where the place of residence of the entity cannot be determined, then the entity may not be entitled to relief or exemption under the agreement unless otherwise agreed to by the competent authorities of the contracting states.

Dual residence will deliberately ensure that location of their senior management offices or the place where company board meetings are held is in a particular jurisdiction.

Proposed Amendment(s)

4.5. We propose the following amendment to paragraph 3:

> ***3. Whereby reason of the provisions of paragraph 1, a person other than an individual is a resident of both Contracting States, ~~then it shall be determined to be a resident only of the State in which its place of effective management is situated~~ the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Agreement, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such an agreement, such a person shall not be entitled to any relief or exemption from tax provided by this Agreement except to the extent and in such a manner as may be agreed upon by the competent authorities of the Contracting States.***

Kenya should take into account the sectors that attract Foreign Direct Investment (FDI) and the nature of businesses growing in its jurisdiction.

5.0 Article 5: Permanent Establishment (PE)

a. Paragraph 2

5.1. This paragraph provides a list of the places that shall be determined to be a PE. The list is borrowed from both the OECD and UN Model double tax treaties. However, the list is by no means exhaustive, and parties are at liberty to include other illustrations that relate to their specific circumstances. It is our view that in negotiating this clause, Kenya should take into account the sectors that attract Foreign Direct Investment (FDI) and the nature of businesses growing in its jurisdiction.

Proposed Amendment(s)

5.2. We would, therefore, propose inclusion of the following examples immediately after paragraph 2(f):

> ***g. a farm, plantation, or other place where agricultural, forestry plantation or related activities are carried on.***
>
> ***h. an installation or structure used for the exploitation of natural resources;***
>
> ***i. a sales outlet;[11] and***
>
> ***j. a warehouse in relation to a person providing storage facilities for others.***

These illustrations widen and clarify the instances in which a PE exists and should be considered for inclusion.

b. Paragraph 3 - Time Threshold and Services PE

5.3. This paragraph provides that a range of activities shall constitute a construction PE. However, it lists fewer activities than those recommended under the UN Model. The UN Model is much broader and proposes inclusion of assembly projects as well as supervisory activities in connection with such projects in order to increase the threshold of creating a PE.

5.4. This paragraph also provides a 12-month threshold for which a building site, construction and any similar activity may be termed as a PE. The UN Model Convention, which is favoured by developing countries, recommends that the threshold for a construction PE be limited to a 6-month period for the reason that construction, assembly and any other similar activity could, as a result of modern technology, be of a very short duration and still result in substantial profit for the enterprise.

5.5. Kenya applies the 6-month threshold in determination of a PE in domestic law,[12] and it is therefore, recommended that the same threshold or a shorter period

11. Paragraph h) and i) examples are included in the DTA between Portugal and India.
12. See Section 2 of the Income Tax Act Kenya, definition of Permanent Establishment.

should be applied for all its treaties for uniformity.

5.6. We further note that the paragraph fails to provide for creation of a PE in cases of enterprises providing services, including consultancy services. The UN Model proposes the inclusion of this as the provision of these services by enterprises of industrialised countries could generate large profits in developing countries.[13] We, therefore, propose that this be included under paragraph 3 as per the draft amendment below.

Proposed Amendment(s)

5.7. The paragraph should be amended in line with the UN Model Convention to provide as follows:

a. A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than ~~twelve~~ six months;

b. The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

c. Paragraph 3(a) – Anti-abuse Provision For Time Threshold

5.8. The OECD Commentaries 2017[14] point out that it has sometimes been found that enterprises, in a bid to beat the PE threshold, divided their contracts up into several parts: each covering a period lower than the time stipulated in the DTA. Each contract is then attributed to a different company owned by the same group. In doing so, the entity is able to beat the PE threshold as each company undertakes an activity for less than the stipulated time it takes to constitute a PE.

5.9. It is, therefore, in Kenya's best interest to prevent such abuse as it will result in reduced revenue where such fragmentation happens.

> *The OECD Commentaries 2017 point out that it has sometimes been found that enterprises, in a bid to beat the PE threshold, divided their contracts.*

Proposed Amendment(s)

5.10. We would propose that the same anti-fragmentation provision be included in this paragraph, immediately after 3(a) as follows:

For the sole purpose of determining whether the six-month period referred to in paragraph 3(a) has been exceeded:

i. where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction, assembly or installation project or supervisory activities in connection therewith, and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding six months, and

ii. connected activities are carried on at the same building site or construction, assembly or installation project or supervisory activities in connection therewith during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise. These different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.

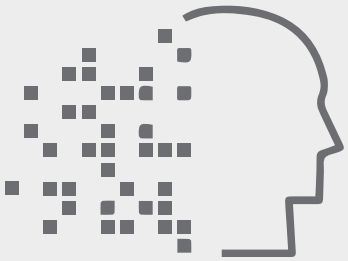
d. Paragraph 4(f)

5.11. The wording and arrangement of this paragraph is such that the requirement for services to be auxiliary or preparatory in nature applies only to sub-paragraph (f) rather than to the entirety of paragraph 4: sub-paragraphs (a) to (f). This

13. See paragraph 9 of the Commentary to Article 5 of the UN Model Convention
14. See paragraph 51 and 52 of the Commentaries to Article 5 in the OECD Model Convention.

modification is recognized by both the OECD and the UN in their 2017 updates thus ensuring that all the activities covered in Paragraph 4 are subject to the condition that they are preparatory or auxiliary.

5.12. If the phrasing is left as it stands, then any of the instances listed will not be considered a PE even where these activities constitute the sole business of a particular enterprise.



Prevent an enterprise from fragmenting a cohesive business operation into several smaller operations that might qualify as preparatory or auxiliary activities by themselves.

Proposed Amendment(s)

5.13. This anomaly was picked up and amended in the 2017 UN and OECD Models and the wording has been amended, which we propose to be incorporated in this draft as follows:

f. the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e), ~~provided that the overall activity of the fixed place of business resulting from this combination is a preparatory or auxiliary character.~~ provided that such activity or, in the case of subparagraph (f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

5.14. This phrasing will ensure that the qualification of preparatory or auxiliary character applies to the entire paragraph 4 and not just paragraph 4(f).

e. Paragraph 4.1 Anti-fragmentation

5.15. We propose the inclusion of paragraph 4.1 which was added to the OECD and UN Models in 2017 pursuant to the OECD BEPS Action 7 Report to counter the fragmentation of activities among different places or among connected enterprises to take inappropriate advantage of the exception to the definition of a PE in Paragraph 4.

5.16. The provision is intended to prevent an enterprise from fragmenting a cohesive business operation into several smaller operations that might qualify as preparatory or auxiliary activities by themselves. In the absence of such an anti-fragmentation rule, the exceptions in Paragraph 4 would apply to each place separately.

Proposed Amendment(s)

5.17. We propose inclusion of the following provision in line with the UN and OECD Models 2017:

4.1. Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and;

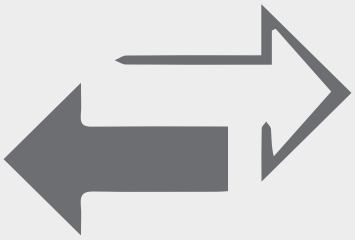
a. that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

b. the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

Updated to capture the use of such intermediary agents and provide for cases where they form a PE for the enterprise for which they operate.

f. Paragraph 5 – Agency PE

5.18. Paragraph 5 deals with instances where an agent can constitute a PE. The paragraph as worded is open to abuse as it may allow a Portuguese entity to use commissionaire agents and other intermediary agents in order to artificially avoid creating a PE in Kenya. Since Kenya, under the Agreement, can only tax the Portuguese entity if it establishes a PE in Kenya, such arrangements have an adverse impact on Kenya's tax base. The 2017 UN and OECD Models are updated to capture the use of such intermediary agents and provide for cases where they form a PE for the enterprise for which they operate.



Transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use.

Proposed Amendment(s)

5.20. We, therefore, propose that paragraph 5 be deleted and amended to reflect the updated provisions of the OECD and UN Models 2017 as follows:

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person other than an agent of independent status to whom paragraph 7 applies is acting in a Contracting State on behalf of an enterprise. That enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, if such a person:

a. habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are

i) in the name of the enterprise, or

ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

iii) for the provision of services by that enterprise, unless the activities of such person are limited to those mentioned in Paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph;

b. the person does not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts, but habitually maintains in that State a stock of goods or merchandise from which that person regularly delivers goods or merchandise on behalf of the enterprise.

g. Paragraph 7 – Exceptions to the Agency PE

5.21. The paragraph as stated in the draft only provides that an agent of independent status shall not create a PE of its principal. However, it does not include the conditions that must apply to demonstrate independence. These conditions are included in the UN and OECD Models 2017 to the effect that independent agents do not constitute a PE provided the agent is not exclusively or almost exclusively acting for the entity.

Proposed Amendment(s)

5.22. The provision should, therefore, be amended to include an additional sentence as follows:

7. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carried on business in that State through a broker, general commission agent or any other agent of an

independent status, provided that such persons are acting in the ordinary course of their business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

Deductions are allowable by the PE in determining the income subject to tax in the contracting state in which the PE is formed-including general and administrative expenses.

6.0 Article 7: Business Profit

a. Paragraph 1 – profits taxable in the PE State

6.1. Paragraph 1 provides for the taxation of profits attributable to the PE. The UN Model recommends the inclusion of a 'limited force of attraction rule'. This allows the country in which the PE is located to tax, not only the profits attributable to the PE but other profits of the enterprise derived in that State to the extent that they relate to sales of goods or other business activity that is the same or a similar kind as those of the PE.

6.2. This is an anti-avoidance provision to ensure that an enterprise resident in one Contracting State does not divert business in the other Contracting State away from the PE in order to ensure that the PE does not reflect the income and, therefore, does not pay taxes on that amount.

Proposed Amendment(s)

6.3. We propose that the wording in the UN Model 2017 be applied and that the provision be amended to include the underlined section as below:

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

b. Paragraph 3 – allowable deductions

6.4. Paragraph 3 provides for the deductions allowable by the PE in determining the income subject to tax in the contracting state in which the PE is formed-including general and administrative expenses. However, there is no restriction on these deductions with regard to related party expenses.

6.5. Such an open provision for deducting any expenses is bound to be abused by multinationals to shift the profits to a related entity in a low tax jurisdiction. It is to prevent such shifting of profits that the deduction of such expenses is limited under Section 18 of the Kenya Income Tax Act.

Proposed Amendment(s)

6.6. We propose that the paragraph be amended in line with the UN Model 2017 in order to reduce instances of profit shifting, to read as follows:

3. In determining the profits of a permanent establishment, there shall be allowed as deductions of expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. Nothing in this

paragraph shall require a Contracting State to allow the deduction of any expenditure which, by reason of its nature, is not allowed as a deduction under the taxation laws of that State. Further, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

The taxation of enterprises carrying out international transport using aircrafts and through the operation of ships shall primarily be in the place where the effective management of the enterprise is situated.

c. Paragraph 5 – PE Being a Purchasing Enterprise

6.7. This paragraph provides that the mere purchase of goods or merchandise for an enterprise shall not constitute a PE for that enterprise. The OECD proposed to delete this provision from the Model Convention. It is argued if the purchasing activities had been performed by an independent enterprise, the purchaser would have been remunerated on an arm's length basis for its services.

6.8. Further, such an exemption restricted to purchasing activities undertaken for the enterprise required that expenses incurred for the purposes of performing these activities be excluded in determining the profits of the PE, such an exemption could raise administrative problems. It was, therefore, considered that a provision according to which no profits should be attributed to a permanent establishment by reason of the mere purchase of goods or merchandise for the enterprise was not consistent with the arm's length principle and should not be included in the Article.[15]

Proposed Amendment(s)

6.10. Paragraph 5 of the Article should be deleted in its entirety as it is subject to abuse and is not in line with the arm's length principle applied in Kenya.

7.0 Article 8: Shipping and Air Transport

a. Paragraph 1 – Residence

7.1. Paragraph 1 provides for the taxation of enterprises carrying out international transport using aircrafts and through the operation of ships shall primarily be in the place where the effective management of the enterprise is situated.

7.2. As noted in section 3.1 to 3.3, discussing the general definitions under Article 3, the use of 'place of effective management' as a criterion for the agreement benefit is likely to be subject to abuse.

7.3. Paragraph 1 should, therefore, be amended to remove the basis of taxation from that of place of effective management and instead apply the place of residence test. This will be determined in accordance with Article 4.

15. See paragraph 43 of the Commentary to Article OECD Model Commentary

7.4. Accordingly, paragraph 3 guiding on the position to apply where the place of effective management is on board a ship shall not be necessary in the article.

b. Paragraph 2 – Chargeable Amount and Tax Rate

7.5. Paragraph 2 also provides that the profits derived from the operation of ships in international traffic in the other contracting state shall be deemed to be an amount not exceeding of 5% of the amount received by the enterprise on account of carriage of passengers or freight embarked in that other state. Further, it states that the tax chargeable shall be reduced by an amount equal to fifty percent thereof.

7.6. The provisions of paragraph 2 are problematic particularly when read together with Kenya's Income Tax Act. Section 9 (1) of the Act provides that Kenya may tax the gross amounts received by a non-resident ship owner, charterer or air transport operator on account of carriage of passengers who embark or cargo or mail which is embarked in Kenya, other than those embarked in the process of transhipment. The Third Schedule of the Act then provides that in respect of gains or profits from the business of a ship owner which is chargeable to tax under Section 9(1) of the Act, the tax payable will be 2.5% of the gross amount received.

7.7. Applying the agreement provisions to the Income Tax Act, then Kenya will be permitted to only tax an amount not exceeding 5% of the gross income at the rate of 1.25% (being 50% of the tax chargeable). The amount of tax payable under the agreement will, therefore, be a small fraction of the tax that would be payable without the agreement.

7.8. This provision limits the application of the amount of income that may be subject to tax. It should be noted that Kenya's ports connect the landlocked East African countries to the rest of the world. A provision that limits taxation to such an extent will likely deny Kenya income from shipping lines resident in Portugal.

It should be noted that Kenya's ports connect the landlocked East African countries to the rest of the world. A provision that limits taxation to such an extent will likely deny Kenya income from shipping lines resident in Portugal.

Proposed Amendment(s)

7.9. We propose that paragraphs 1 and 2 be amended as below and that paragraph 3 be deleted in its entirety:

1. ***Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.***
2. ***Notwithstanding paragraph 1 of this Article, where an enterprise of a Contracting State derives profits from the operation of ships in international traffic in the other Contracting State, such profits shall be deemed to be the gross amount received by the enterprise on account of the carriage of passengers or freight embarked in that other State.***

8.0 Article 9: Associated Enterprises

8.1. The draft agreement does not provide for an exemption to the requirement for a Contracting State to make a corresponding adjustment in instances where the adjustment is as a result of fraud, gross negligence, or wilful default.

8.2. The UN Model Convention 2017 includes an additional paragraph 3 aimed at promoting accountability. This provision denies the secondary adjustment recommended in paragraph 2 in cases where the enterprise is found guilty of fraud, gross negligence, or wilful default.

Proposed Amendment(s)

8.3. We propose a similar provision as paragraph 3, in line with the UN Model Convention be included as follows:

3. The provisions of paragraph 2 shall not apply where judicial, administrative, or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence, or wilful default.

9.0 Article 10: Dividend

9.1. Paragraph 2 provides for reduced tax rate of 7.5% for dividends paid if the beneficial owner is a company that holds at least 10% of the capital of the company paying the dividend.

9.2. The minimum portfolio rate percent of 10% is quite low (even lower than the domestic rate of 12.5%) and is not in keeping with the rates provided by Kenya in its other DTAs. We therefore propose that the percentage be amended to 25% shareholding in line with the proposals of the UN Model.

Proposed Amendment(s)

9.3. In line with the provisions of the UN Model 2017, we propose that paragraph 2(a) be amended as follows:

2. …

a) 7.5% per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least ~~10~~25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend); or

(b) …

States are at liberty to determine the appropriate rate of tax, 10% is significantly low as compared to the rates applied in other double taxation agreements.

10.0 Article 11: Interest

10.1. The agreement provides for a rate of 10%. Although States are at liberty to determine the appropriate rate of tax, 10% is significantly low as compared to the rates applied in other double taxation agreements. For example, the rates applicable for Canada – 15%, Norway – 20% and U.K – 15%.

10.2. In line with the proposal made in Article 7 relating to the limited force of attraction rule, we would propose an amendment to Paragraph 5 of this Article to require interest that is attributable to the PE through the limited force of attraction rule which should also be taxable under this Article. As such, if the debt claim is of the same or similar kind as that effected through the PE, then Article 7 would apply in taxing this interest income.

Proposed Amendment(s)

10.3. We propose the rate stated in paragraph 2 be amended from 10% to 12.5%.

10.4. We further propose an amendment in line with the UN Model 2017 to reflect the effect of inclusion of the limited force of attraction rule in Article 7 as follows:

5. ***The provisions of paragraphs 1, 2 and 3 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases, the provisions of Article 7 or Article 14, as the case may be, shall apply.***

11.0 Article 12: Royalties

11.1. The DTA provides at paragraph 2 for a rate of 10% for taxation of royalties. Although States are at liberty to determine the appropriate rate of tax, 10% is significantly low as compared to the rates applied in other double taxation agreements. For example, the rates applicable for Canada – 15%, Norway – 20% and U.K – 15%.

The definition of royalties included in paragraph 3 is not in line with the UN Model Convention and specifically excludes payments made for the 'use of or right to use industrial, commercial or scientific equipment'.

11.2. The definition of royalties included in paragraph 3 is not in line with the UN Model Convention and specifically excludes payments made for the *'use of or right to use industrial, commercial or scientific equipment'.* This definition of royalties is also incorporated in Kenya's Income Tax Act, and there is no basis for it to be excluded from the agreement.

11.3. Further, in line with the proposal with reference to Article 7 relating to the limited force of attraction rule, we would also like to propose an amendment to paragraph 4 requiring that royalties attributable to the PE through the limited force of attraction rule should also similarly be taxed in accordance with Article 7.

Proposed Amendment(s)

11.4. We propose the rate stated in paragraph 2 be amended from 10% to 12.5%.

11.5. Further, the definition of royalties contained in paragraph 3 be amended, and the effect of the limited force of attraction rule be incorporated in paragraph 4 in line with the UN Model as follows:

3. ***The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.***
4. ***The provisions of Paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.***

12.0 Article 13: Technical Fees

12.1. Paragraph 2 of the Article provides for a tax rate of 10%. Although States are at liberty to determine the appropriate rate of tax, 10% is significantly low as compared to the rates applied in other double taxation agreements.

12.2. Also, in line with the proposal with reference to Article 7 relating to the limited force of attraction rule, we would also like to propose an amendment to paragraph 4 requiring that technical fees attributable to the PE through the limited force of attraction rule should also similarly be taxed in accordance with Article 7.

Proposed Amendment(s)

12.3. We propose the rate stated in paragraph 2 be amended from 10% to 12.5%.

12.4. We further propose an amendment in line with the UN Model 2017 to reflect the effect of inclusion of the limited force of attraction rule in Article 7 as follows:

> ***4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with: (a) such permanent establishment or fixed base, or (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.***

13.0 Article 14: Capital Gains

13.1. Paragraph 3 provides that gains from the alienation of ships or aircraft and moveable property pertaining to the operation of such ships or aircraft shall be taxable in the contracting state where the place of effective management is situated.

13.2. In line with the proposals and discussions in sections 3.2 to 3.3 regarding the risk of abuse in having the Place of Effective Management as a basis of determining place of taxation, we would propose that the reference to the Place of Effective Management be removed and taxation benefit be in the Contracting State where the enterprise is resident, as will have been determined under Article 4.

13.3. We would also propose including a paragraph similar to paragraph 5 of the Article in the UN Model and the ATAF model which provides for taxation of a gain on the alienation of shares and comparable interests of entities other than those principally owning immovable property situated in the other contracting state. Both models propose that parties determine the level of holdings of the alienator that would be substantial to warrant taxation of the gain. Consequently, even if a substantial shareholding is alienated through a number of transfers of smaller shareholdings, the taxing right granted by the paragraph will still apply if the shares transferred were alienated at any time during the 12-month period.

Consequently, even if a substantial shareholding is alienated through a number of transfers of smaller shareholdings, the taxing right granted by the paragraph will still apply if the shares transferred were alienated at any time during the 12-month period.

Proposed Amendment(s)

13.4. Paragraph 3 should be amended to remove reference to Place of Effective Management and read as follows:

- ***Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in ~~the Contracting State in which the place of effective management of the enterprise is situated~~ that State.***

13.5. A new paragraph should also be inserted immediately after paragraph 4 to provide for taxation of transfer of shares or interests in entities other than those with substantial property in the other contracting state. The percentage shareholding considered significant should be applied as 12.5%. The paragraph would, therefore, read as follows:

- ***Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least 12.5% per cent of the capital of that company or entity.***

14.0 Article 16: Dependent Personal Services

14.1. In order to align with amendments as discussed in section 3.2 to 3.3, we would propose the removal of reference to the Place of Effective Management as the place of taxation of persons who exercise employment aboard a ship or aircraft operated in international traffic in Paragraph 3 of this Article.

Proposed Amendment(s)

14.2. We would propose the following amendment to this paragraph:

- ***Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic, ~~may be taxed in the Contracting State in which the place of effective management of the enterprise is situated~~ shall be taxable only in the first-mentioned State.***

15.0 Article 17: Directors' Fees

15.1. This Article excludes the taxation of remuneration paid to top level managerial officials of an enterprise. Both the UN Model and the ATAF model propose the inclusion of these top-level managers in this Article on the basis that where a top-level managerial position of a company resident in Kenya is occupied by a resident of Portugal, the remuneration paid to that official should be subject to the same principles as director's fees. Since it is the practice for many enterprises to have foreign residents hold top-level management positions, exclusion of this provision would lead to tax revenue loss in Kenya.

Proposed Amendment(s)

15.2. We, therefore, propose that the topic of the Article be changed to read *Directors Fees and Remuneration of Top-Level Managerial Officials* to ensure clarity on whose income the Article intends to cover.

15.3. The following paragraph should also be included immediately after paragraph 1 in line with the ATAF model:

- ***Salaries, wages, and other similar remuneration derived by a resident of a Contracting State in the individual's capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State unless such salaries, wages or other similar remuneration are borne by a permanent establishment situated in the first mentioned State.***

16.0 Article 19: Pension and Social Security Payments

16.1. The draft provision states that pension remuneration should be taxable in the state of resident of the recipient. We would propose, however, that in the case of a pension payment from a public scheme, the same should be taxed in the State of source.

Proposed Amendment(s)

16.2. We, therefore, propose the following additional paragraph be included:

2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

17.0 Article 23: Other Income

17.1. The wording applied in this article is similar to the one applied in the UN Model save for Paragraph 3 which deviates from the standard provision. It should be noted that the wording of paragraph 3 as it appears in the UN model is important to developing countries seeing that it allows for taxation of other income not specified in the foregoing articles to be taxed in the source state.

The draft provision states that pension remuneration should be taxable in the state of resident of the recipient. We would propose, however, that in the case of a pension payment from a public scheme, the same should be taxed in the State of source.

17.2. The wording proposed in paragraph 3 of the draft takes on a completely different meaning and does not convey the intendment of the UN Model paragraph 3.

Proposed Amendment(s)

17.3. We propose that paragraph 3 be deleted in its entirety and be replaced with the following:

*2. **Notwithstanding the provisions of Paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Agreement and arising in the other Contracting State may also be taxed in that other State.***

18.0 Article 28: Use and Transfer of Personal Data

18.1. This Article provides for the treatment of data obtained under the Agreement, including a paragraph to the effect that a person whose data has been transferred shall have direct access to such data upon request and to correct such data.

18.2. It is not clear the purpose of this provision, as the same cannot be found in any of the model conventions.

18.3. We would, therefore, propose that the same be deleted in its entirety. All provisions relating to exchange of information and confidentiality of such data is covered in the Multilateral Agreement for Mutual Administrative Assistance in tax matters (to which both Kenya and Portugal are members) as well as local laws in Kenya on data privacy and protection.

Proposed Amendment(s)

18.4. The Article should, therefore, be deleted in its entirety.

19.0 Protocol to the Agreement

Specific comments in relation to each of the paragraphs are as below:

19.1. Paragraph 1 regarding wholly, or partly, fiscally transparent entities is covered in the comments and proposed changes of Article 1 on 'Persons Covered' in section 2.

19.2. Paragraph 2 to be amended to read 6 months instead of 12 months, in line with proposals made in sections 4.4, 4.6 and 4.7.

19.3. Paragraph 4 on force of attraction has been discussed and included in sections 5.1 to 5.3.

19.4. Paragraph 5 regarding deductibility of PE expenses is also covered in sections 5.4 to 5.6.

19.5. Paragraph 6 may not be necessary with specific reference to Article 8, as the amendment proposed in section 7.5 to 7.9 states that the taxable amount shall be considered gross receipts.

19.6. Paragraph 7 may not be necessary with the proposed deletion of Article 28 as discussed in section 1

DOUBLE TAX AGREEMENT BETWEEN THE GOVERNMENT OF THE REPUBLIC OF KENYA AND THE REPUBLIC OF TURKEY

20.0 Title

20.1. The title and preamble form part of the Agreement and constitute a general statement of the object and purpose of the treaty. They, therefore, play an important role in the interpretations of the provisions of the Agreement.

20.2. It is generally understood that the principal purpose of the tax treaty is to enhance bilateral trade between the contracting states by eliminating double taxation. Treaties have, however, been subject to abuse and have been used for tax planning and tax avoidance.

20.2. The title to the draft Agreement, however, only makes reference to the avoidance of double taxation and the prevention of fiscal evasion, without making any direct reference to the Agreement's purpose of the prevention of tax avoidance.

20.3. The OECD and UN Model 2017 propose the inclusion of an explicit statement to the effect that the contracting states do not intend that the provisions of the treaty will create opportunities for non-taxation or reduced taxation through tax evasion and avoidance.

20.4. The inclusion of such a definitive statement in the preamble creates an all-encompassing General Anti-Avoidance Rule (GAAR) that can be applied to disallow any kind of transaction that is intended for tax avoidance or evasion.

Proposed Amendment

20.5. The title should be amended to explicitly include the Agreement's purpose to avoid tax avoidance as below:

- ***[DRAFT] AGREEMENT BETWEEN THE GOVERNMENT OF THE REPUBLIC OF TURKEY AND THE GOVERNMENT OF THE REPUBLIC OF KENYA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION AND AVOIDANCE WITH RESPECT TO TAXES ON INCOME.***

21.0 Article 1: Persons Covered

21.1. The draft agreement states that the treaty is to apply only to persons who are resident of one or both contracting states.

21.2. It fails to take into account the developments captured in Article 1 paragraph 2 of both the 2017 UN and OECD Models relating to payments that are made to entities that are partly, or wholly, fiscally transparent, such as partnerships or trusts; or in relation to payments that have a different character in the two contracting states (hybrid instruments), for instance, where one state considers a payment as interest while the other considers it to be dividend. Such a difference in treatment of classification is known as a mismatch which can easily result in double non-taxation of that particular income. The effect of a mismatch in relation to partnerships is illustrated in paragraph 2.3.

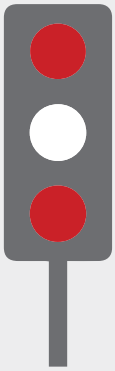
21.3. The Agreement also fails to take into account paragraph 3 of both the 2017 UN and OECD Models. This paragraph confirms the principle that the agreement does not restrict a contracting state's right to tax its own residents, except where this is intended, and lists the provisions with respect to which that principle is not applicable.

The OECD and UN Model 2017 propose the inclusion of an explicit statement to the effect that the contracting states do not intend that the provisions of the treaty will create opportunities for non-taxation or reduced taxation through tax evasion and avoidance.

Proposed Amendment(s)

21.4. In line with the OECD 2017 Model and the UN 2017 Model, we would recommend that the Article be amended as follows:

- This Agreement shall apply to persons who are residents of one or both of the Contracting States.
- ***For the purposes of this Agreement, income derived by or through an entity or arrangement that is treated as wholly, or partly, fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.***
- ***This Agreement shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 22,23,24 and 26.***



International Traffic:
Any transport by ship or aircraft operated by an enterprise which has its place of effective management in a contracting state.

22.0 Article 3: General Definitions

22.1. The term 'international traffic' has been defined as ***'any transport by ship or aircraft operated by an enterprise which has its place of effective management in a contracting state, except when the ship or aircraft is operated solely between places in the other Contracting State'*** (emphasis added)

22.2. The definition of international traffic to cover transport by enterprises whose place of effective management is in a contracting state opens avenues for tax planning. It is indeed possible that an enterprise which is not resident in Turkey but seeks to obtain the benefit of the Agreement may manipulate its senior management operations to ensure that the effective management occurs in Turkey in order to obtain the benefit of the Agreement.

22.3. The term 'place of effective management' has been defined to include ***'the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view and, where the key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made.'***

22.4. While this definition appears to be sufficiently detailed, the use of 'and' (highlighted above) may indicate that all the three requirements listed in the definition must be met for a jurisdiction to be considered to be the place of effective management of a person. As such, where one or more functions are carried out in a different jurisdiction, then the risk of a dual-resident or a stateless entity will arise. Such an ambiguity leaves open the possibility of manipulation for tax planning purposes.

Proposed Amendment(s)

22.5. In line with the OECD Model 2017 and the UN Model 2017, we would recommend that:

i. the definition of International traffic be amended to read as follows:

- ***'Any transport by ship or aircraft operated by an enterprise ~~which has its place of effective management in~~ of a contracting state, except when the ship or aircraft is operated solely between places in the other Contracting State and the enterprise operating the ship or aircraft is not an enterprise of that State'.***

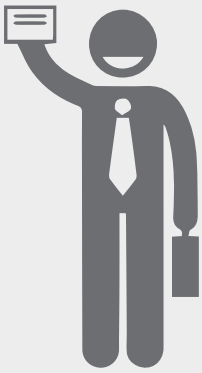
ii. The definition of 'place of effective management' be amended to read as follows:

'The place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view ~~and~~ or where the key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made'.

23.0 Article 4: Resident

23.1. Paragraph 3 of the Article provides for the manner in which the residence of a person, other than an individual, is to be determined in cases where paragraph 1 cannot be applied. It states that the residence shall be determined based on the place where the effective management of that person is situated.

23.2. The paragraph as drafted may lead to tax avoidance cases. As such, entities with dual residence may deliberately ensure that location of their senior management offices or the place where company board meetings are held is in a particular jurisdiction, in order to make that jurisdiction the place of effective management and hence constitute it as the place of residence of that entity.



States that the residence shall be determined based on the place where the effective management of that person is situated.

23.3. We note that the definition provided in Article 3 of the term 'place of effective management' is very specific covering important aspects, such as, determination of the place that plays a leading part in the management of a company from an economic and functional point of view, and where the key management and commercial decisions are to be made. However, there is still a possibility of all these functions being at different jurisdictions and still leaves room for a lot of debate on the place of jurisdiction with the possibility for tax avoidance.

23.4. The 2017 UN and OECD Models having noted this possibility of avoidance recommend that the determination of this tie-breaker on a case-by-case basis, takes into account various factors: where the person's headquarters are located or where the board meetings are held or where its accounting records are kept et cetera. Furthermore, that where the place of residence of the entity cannot be determined, then the entity shall not be entitled to any relief or exemption under the Agreement.

Proposed Amendment(s)

23.5. We, therefore, propose the following amendment to paragraph 3:

4. Where by reason of the provisions of paragraph 1, if a person other than an individual is a resident of both Contracting States, ~~then it shall be determined to be a resident only of the State in which its place of effective management is situated~~ the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Agreement, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such an agreement, such a person shall not be entitled to any relief or exemption from tax provided by this Agreement except to the extent in which such manner as may be agreed upon by the competent authorities of the Contracting States.

24.0 Article 5: Permanent Establishment (PE)

a. Paragraph 2

24.1. This paragraph provides a list of the places that shall be determined to be a permanent establishment. The list is borrowed from both the OECD and UN Model double tax treaties. However, the list is by no means exhaustive and parties are at liberty to include other illustrations that relate to their specific circumstances.

Proposed Amendment(s)

24.2. We would, therefore, propose inclusion of the following examples immediately after paragraph 2(f):

- ***a sales outlet***
- ***a warehouse in relation to a person providing storage facilities for others.***

These particular illustrations cover persons who have only a sales outlet and those providing storage facilities as their main business in order for their activities to create a PE.

b. Paragraph 3 (a)-Time Threshold

24.3. This paragraph provides a range of activities that constitute a construction PE. However, it lists fewer activities than those recommended under the UN Model. The UN Model is much broader and proposes inclusion of assembly projects as well as supervisory activities in connection with such projects in order to increase the chances of creation of a PE.

24.4. This paragraph also provides a 12-month threshold for which a building site, construction and any similar activity may be termed as a PE. The UN Model Convention, which is favoured by developing countries, recommends that the threshold for construction PE be limited to a 6-month period for the reason that a construction, assembly and similar activity could, as a result of modern technology be of a very short duration and still result in substantial profit for the enterprise.

The UN Model is much broader and proposes inclusion of assembly projects as well as supervisory activities in connection with such projects in order to increase the chances of creation of a PE.

24.5. Kenya applied the 6-month threshold in determination of a PE in domestic law and it is, therefore, recommended that the same threshold or a shorter period should be applied for all its treaties for uniformity.

Proposed Amendment(s)

24.6. The paragraph should be amended in line with the UN Model Convention to provide as follows:

3. The term 'permanent establishment' also encompasses

- ***A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than ~~twelve~~six months;***

c. Paragraph 3(a)- Anti-abuse Provision For Time Threshold

24.7. The OECD Commentaries 2017 point out that it has sometimes been found that enterprises, in a bid to beat the PE threshold, divided their contracts up into several parts, each covering a period lower than the time stipulated in the DTA. Each contract is then attributed to a different company owned by the same group. In doing so, the entity is able to beat the PE threshold as each company undertakes an activity for less than the stipulated time it takes to constitute a PE.

24.8. It is, therefore, in Kenya's best interest to prevent such abuse as it will result in reduced revenue where such fragmentation happens.

Proposed Amendment(s)

24.9. We would propose that the same anti-fragmentation provision be included in this paragraph, immediately after 3(a) as follows:

- ***For the sole purpose of determining whether the six-month period referred to in paragraph 3(a) has been exceeded:***
  - ***iii) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding six months, and***
  - ***iv) connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise, these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.***

d. Paragraph 4(f)

24.10. The wording and arrangement of this paragraph is such that the requirement for services to be auxiliary or preparatory in nature applies only to sub-paragraph (f) rather than to the entirety of paragraph 4- subparagraphs (a) to (f).

24.11. If the phrasing is left as it stands, then any of the instances listed will not be considered a PE even where these activities constitute the sole business of particular enterprises.

The OECD Commentaries 2017 point out that it has sometimes been found that enterprises, in a bid to beat the PE threshold, divided their contracts up into several parts, each covering a period lower than the time stipulated in the DTA.

Proposed Amendment(s)

24.12. This anomaly was picked up and amended in the 2017 UN and OECD Models and the wording has been amended, which we propose to be incorporated in this draft as follows:

g. the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), ~~provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.~~
provided that such activity or, in the case of subparagraph (f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

24.13. This phrasing will ensure that the qualification of preparatory or auxiliary character applies to the entire paragraph 4 and not just paragraph 4(f).

e. Paragraph 4.1 Anti-fragmentation

24.14. We propose the inclusion of paragraph 4.1 which was added to the OECD and UN Models in 2017 pursuant to the OECD BEPS Action 7 Report to counter the fragmentation of activities among different places or among connected enterprises to take inappropriate advantage of the exception to the definition of a PE in paragraph 4.

24.15. The provision is intended to prevent an enterprise from fragmenting a cohesive business operation into several smaller operations that might qualify as preparatory or auxiliary activities by themselves. In the absence of such an anti-fragmentation rule, the exceptions in paragraph 4 would apply to each place separately.

Proposed Amendment(s)

24.16. We propose inclusion of the following provision in line with the UN and OECD Models 2017:

- ***Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and:***
  - ***c) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or***
  - ***d) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.***

Since Kenya, under the Agreement, can only tax the Turkish entity if it establishes a PE in Kenya, such arrangements have an adverse impact on Kenya's tax base.

f. Paragraph 5

24.17. Paragraph 5 deals with instances where an agent can constitute a PE. The paragraph as worded is open to abuse as it may allow a Turkish entity to use commissionaire agents and other intermediary agents to artificially avoid creating a PE in Kenya. Since Kenya, under the Agreement, can only tax the Turkish entity if it establishes a PE in Kenya, such arrangements have an adverse impact on Kenya's tax base.

24.18. The UN and OECD Models 2017 have updated their provisions to capture the use of such intermediary agents while also ensuring that independent agents do not constitute a PE provided the agent is not exclusively or almost exclusively acting for the entity.

Proposed Amendment(s)

24.19. We, therefore, propose that paragraph 5 be deleted and amended to reflect the updated provisions of the OECD and UN Models 2017 as follows:

6. Notwithstanding the provisions of paragraphs 1 and 2, where a person other than an agent of independent status to whom paragraph 7 applies is acting in a Contracting State on behalf of an enterprise. that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, if such a person:

c) habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are:

iv) in the name of the enterprise, or

v) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

vi) for the provision of services by that enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

d) the person does not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts, but habitually maintains in that State a stock of goods or merchandise from which that person regularly delivers goods or merchandise on behalf of the enterprise.

> *Limited force of attraction rule allows the country in which the PE is located to tax, not only the profits attributable to the PE but other profits of the enterprise derived in that State to the extent that they relate to sales of goods or other business activity that is the same or a similar kind as those of the PE.*

g. Paragraph 7 - Exceptions to Agency PE

24.20. The paragraph as stated in the draft only provides that an agent of independent status shall not create a PE of its principal. However, it does not include other conditions that must apply to demonstrate independence. These conditions are included in the UN and OECD Models 2017 and should also be included in the draft Agreement.

Proposed Amendment(s)

24.21. The provision should, therefore, be amended to include an additional sentence as follows:

- ***An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carried on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. <u>Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.</u>***

25.0 Article 7: Business Profit

a. Paragraph 1 - Profits Taxable in the PE State

25.1. Paragraph 1 provides for the taxation of profits attributable to the PE. The UN Model recommends the inclusion of a 'limited force of attraction rule.' This allows the country in which the PE is located to tax, not only the profits attributable to the PE but other profits of the enterprise derived in that State to the extent that they relate to sales of goods or other business activity that is the same or a similar kind as those of the PE.

25.2. This is an anti-avoidance provision to ensure that an enterprise resident in one Contracting State does not divert business in the other Contracting State away from the PE in order to ensure that the PE does not reflect the income and therefore does not pay taxes on that amount.

Proposed Amendment(s)

25.3. We propose that the wording in the UN Model 2017 be applied and that the provision be amended to include the underlined section as below:

> ***2. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.***

b. Paragraph 5 - P.E Being a Purchasing Enterprise

25.4. This paragraph provides that the mere purchase of goods or merchandise for an enterprise shall not constitute a PE for that enterprise. The OECD proposed to delete this provision from the Model Convention. It is argued if the purchasing activities had been performed by an independent enterprise, the purchaser would have been remunerated on an arm's length basis for its services.

25.5. Further, such an exemption restricted to purchasing activities undertaken for the enterprise required that expenses incurred for the purposes of performing these activities be excluded in determining the profits of the PE. Such an exemption could raise administrative problems.

25.6. It was therefore considered that a provision according to which no profits should be attributed to a PE by reason of the mere purchase of goods or merchandise for the enterprise was not consistent with the arm's length principle and should not be included in the Article.[16]

Proposed Amendment(s)

25.7. Paragraph 5 of the Article should be deleted in its entirety as it is subject to abuse and is not in line with the arm's length principle applied in Kenya.

26.0 Article 8: Shipping and Air Transport

26.1. Paragraph 1 and 2 provides for the taxation of enterprises carrying out international transport using aircrafts and through the operation of ships shall

> *A provision according to which no profits should be attributed to a PE by reason of the mere purchase of goods or merchandise for the enterprise was not consistent with the arm's length principle and should not be included in the Article.*

16. See paragraph 43 of the Commentary to Article OECD Model Commentary

primarily be in the place where the effective management of the enterprise is situated.

26.2. As noted in section 22.1 to 22.4 discussing the general definitions under Article 3, the use of 'place of effective management' as a criterion for the Agreement benefit is likely to be subject to abuse.

26.3. Accordingly, paragraph 3 guiding on the position where the place of effective management is on board a ship should not apply and may, therefore, be deleted.

26.4. Further, paragraph 2 provides that the profits shall be deemed to be an amount not exceeding of 2.5% of the amount received by the enterprise on account of carriage of passengers or freight embarked in that other state. In addition, the tax chargeable shall be reduced by an amount equal to 75%.

26.5. This provision limits the application of the amount of income that may be subject to tax. It should be noted that Kenya's ports connect the landlocked East African countries to the rest of the world. A provision that limits taxation to only the state of residence will likely deny Kenya income from shipping lines resident in Turkey.

26.6. Further, both the amount of income subject to tax and the percentage by which the tax should be reduced that have been proposed are much lower than in any other DTA that Kenya has entered. Other than the effect of reduced revenue to Kenya, a lower rate may also be applied by other States that have double tax treaties with Kenya where these treaties provide for a most favoured nation provision. (See Kenya-France DTA)

Proposed Amendment(s)

26.7. In line with the UN Model 2017 as well as earlier the proposal to delete reference to place of effective management in the definition of international traffic, we propose that paragraphs 1 and 2 be amended as below, and that paragraph 3 be deleted in its entirety:

1. ***Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.***
2. ***Profits of an enterprise of a Contracting State from the operation of ships in international traffic shall be taxable only in that State unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by 50 per cent.***

27.0 Article 10: Dividend

27.1. Paragraph 2 provides for reduced tax rate of 7.5% for dividends paid to residents of Turkey where the beneficial owner of the dividend holds at least 25% of the company paying the dividend.

27.2. The paragraph, however, does not provide a time threshold within which such

It may easily be argued that one would obtain the benefit of the reduced rate even when they have held the 25% shareholding for any period during that financial year.

shares must be held. Where this is not provided, it may easily be argued that one would obtain the benefit of the reduced rate even when they have held the 25% shareholding for any period during that financial year. Without giving a minimum timeframe in which, the 25% shareholding is to be held, this provision is likely to be abused by non-residents shareholders who may increase their shareholdings just before dividends are paid in order to obtain the concessional tax rate.

27.3. We would, therefore, propose an amendment in line with the UN Model Convention requiring that the shares be held for at least a year. This will limit opportunistic access to reduced source country taxation and help foster genuine longer-term direct investment.

Proposed Amendment(s)

27.4. In line with the provisions of the UN Model, we propose that paragraph 2(a) be amended as follows:

2. …

(a) 7.5% per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend); or

(b) ….

Exemption from tax is provided on interest where the interest is paid to the Government of the other Contracting State, where the term Government has been defined.

28.0 Article 11: Interest

28.1. The agreement provides for a rate of 10%. Although States are at liberty to determine the appropriate rate of tax, 10% is significantly low as compared to the rates applied in other double taxation agreements. For example, the rates applicable for Canada – 15%, Norway – 20% and U.K – 15%.

28.2. We also note that paragraph 4 provides for exemption from tax on interest where the interest is paid to the Government of the other Contracting State, where the term Government has been defined to include *'any institution wholly or substantially owned by the Government of the Republic of Turkey [Kenya] as may be agreed from time to time...'* It is important that what would be considered as substantially owned is defined. This may be included in the Protocol to the Agreement. See proposal in section 33.

28.3. In line with the proposal made in Article 7 paragraph 1 relating to the limited force of attraction rule, we would propose a corresponding amendment in paragraph 6 of this Article requiring that interest that is attributable to the PE through the limited force of attraction rule, where the debt claim is of the same or similar kind as those effected through the PE, then Article 7 would apply in taxing this income.

Proposed Amendment(s)

28.4. We propose the rate stated in paragraph 2 be amended from 10% to 12.5%.

28.5. We further propose an amendment in line with the UN Model 2017 to reflect

the effect of inclusion of the limited force of attraction rule in Article 7 as follows:

- ***The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.***

29.0 Article 12: Royalties and Fees For Technical Services

29.1. The Agreement provides for a rate of 10%. Although States are at liberty to determine the appropriate rate of tax, 10% is significantly low as compared to the rates applied in other double taxation agreements.

29.2. The definition of royalties in paragraph 3 is limited and excludes some of the elements that are proposed in the UN Model definition. This limits the payments and transactions that would be subject to tax in the source state, and we would, therefore, propose that the same be amended to include all the aspects as recommended in the UN Model.

29.3. In line with the proposal made in Article 7 paragraph 1 relating to the limited force of attraction rule we would propose a corresponding amendment in paragraph 5 of this Article requiring that royalties or technical fees that are attributable to the PE through the limited force of attraction rule, where the royalties or fees are effectively connected with the PE, then Article 7 would apply in taxing this income.

Proposed Amendment(s)

29.4. We propose the rate stated in paragraph 2 be amended from 10% to 12.5%.

29.5. Paragraph 3 should be amended in line with the UN Model to read as follows:

> ***3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific ~~experiment~~ experience.***

29.6. Paragraph 5 should be amended in line with the UN Model 2017 to reflect the effect of inclusion of the limited force of attraction rule in Article 7 as follows:

> ***5. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties or fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the royalties or fees for technical services are effectively connected with: (a) such permanent establishment or fixed base, or (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.***

30.0 Article 13: Taxation of Capital Gains

30.1. Paragraph 3 provides that gains from the alienation of ships or aircraft operated in international traffic and moveable property pertaining to the operation of such ships or aircraft shall be taxable in the contracting state where the place of effective management is situated.

30.2. In line with the proposals and discussions in section 22 regarding the risk of abuse in having the place of effective management as a basis of determining place of taxation, we would propose that the reference to the place of effective management be removed and taxation benefit be in the Contracting State where the enterprise is resident, as will have been determined under Article 4.

30.3. It should also be noted that paragraph 3 seeks to exclude *'boats engaged in inland waterways transport'* from taxation in the state where the boat operates or owns income. There is no basis of including these boats within this exception which only seeks to cater for vessels operated in international traffic, which should be the only subject to this exception. There may be an imbalance occasioned where a boat located in Kenya which is in the business of inland shipping in Kenya, is disposed, whether within or outside Kenya, with no commensurate tax being paid for that boat in Kenya. This is because the capital gains tax and other expenses incurred in operating this boat will very likely have been expensed in Kenya and as such the gain from their disposal should be taxed in Kenya.

30.4. Paragraph 4 which provides for indirect disposal of immovable property through the sale of shares follows a different structure from that of the UN Model. The change in structure and wording has eliminated the requirement that taxation will fall due if the value of the shares derived more than 50% of their value

"Gains from the alienation of ships or aircraft operated in international traffic and moveable property pertaining to the operation of such ships or aircraft shall be taxable in the contracting state where the place of effective management is situated."

directly or indirectly from immovable property at any time during that last year.

30.5. We also note that paragraph 5 of the Article excludes gains from the alienation of comparable interests, such as interests in a partnership or a trust.

Proposals for Amendment

30.6. Paragraph 3 should be amended to remove reference to place of effective management as well as reference to disposal of vessels engaged in inland waterways transport as follows:

- ***Gains derived by a resident of a Contracting State from the alienation of ships or aircraft operated in international traffic, ~~boats engaged in inland waterways transport,~~ or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in ~~the Contracting State in which the place of effective management of the enterprise is situated~~ that State.***

30.7. Paragraph 5 should be deleted in its entirety and replaced with the following paragraph in line with the UN model:

- ***Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.***

30.8. Paragraph 5 should be amended to cover gains on transfer of comparable interests such as partnerships and trusts as follows:

- ***Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least 50 per cent of the capital of that company or entity.***

31.0 Article 15: Income from Employment

31.1. In order to align with amendments as discussed in section 22.1 to 22.4, we would propose the removal of reference to the place of effective management as the place of taxation of persons who exercise employment aboard a ship or aircraft operated in international traffic in paragraph 3 of this Article.

31.2. The paragraph also includes taxation of employment income aboard vessels engaged in inland waterways transport. This in our view should be taxable in the State in which the employment is exercised and should not be excluded in this paragraph.

Proposed Amendment(s)

31.3. We would propose the following amendments to this paragraph:

- ***Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment, exercised aboard a ship or aircraft operated in international traffic, ~~or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated~~ shall be taxable only in the first-mentioned State.***

> *This Article provides for application of the 'principal purpose test' and the 'beneficial owner' requirement to be met in order for a person or enterprise to enjoy the benefits under the treaty.*

32.0 Article 28: Limitation of Benefits

32.1. This Article provides for application of the 'principal purpose test' and the 'beneficial owner' requirement to be met in order for a person or enterprise to enjoy the benefits under the treaty. However, the Article limits these tests only to the benefits under Articles 10, 11, 12, 13 and 21. While these Articles are the main ones providing for lower tax rates on specific incomes, the limitation of benefits clauses should apply to the entire Agreement to forestall any risk of abuse in any way.

Proposed Amendment(s)

32.2. Paragraph 1 of the Article should be deleted in its entirety and replaced with the following 2 paragraphs:

1. ***The benefits of this Agreement shall not be granted to a resident of a contracting state who is not the beneficial owner of the income derived from the other Contracting State.***
2. ***Notwithstanding the other 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 a 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 this Agreement.***

Paragraph 2 in the Agreement should subsequently be numbered paragraph 3.

33.0 Protocol to the Agreement

33.1. We would propose an additional paragraph in the Protocol to define 'substantially owned' by the Government of a Contracting State for purposes of enjoying exemption from taxes on interest under Article 11 paragraph 4 (Section 28.4).

33.2. Article 11 paragraph 4 provides for exemption from tax on interest where the interest is paid to the Government of the other Contracting State, where the term Government has been defined to include *'any institution wholly or substantially owned by the Government of the Republic of Turkey [Kenya] as may be agreed from time to time...'* It is important that Contracting States are clear on what would be considered as substantially owned is defined. This may be included in the Protocol to the Agreement. We propose that the exemption in this case only apply where the Government owns at least 85% of the institution.

Proposed Amendment(s)

33.3. An additional paragraph should be included in the Protocol as follows:

4. With Reference to Article 11 Paragraph 4 (Interest)

The term 'substantially owned' as applied in this paragraph means that the government must hold at least 85% ownership in the institution.

Paragraph 4 should subsequently be renumbered paragraph 5.

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NOTES

Jaflo Limited | Block 3 | 106 Brookside Drive | Westlands
P. O. Box 25112 - 00100 Nairobi - Kenya

Contacts
Email: info@taxjusticeafrica.net
Tel: +254 728 279 368

Jaflo Limited | Block 3 | 106 Brookside Drive | Westlands

Contacts
Email: info@eataxgovernance.net / coordinator@eataxgovernance.net
Tel: (254) 20 24 73373, (254) 728 279 368
Website: www.eataxgovernance.net
www.taxjusticeafrica.net

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