A CRITIQUE OF INTERNATIONAL TAX MEASURES AND THE OECD BEPS PROJECT IN ADDRESSING FAIR TREATY ALLOCATION OF TAXING RIGHTS BETWEEN RESIDENCE AND SOURCE COUNTRIES: THE CASE OF TAX BASE ERODING INTEREST, ROYALTIES AND SERVICE FEES FROM AN AFRICAN PERSPECTIVE

Annet Wanyana Oguttu
NDip (Legal Practice) HDip (UJ) LLB (Makerere University) LLM (UNISA) LLD (UNISA)
Professor, Department of Taxation, Faculty of Economic and Management Sciences, University of Pretoria

1 Introduction

To encourage international trade and investment, countries often sign double taxation agreements ("DTAs"), one of the main purposes of which is to prevent double taxation which can impede trade and investment. Double taxation can for instance arise if an investor's country or state of residence (residence country/state) applies the residence basis of taxation to tax on the income of the investor's foreign investments and the country or state of investment (source country/state) applies the source basis of taxation to tax the foreign investor's income that is derived from that country. DTAs contain allocation rules that limit the taxing rights of either of the contracting countries depending on the type of income in these circumstances.

When the flows of income from trade and investment are balanced between the two contracting countries (which is generally the case for DTAs between two capital exporting – usually developed – countries), it often does not materially differ if each state agrees to significantly curtail its source jurisdiction to tax, as its residence taxation of income sourced in the other country is correspondingly increased. If, however, the flows of income from trade and investment are unbalanced (which is generally the case in DTAs between capital exporting and capital importing – usually developing – countries), the conclusion of a DTA under which each country gives up some of its source jurisdiction to tax, often has the effect of shifting revenue from the capital importing country to the capital exporting country. Since developing countries are normally the net capital importers, they often struggle to preserve their source country right to tax.[1]

[1] V Thuronyi *Tax Law Design and Drafting* (1998) ch 18 s III B.

From the early twentieth century when the then industrialised countries started developing international tax principles to prevent double taxation due to growing international trade, there has been a struggle between developed (largely capital exporters) and developing (largely capital importers) countries to ensure favourable DTA taxing rights. This is due to the differing interests of these countries to protect their tax bases. On the one hand, as producers of capital, capital-exporting countries derive revenue from taxing value added at the production stage, so they generally feel entitled to the tax revenue derived by their residents in producing such capital. On the other hand, capital-importing countries derive revenue from taxing the income generated by sales activities, derived from the exploitation of the foreign invested capital within their borders.[2] Thus, in any DTA negotiations, the main interest of capital-exporting countries is to negotiate a competitive edge for their residents that invest in foreign countries by ensuring that they are taxed at the lowest possible rates and that they tax the lion's share of income derived from such foreign investments. Conversely, capital-importing countries have an interest to ensure that they get their fair share of tax derived from foreign investors since they provide the infrastructure that supports these investments.

History seems to indicate that international tax development and the allocation of taxing rights, initially by the League of Nations (post-World War I) and then by the Organisation for Economic Cooperation and Development ("OECD"), favoured developed countries. The efforts of the United Nations ("UN") to champion the case of developing countries have over the years been hampered by under-funding and lack of strong support from developed countries. Even the OECD's 2013-2015 Base Erosion and Profit Shifting ("BEPS") Project that purported to reform the international tax arena, neglected to deal effectively with matters relating to the allocation of taxing rights between residence and source countries. This being so, even though it is common cause that these issues divide capital-exporting and capital-importing countries and underpin base erosion in developing countries.

Following from this background, this article endeavours to shed some light on how certain treaty allocation rules favour developed (residence-based) countries, as opposed to developing (source-based) countries. This article explains how the treaty allocation rules that apply to the three types of income pertinent to developing countries (interest, royalties, and service fees) are skewed in favour of residence countries and how this affects the tax bases of these countries. In response, source countries have devised measures to preserve their tax bases, which, in certain respects, diverge from current DTA principles. This development may not be conducive to international trade. Flowing from the above, this article further highlights the dangers of an international tax system that promotes the interests of developed countries and argues for the reform of DTA principles, especially the allocation of taxing rights, to ensure a more equitable and effective international tax system.

[2] AA Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* (*Series of International Taxation*) (1991) 88-95.

2 Background to tax treaties and allocation rules

To subject a person's income to tax, a connection or nexus must exist between the tax jurisdiction and the income. The main bases of taxation used in the world are the "source" and "residence" bases of taxation.[3] In terms of the source basis of taxation, persons are taxed on income that originates within the jurisdiction or geographical confines of a country, irrespective of the taxpayer's country of residence.[4] In terms of the residence basis of taxation, residents are taxed on their worldwide income, regardless of the source.[5] Since countries use different bases of taxation, double taxation may occur. This could take the form of "economic" or "juridical" double taxation. Economic double taxation occurs when two countries tax the same income but different persons.[6] Juridical double taxation occurs when two countries impose the same or comparable taxes on the same taxpayer, in respect of the same subject matter, for identical periods.[7] An example of juridical double taxation is if one country (residence-based country) taxes its residents on their foreign source income and the country in which the investment is made (source-based country) taxes the same income as it is derived in that country.[8] The focus of this article is on juridical double taxation.

Since double taxation can impede international trade and investment, countries often implement prevention measures. Some countries apply unilateral measures contained in domestic laws that exempt foreign source income from taxation, or they grant credits for foreign taxes paid. Where countries have signed a double tax treaty; the treaties contain provisions to prevent double taxation.[9] If the double taxation arises as a result of the coincidence of residence and source taxation by the two contracting states (note that double taxation can also arise where there is coincidence of residence/residence and also source/source coincidence but these are not the focus of this work);[10] DTAs employ the notion of "allocating taxing rights" between the residence and source states; sometimes referred to as treaty distributive rules.

---

3 D Meyerowitz *Meyerowitz on Income Tax* (2008) para 7.1.

4 L Edwards & C Waelde *Law and the Internet: Regulating Cyberspace* (1997) 171; H Suddards *E-commerce: A Guide to the Law of Electronic Business* (1999) 259.

5 L Olivier "Residence-based Taxation" (2000) 20 *SALJ* 20.

6 For example, a company taxed on its income; and yet the same income is also taxed when distributed to shareholders as dividends. See BJ Arnold & MJ McIntyre *International Tax Primer* (2002) 29.

7 R Rohatgi *Basic International Taxation* (2002) 12; M Hampton *The Offshore Interface: Tax Havens in the Global Economy* (1996) 12.

8 Arnold & McIntyre *International Tax Primer* 315.

9 Article 23A and B of treaties based on the OECD MTC.

10 Double taxation as a result of a coincidence of residence bases of taxation arises when a person is dual resident. For example, a natural person that is "ordinarily resident" in one country and also physically present in another country for the required number of days in that country. Another example is where a company is incorporated in one country and yet effectively managed in another. Article 4 of the OECD sets out the tie-breaker rules to prevent such double taxation. See AW Oguttu "Resolving Double Taxation: The Concept 'Place of Effective Management' Analysed from a South African Perspective" (2008) 41 *CILSA* 81. Double taxation as a result of a coincidence of source bases of taxation arises when more than one country assets that the same income is sourced in each country. Tax treaties usually specify explicitly (using the word "shall") or implicitly (using the word "may") a single-source rule for particular categories of income. See Thuronyi *Tax Law Design* ch 18 s V B.

The rules for allocating taxing rights depend on the nature of the income.[11] In some instances, exclusive rights to tax are allocated to one country by the use of the words "shall be taxed only in". In other instances, exclusive rights to tax are not allocated to either of the contracting countries, but the primary right to tax is allocated to one country and the secondary (residual) right to another. DTAs generally award the primary taxing rights to the source country and the secondary right to the residence country. Secondary rights are awarded using the words "may be taxed in". If the residence country exercises its secondary right to tax, it is obliged to provide double taxation relief to its residents for foreign taxes paid to the source country, by using either a credit method (credit for foreign taxes paid) or exemption method (exempting foreign taxes paid).[12]

Treaty allocation rules are not designed to impose tax, but to limit taxes that can be imposed by the contracting countries.[13] DTAs primarily relieve double taxation,[14] by establishing boundaries or limitations within which domestic tax provisions can be enforced. This is done by restricting contracting countries' tax claims in cases of overlap.[15] This is created by one of the contracting countries undertaking not to levy tax or to levy tax only to a limited extent, or by undertaking to provide credit or exemption for foreign taxes paid.

The treaty allocation rules for different types of income and the limitations to tax imposed by the contracting countries depend on the Treaty Model used. There are mainly two Treaty Models employed internationally for drafting DTAs, namely, the OECD Model Tax Convention ("OECD MTC")[16] and the UN Model Tax Convention ("UN MTC").[17] The OECD MTC embodies rules and proposals by developed capital-exporting countries. Thus, the allocation rules in treaties based on this model favour the resident's country (capital-exporting country's) revenue position over capital-importing countries (as discussed further on in the article). Treaties based on the OECD MTC tend to reduce source countries' taxes; requiring them to give up some or all of its tax on certain categories of income earned by residents of the other treaty country.[18] The UN MTC, however, favours capital-importing countries as opposed to capital-exporting countries. It generally imposes fewer restrictions on the taxing rights of source countries. For instance, it does not contain specific limitations on withholding tax rates on dividends, interest, and royalties imposed by the source country.[19]

---

11 L Olivier & M Honiball *International tax: A South African perspective* (2011) 279.

12 280-281.

13 273-274.

14 Arnold & Mclyntre *International Tax Primer* 105.

15 Oliver & Honiball *International Tax* 273.

16 OECD *Model Tax Convention on Income and on Capital* (2014: Condensed Version).

17 United Nations *Model Tax Convention between Developed and Developing Countries* (2011).

18 Arnold & McIntyre *International Tax Primer* 109.

19 29.

3 Historical perspective of allocation of taxing rights between source and residence countries

The onset of the industrial revolution in the nineteenth century saw an increase in foreign investments by European residents. The demand for raw materials and the search for guaranteed markets and profitable investment outlets spurred European countries such as Britain, France, Germany, Belgium, Spain, Portugal and Italy to scramble for, partition and eventually colonise other territories around the world such as in Africa, Asia and Latin America from the 1870s to the 1900s.[20] Colonial power struggles, acquisition of territories around the world and European nationalism sparked World War 1 (1914-1918).[21] The allied victors of World War I formed the "League of Nations" at the Paris Peace Conference held on 10 January 1920.[22] Industrialised countries introduced income and corporate taxes to finance rebuilding after the War.[23] In response, companies involved in significant international trade started crafting schemes to reduce their taxes. The ensuing capital flight hindered countries' efforts to finance rebuilding.[24] However, countries realised that international trade could be impacted if cross-border income was subject to tax in the country of residence and the country of source.[25] The increase in international trade and the free movement of capital necessitated a need to develop domestic tax rules and rules to prevent double taxation.[26]

Industrialised nations appealed to the Financial Committee of the League of Nations at the 1920 Brussels International Financial Conference to take action to eliminate double taxation.[27] Resolution 12 of the Brussels Conference referred to "ensuring the due payment by everyone of his fair share of taxes" and Resolution 13 called for action to "prevent the flight of capital in order to avoid taxation".[28] Consequently, in 1921 the League of Nations appointed a team of four economists[29] known as the "Committee of Technical Experts on Double Taxation and Evasion" to report on the economic aspects of

20 EG Iweriebor "The Colonisation of Africa" (2011) *Exhibitions* <http://exhibitions.nypl.org/africanaage/essay-colonization-of-africa.html> (accessed 23-06-2015); O Adebayo "Colonial Political Systems" in T Falola (ed) *Colonial Africa, 1885–1939 III* (2002).

21 M Kelly "5 Top Causes of World war 1" (undated) *American History* <http://americanhistory.about.com/od/worldwari/tp/causes-of-world-war-1.htm> (accessed 22-06-2015).

22 Wikipedia "League of Nations" (undated) *Wikipedia* <https://en.wikipedia.org/wiki/League_of_Nations> (accessed 22-06-2015).

23 RS Avi-Yohan *Advanced Introduction to International Tax Law* (2015) 3.

24 MJ McIntyre *Developing Countries and International Cooperation on Income Tax Matters: A Historical View* (2015) 1.

25 Avi-Yohan *Advanced Introduction to International Tax Law* 3.

26 JA Becerra *Interpretation and Application of Tax Treaties in North America* 2 ed (2013) ch 2 para 2.1.

27 Ch 2 para 2.1; Avi-Yohan *Advanced Introduction to International Tax Law* 3.

28 League of Nations Economic and Financial Committee "Report on Double Taxation" (5 April 1923, Geneva, League of Nations) EFS 73 F 19 <http://adc.library.usyd.edu.au/view?docId=law/xml-main-texts/brulegi.xml&chunk.id=d640e396&toc.id=d640e396&database=&collection=&brand=ozfed> (accessed 25-05-2015).

29 Consisting of Prof Einaudi from Italy, Prof. Bruins from the Netherlands, Sir J Stamp from the UK and Prof Seligman from the USA. See Avi-Yohan *Advanced Introduction to International Tax Law* 3.

international double taxation. Their "Report on Double Taxation", issued in 1923,[30] referred to:

> "… the necessity of dealing with the questions of tax evasion and double taxation in co-ordination with each other. It is highly desirable that countries should come to an agreement with a view to ensuring that a taxpayer shall not be taxed twice on the same income by a number of different countries, and it seems equally desirable that such international cooperation should prevent certain income from escaping taxation altogether …"[31]

The report made recommendations on the prevention of tax evasion and avoidance and the prevention of double taxation. With regard to double taxation, the League of Nations published its first international Model Tax Convention (MTC) in 1928. The MTC recognised that the prevention of double taxation could only happen through the appropriate sharing of taxing rights between source and residence countries. It acknowledged that appropriate sharing of taxing rights would provide an incentive for residence and source countries to cooperate to reduce international double taxation. This would increase international tax equity through a reasonable compromise between the interests of capital-exporting and capital-importing countries.[32] Under the 1928 MTC, the competent authorities of the two contracting states accomplished the allocation of taxing rights by using some form of formulary apportionment.[33] The primary jurisdiction to tax residents was given to residence countries. If double taxation arose, the taxing rights were given to the source country since the income arose in the source country.[34] To allocate taxing rights in respect of business income, the 1928 MTC adopted the "permanent establishment" ("PE") concept.[35] The PE concept determined that business activities of a foreign enterprise should not be taxed by a source country unless that enterprise has a significant and substantial economic presence in that country.[36]

In 1929, the Fiscal Committee of the League of Nations was formed to carry out further work on the MTC. In 1940 and 1943, this Fiscal Committee met in Mexico City. The committee comprised two representatives from developed countries (Canada and the United States of America ("USA")) and nine representatives from developing countries (Argentina, Bolivia, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela).[37] The 1928 MTC was revised and a new draft convention (popularly known as the Mexico Draft) was issued.[38] Unlike the 1928 MTC, the Mexico Draft assigned the primary taxing rights to the source country, which favoured developing countries. It also asserted that all business profits derived in a source country should be taxable in that country unless the activities were "isolated and occasional" and

30 League of Nations Economic and Financial Committee 28.

31 28 (emphasis added).

32 Skaar *Permanent Establishment* 88-95.

33 McIntyre *Developing Countries and International Cooperation* 3.

34 Avi-Yohan *Advanced Introduction to International Tax Law* 3.

35 This concept was applied in the 1899 first international tax treaty entered into between Austria-Hungary and Prussia based on judicial practice in Prussia. See Skaar *Permanent Establishment* 75-77.

36 K Vogel *Double Tax Conventions* (1997) 280.

37 United Nations *Manual for the Negotiation of Double Tax Treaties between Developed and Developing Countries* (2003) para 57.

38 Becerra *Interpretation and Application of Tax Treaties* ch 2 para 2.3.

if the enterprise did not have a PE in that country.[39] The Mexico Draft also allowed source countries to tax investment income.[40] It, for example, provided that royalties derived from the right to use a patent or secret process would be taxable where the right is exploited.[41]

Thereafter, the Fiscal Committee of the League of Nations met in London in 1945 and promulgated the London Draft,[42] which effectively overturned the Mexico Draft. The London Draft required an enterprise, resident in one country, to have a PE in another country (source country) for that other country to tax any of its business profits. The London Draft also imposed limitations on the taxation of investment income by source countries, and reserved taxing rights in respect of royalties for residence countries, thus not favouring developing countries.[43]

In 1945, at the end of World War II, the League of Nations was dissolved[44] and was superseded by the UN to promote international cooperation. However, the further development of the MTC was passed on to the Organisation for European Economic Cooperation ("OEEC") (which represented all European countries) in 1948.[45] In 1961, the OEEC became the OECD.[46] The OECD's main purpose was to build strong economies in its member countries.[47] In 1963, the OECD published its first draft MTC.[48] The Commentary on Article 1 of the draft MTC referred to the fact that the "Commentary is intended to be applied between member countries of the OECD".[49] The final draft MTC was published in 1977 (which was followed by revisions in 1992, 1994, 1995, 1997, 2000, 2003, 2005, 2008, 2010, 2014 and 2017).[50] Although the current MTC recognises the importance of revenue sharing between source and residence countries, it is biased in favour of capital-exporting countries. For example,

[39] McIntyre *Developing Countries and International Cooperation* 4.

[40] Becerra *Interpretation and Application of Tax Treaties* ch 2 para 2.3.

[41] McIntyre *Developing Countries and International Cooperation* 4.

[42] League of Nations *Fiscal Committee: Report on the Work of the Tenth Session of the Committee, held in London from March 20th to 26th, 1946* (C 37 M37 1946.II.A) 8.

[43] McIntyre *Developing Countries and International Cooperation* 4.

[44] G George *The League of Nations: From 1929 to 1946* (1996) 25.

[45] The OEEC was formed in 1948 to administer American and Canadian aid under the Marshall Plan for the reconstruction of Europe after World War II. See Becerra *Interpretation and Application of Tax Treaties* ch 2 para 2.4.

[46] The OECD is an international organisation that was established in 1961 to contribute to economic development and growth in its member countries. The organisation seeks to promote economic development by issuing publications and statistics on various topics, such as competition, corporate governance, electronic commerce, trade and taxation. Through its publications, the OECD chooses the tools of dialogue, consensus, peer review and pressure in order to encourage economic development and change in the market economy. Though the primary focus of the OECD is on member countries, its additional goals of contributing to the expansion of world trade and the development of the world economy affect non-members as well. See OECD "History of the OECD" (undated) *OECD* <http://www.oecd.org/document/63/0,2340,and_2649_201185_1876671_1_1_1_1,00.html> (accessed 25-05-2016).

[47] Becerra *Interpretation and Application of Tax Treaties* ch 2 para 2.4.

[48] See generally OECD *Draft Double Taxation Convention on Income and on Capital: Report of the OECD Fiscal committee* (1963).

[49] Becerra Becerra *Interpretation and Application of Tax Treaties* ch 2 para 2.4; MB Carroll *Global Perspectives of an International Tax Lawyer* (1978) 5.

[50] J Owens & M Bennette "OECD Model Tax Convention" (2018) *OECD*<http://www.oecdobserver.org/news/archivestory.php/aid/2756/OECD_Model_Tax_Convention.html> (accessed 31-08- 2016). The BEPS Project will result into further revisions to the Model.

Article 10 (which deals with dividends) and Article 11 (which deals with interest) limit source countries' taxing rights. Article 12 gives taxing rights of royalties to residence countries and Article 21 gives taxing rights for any other income, not specified in the MTC, to residence countries. The MTC, in practice, created limitations in respect of source taxation which, in turn, created tax minimising opportunities.[51]

As demonstrated above, the allocation of taxing rights has for years favoured developed countries. It was only in the Mexico Draft that developing country interests received favourable attention, but the London Draft reversed this to some extent. When the OECD assumed responsibility for the development of the MTC, participation by developing countries stopped.[52] As an alternative, developing countries started advocating their own MTC under the umbrella of the UN. On 4 August 1967, the UN Economic and Social Council passed a resolution, requesting the Secretary General to create an *ad hoc* working group of tax experts and tax administrators to formulate guidelines for tax treaties between developed and developing countries.[53] In 1968 a UN Ad Hoc Group of Experts on Tax Treaties ("UN Ad Hoc Group of Experts") was set up, comprising of tax experts from 20 developed and developing countries, all acting in their private capacities.[54] In 1979, the UN Ad Hoc Group of Experts published a Manual for Negotiating Bilateral Tax Treaties between Developing and Developed countries. In 1980, this culminated in the UN Model Double Taxation Convention between Developed and Developing Countries[55] (which was revised in 2001 and 2014). The core of the UN MTC was however derived from the OECD MTC. This resulted in the UN MTC having some shortcomings as it allowed foreign investors to limit their tax exposures in source countries.[56] However, the UN MTC differs from the OECD MTC in some respects. For example, with respect to the PE concept, it grants additional taxation of business profits to source countries. Article 12 allows source countries to tax royalties with taxing limits to be determined through bilateral negotiations. Articles 10 and 11 leave the taxing limits on interest and dividends income that the source country may levy open to treaty negotiation. Article 21 gives taxing rights over any other income, not specified in the MTC, to the source country.[57] In 1980, the membership of the UN Ad Hoc Group of Experts was increased to 25 members: 10 from developed countries (Finland, France, Germany, Spain, Switzerland, United Kingdom ("UK"), USA, Japan, Israel and The Netherlands) and 15 from developing countries (Argentina, Brazil, China, India, Indonesia, Jamaica, Mexico, Pakistan, Russian Federation, Burkina Faso, Ghana, Egypt, Morocco,

[51] McIntyre *Developing Countries and International Cooperation* 5.

[52] 6.

[53] 6.

[54] 6.

[55] UN *Model Double Taxation Convention* para18 of the Introduction. Further revisions to the Model are anticipated in light of the BEPS Project.

[56] McIntyre *Developing Countries and International Cooperation* 6.

[57] 6.

Nigeria, Cote d'Ivoire and a representative from the Palestinian Authority).[58] However, due to funding limitations the UN Ad Hoc Group of Experts only held one week-long formal meeting annually, in addition to informal subcommittee meetings.

Despite the UN's measures to promote the interests of developing countries over the years, the OECD MTC remained the dominant model for bilateral tax treaties negotiated around the world. Since the OECD MTC favours developed countries, they are generally not keen on signing treaties with developing countries that are based on the UN MTC. This, coupled with developing countries' general lack of experience and capacity in negotiating DTAs, their general lack of a clear understanding of tax treaty principles, and the fact that they are usually price takers, often lead to developing countries signing treaties based on the OECD MTC, which shows the strong position of the other developed contracting state; even though the UN Model is more protective of their interests. This partly explains why many developing countries, especially those in Africa, have entered into few DTAs, as they presume that would result in them giving up more of the revenue from source taxation.

With administrative challenges and the lack of funding of the UN Committee, developing countries appeared to have given up on the fight for fair allocation of taxing rights. Therefore, over the years developed countries (under the umbrella of the OECD) took the upper hand in the discourse on international tax reform issues. For example, in 1998 the OECD issued a report, *Harmful Tax Competition*, which sought to address the harmful tax practices of both tax-haven jurisdictions and harmful preferential tax regimes, which distort financial and investment flows among countries.[59] The report confirms that rich countries find it easier to pressure smaller tax haven jurisdictions to close their harmful tax practices but do not easily accept limits placed on them to prevent harmful tax practices that attract investments in their jurisdictions.[60] Successive efforts by the OECD Global Forum to prevent harmful tax practices show that the OECD focussed on improving transparency and the exchange of information by tax-haven jurisdictions. This resulted in changes to Article 26 of the OECD MTC, (adopted in the UN MTC)[61] and the development of the 2002 Model Agreement on Exchange of Information on Tax Matters which can be used to exchange information with countries that do have DTAs. However, the OECD failed to address harmful preferential tax regimes among its member countries, which resulted in many OECD member countries enacting these regimes, which the OECD is now attempting to address through the BEPS Project.[62] This skewed approach of pushing international tax reforms that protect

[58] Other members are Argentina, Brazil, China, Finland, France, Germany, India, Indonesia, Israel, Jamaica, Japan, Mexico, The Netherlands, Pakistan, Russian Federation, Spain, Switzerland, UK, USA and a representative from the Palestinian Authority.

[59] OECD *Harmful Tax Practices* (1998) para 75.

[60] AW Oguttu *International Tax Law: Offshore Tax Avoidance in South Africa* (2015) 27.

[61] AW Oguttu "A Critique on the Effectiveness of 'Exchange of Information on Tax Matters' in Preventing Tax Avoidance and Evasion: A South African Perspective" (2014) 68 *Bulletin for International Taxation*; Arnold & McIntyre *International Tax Primer* 122-123.

[62] OECD/G20 BEPS Project *Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance: Action 5* (2015) 20.

the interests of developed countries causes one to have tempered expectations about the OECD's initiatives.[63] The fact that the UN Committee has a number of representatives from developed countries (10 of 25) further entrenches this perception. Although these members may be sympathetic to developing countries, the fact that a good number of decision makers in the UN Committee also belong to OECD member countries, meant that the UN Committee became less influential in developing international tax reforms. OECD countries also decreased their funding of the UN Committee; on arguments of the relevance of its work since it largely approved the measures recommended by the OECD.

As a gesture of good will, the OECD has over the years endeavoured to involve developing countries in its deliberations on DTAs and international tax principles through, for example, inviting observers to some meetings, and through inviting a select group of developing countries to comment on positions taken by the OECD in the Commentary to its MTC. However, these measures have not effectively enabled developing countries to influence the core decisions of the OECD on international tax matters.[64] A primary inhibitor is the fact that changes (to the OECD MTC) require consensus of OECD member countries. Certain member countries have been unwilling to change certain aspects of the OECD MTC as it could hamper their competitiveness, and reduce their ability to attract capital from other countries even if this meant their residents were avoiding taxes in other countries.[65] The OECD requires uniformity in the way international tax principles are applied and since many of its member countries have been reluctant to effect changes, it often takes decades for changes to be effected in the DTAs themselves. Relatively less controversial changes are often effected through its Commentary but more substantive issues such as the allocation of taxing rights between residence and source countries which require changes to the OECD MTC itself,[66] have largely been left unattended for decades.

Nevertheless, the last decade has seen a steady increase in the training of revenue officials in developing countries on DTAs and international tax principles and the improvement of treaty negotiating capacity. There has also been an increase in research and civil society outcry against the negative implications of the treaties signed by African countries.[67] For example, in October 2014, the Tax Justice Network instituted a case in the Kenya High Court (undecided and unreported at the time of writing this article) against the Kenyan government and Kenyan Revenue Authority[68] for signing a DTA with

[63] M Herzfeld "News Analysis: Political Reality Catches Up With BEPS" *Tax Analysts* 3 February 2014.

[64] McIntyre *Developing Countries and International Cooperation* 6.

[65] 6.

[66] 6.

[67] M Hearson "Tax treaties in Sub-Saharan Africa: A critical review" (23-11-2015) *Tax Justice Network* 1 <https://martinhearson.wordpress.com/2015/11/23/tax-treaties-in-sub-saharan-africa-a-critical-review/> (accessed 18-02-2016).

[68] J Martin "TJN Africa's challenge to "loophole-ridden: Kenya-Mauritius tax agreement to be heard in Kenya High Court MNE Tax" (12-11-2015) *Multinational Tax and Transfer Pricing News* <http://mnetax.com/tjn-africas-court-challenge-to-loophole-ridden-kenya-mauritius-tax-agreement-moves-forward-11832> (accessed 29-02-2016); E Odari "Tax Drainage: Kenya/Mauritius DTA and its potential impact on tax base erosion in Kenya" (2015) *Tax Justice Network-Africa* <www.taxjusticeafrica.net/?smd_process_download=1&download_id=2214> (accessed 28-11-2016).

Mauritius that limited taxing rights for Kenya, such as low withholding tax rates.[69] A number of countries have also taken measures to review their DTA policies and some of them have taken bold steps to terminate or renegotiate their tax treaties with unfavourable taxing rights. For example, in June 2013 Malawi terminated its 1969 colonial treaty with the UK, Northern Ireland, and the Netherlands,[70] and entered into a new treaty with the Netherlands in 2014 with more favourable terms.[71] In 2013, Rwanda re-negotiated its 2001 DTA with Mauritius, in terms of which all the withholding taxes were at a zero rate, giving taxing rights to Mauritius.[72] Zambia is currently re-negotiating several of its colonial era treaties that were negotiated on poor terms.[73] In 2015, South Africa renegotiated its 1997 DTA with Mauritius to address the various treaty abuse loopholes in the previous DTA.[74] In 2014, Uganda announced the suspension of all of its DTA negotiations pending a review into the treaty terms that it should seek in such negotiations.[75]

The last decade has also seen a revival of momentum in building up a united front to reinforce the UN Committee's role in championing the cause of developing countries. At the March 2002 Monterrey International Conference on Financing for Development,[76] developing countries called for the strengthening of international tax cooperation through enhanced dialogue among tax authorities, and special attention to be given to the needs of developing and transitional countries. Consequently, in November 2004, the Economic and Social Council of the UN elevated the UN Ad Hoc Group of Experts to the status of a permanent UN Committee. The hope was that this would increase the voice of developing countries in international forums dealing with tax issues.[77] In the Outcome Document of the UN's Third International Conference on Financing

[69] Note that the treaty sets the rate for interest at 10% (the domestic tax rate is between 15% and 25%) but Article 11 of treaties based on the OECD MTC also limit the interest rate to 10%; for royalties the treaty rate is 10% (the domestic rate is 20%) however Article 12 of treaties based on the OECD MTC does not permit source countries to tax royalties; for dividends the treaty rate is 5% or 10% depending on the shareholding (the domestic rate is 10%). Article 10 of treaties based on the OECD MTC limits the rate to 5% or 25 % depending on the shareholding. See A Abdullatiff "Kenya – Mauritius DTA ratified by the Republic of Kenya" (undated) *Axis* <http://www.axis.mu/uploads/DTA-%20Mauritius%20&%20Kenya.pdf> (accessed 04-03-2016).

[70] Multinational Tax and Transfer Pricing News "Netherlands renegotiates tax treaties with developing nations to add anti-abuse clause" (23-06-2015) *MNE Tax* <http://mnetax.com/netherlands-renegotiates-tax-treaties-ethiopia-ghana-kenya-zambia-to-add-antiabuse-clause-hopes-add-clause-23-treaties-9530> (accessed 18-02-2016).

[71] IMF "Spillovers in International Corporate Taxation" (2014) *IMF* 28 <www.imf.org/external/np/pp/eng/2014/050914.pdf> (accessed 15-06-2016).

[72] The East African "Rwanda-Mauritius tax treaty renegotiated" (undated) *Africa Money* <http://africamoney.info/rwanda-mauritius-tax-treaty-renegotiated-loopholes-closed/> (accessed 22-02-2016).

[73] Hearson "Tax treaties in Sub-Saharan Africa: A critical review" (23-11-2015) *Tax Justice Network* 1.

[74] *Media Release: New South African and Mauritius double taxation Treaty Enters in Force* GN471 in *GG* 38862 of 17-06-2015.

[75] Ladu "Govt suspends double taxation pacts" *Daily Monitor* (6 June 2014); Hearson "Tax treaties in Sub-Saharan Africa: A critical review" (23-11-2015) *Tax Justice Network* 1; Anonymous "Latest Treaty Updates: Uganda" (10-06-2014) *TreatyPro.com* <http://www.treatypro.com/treaties_by_country/uganda.asp> (accessed 18-02-2016).

[76] The International Conference on Financing for Development was held from 18-22 March 2002 in Monterrey, Mexico.

[77] McIntyre *Developing Countries and International Cooperation* 23.

for Development held in Addis Ababa in 2015,[78] world leaders welcomed the work of the UN Committee and decided to enhance its resources to strengthen its effectiveness and operational capacity. To that end, they increased the frequency of its meetings to two sessions per annum, with a duration of four working days each. UN member states were urged to support the Committee through a voluntary trust fund, to enable the Committee to fulfil its mandate and support the increased participation of developing country experts at subcommittee meetings.[79] However, developed countries vehemently rejected proposals by developing countries (led by South Africa) to upgrade the UN Committee to a global intergovernmental tax body.[80] Nevertheless, developing countries seem to not have given up on this drive, and it is expected that they will, at the opportune time, revive the call for a global inter-governmental tax body.

4 OECD BEPS's agenda: The failure to address the allocation of taxing rights between residence and source states

In the aftermath of the 2007/2008 global financial crisis, renewed concerns about multinational enterprises ("MNEs") not paying their fair share of taxes in the countries they transact in, arose.[81] As a result, at the 2012 G20 summit,[82] national leaders explicitly declared the need to prevent BEPS; which involves tax planning strategies (mainly by MNEs) to exploit gaps and mismatches in tax rules by artificially shifting profits to low or no-tax locations where there is little or no economic activity.[83] BEPS is encouraged by the fact that internationally tax rules are still grounded in an economic environment characterised by a lower degree of economic integration across borders and laws that have not kept pace with the activities of global taxpayers.[84]

Even though previous international tax reform measures that resulted in revisions to MTCs over the years have been effective in preventing double taxation, they have not been very effective in preventing international tax avoidance and tax evasion. Previous international tax reform measures also did not adequately deal with the fact that the interaction of domestic tax systems can result in double non-taxation altogether.[85] Many international tax concepts "were built on the assumption that one country would forgo taxation

[78] United Nations General Assembly "Outcome Document of the Third International Conference on Financing for Development: Addis Ababa Action Agenda" UN Doc A/RES/69/313 (17 August 2015) para 23.

[79] Para 23.

[80] Muchhala & Sengupa "Third Conference on Financing for Development: Outcomes document adopted without intergovernmental tax body or new financial commitments" (16-07-2015) <www.acdhrs.org/.../TWN-Addis-Article-15-july-15-AA-Inaction-Agenda-adopted-1.p> (accessed 04-08-2016).

[81] Christian Aid *Death and Taxes: The True Toll of Tax Dodging* (2008) 21-23; Tax Justice Network "Tax Havens and Financial Crisis" (undated) *Tax Justice Network* <http://www.taxjustice.net/topics/finance-sector/tax-havens-financial-crisis/> (accessed 31-08-2016).

[82] G20 Leaders' Declaration Los Cabos Mexico (2012) <http://g20mexico.org/images/stories/temp/G20_Leaders_Declaration_2012.pdf> (accessed 03-08-2014).

[83] OECD "About BEPS and the inclusive framework" (undated) *OECD* <http://www.oecd.org/tax/beps/beps-about.htm> (accessed 11-10-2016).

[84] OECD *Action Plan on Base Erosion and Profit Shifting* (2013) 47.

[85] OECD *Addressing Base Erosion and Profit Shifting* (2013) 5.

because another country would be imposing tax. In the modern global economy, this assumption is not always correct, as tax planning schemes may result in profits ending up untaxed anywhere".[86]

At the behest of the G20, in February 2013, the OECD issued a 15 Point Action Plan to address BEPS.[87] The Action Plan articulates the need for reform noting that "new international standards must be designed to ensure the coherence of corporate income taxation at the international level".[88] In 2015, the OECD issued a package of measures to address BEPS which would ensure that profits are taxed where the economic activities generating these profits are performed and where value is created.[89] Based on this intention, one would presume that the OECD would address the question of fair allocation of taxing rights. However, the OECD made it clear that it was beyond the scope of the BEPS Project to address fundamental issues which divide capital-exporting and capital-importing countries.[90] Although the OECD must be commended for formulating to address BEPS in only two years, not addressing the fundamental issue of fair allocation of taxing rights that is at the centre of diverging interests of developed and developing countries, is an opportunity missed.

Although the OECD acknowledges that the rules aimed at eliminating double taxation have also facilitated double non-taxation,[91] its BEPS Project does not review all treaty rules designed to prevent double taxation (such as those that allocate taxing rights), which may also facilitate double non-taxation. The only rules that could result in double non-taxation which the OECD reviewed are those that relate to dual resident persons (where two contracting countries apply residence taxation to tax the same person). In this regard, Article 4(3) of the OECD MTC (which previously provided that a dual resident entity would be considered resident in the state in which it has its place of effective management ("POEM"))[92] has (in light of the BEPS recommendations) been replaced in the 2017 version of the OECD MTC with a case-by-case solution.[93] The competent authorities of the contracting countries will endeavour, through mutual agreement, to determine where such person will be deemed to be resident, having regard to its POEM, the place where it is incorporated, and other relevant factors. In the absence of such agreement, the person will not be entitled to any treaty benefits.[94]

In Action 6 of the BEPS Report, the OECD points out some treaty abuse schemes that can result from inappropriate allocation of taxing rights. An example is where taxpayers get involved in dividend transfer schemes to take advantage of withholding tax rates on dividends in Article 10 of the OECD

86 47.
87 7 and 47.
88 13.
89 7-8.
90 25.
91 OECD/G20 *Base Erosion and Profit Shifting Project: Information Brief* (2014 Deliverables) 4.
92 See generally Oguttu (2008) *CILSA* 80-104.
93 OECD/G20 BEPS Project *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances: Action 6* (2015) para 47.
94 Para 48.

MTC. A taxpayer entitled to the 15% portfolio rate of Article 10(2)(b) may seek to obtain the 5% direct dividend rate of Article 10(2)(a). They can do this by arranging for a temporary increase in shareholding, for example by taking up additional shares in the company in the source state (amounting to 25%), shortly before a dividend declaration (in respect of ordinary shares) and redeem the shares shortly after the dividend declaration. The concern is that Article 10(2)(a) does not require the company receiving the dividends to have owned at least 25% of the capital for a certain period before the date of the distribution. This may encourage abuse of this provision, for example, where a company with a holding of less than 25% has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the provision, or where the qualifying holding was arranged primarily in order to obtain the reduction.[95] In Action 6, the OECD recommends that a minimum shareholding period before the distribution of the profits will be included in Article 10(2)(a). Additional anti-abuse rules will also be included in Article 10 to deal with cases where intermediaries are established in the source country to take advantage of the treaty provisions that lower the source taxation of dividends.[96]

The OECD arguably may only have dealt with the "tip of the iceberg" in addressing the underlying problems of these tax avoidance schemes and the ensuing double non-taxation, namely the inappropriate allocation of taxing rights between residence and source countries. The OECD chose to focus on addressing the treaty BEPS concerns by recommending the use of anti-treaty abuse provisions[97] and strengthening existing anti-tax avoidance provisions. However, MNEs have abused the existing laws, making them largely ineffective. The OECD failed to acknowledge that the BEPS concerns faced by capital-exporting countries might not be the same as those faced by capital-importing countries. This one-sided approach of addressing BEPS by patching up (or strengthening) current anti-avoidance legislation (that some capital-importing countries do not have or do not have the capacity to implement) is not the only solution to addressing global BEPS concerns.

For most developing capital-importing countries, their treaty BEPS concerns do not only arise due to a lack of anti-avoidance provisions but also because the DTAs they have signed confer inappropriate taxing rights (like low or zero withholding tax rates) which MNEs take advantage of – a matter that anti-avoidance provisions cannot address but that must be addressed by revising the treaty allocation rules. By failing to re-examine the basic principles of allocating taxing rights in tax treaties, the OECD seems to have missed an opportunity to evaluate the whole tax system and to deal with the root of the problems inherent in international tax systems. This implies that the interests of developing countries, as has historically been the case, are again not addressed and so these countries will be unlikely to fully benefit from the OECD's proposed reforms. The underlying BEPS concerns of many developed

95 Para 35.
96 Para 37.
97 Para 11.

countries have centred around how they can preserve the competitiveness of their economies and tax advantages. Indeed, the BEPS Project was marred by the reluctance among OECD member countries that wish to protect their own national interests thus failing to address international tax issues head on. Some BEPS action items that started off strong were significantly watered down due to a lack of consensus on how to proceed, when the taxing rights of certain OECD members were threatened.[98] While these developed countries were busy ensuring that their interests were protected in the new international tax regime, the historical fundamental interests of developing countries were excluded.

5 OECD BEPS Project: Will the inclusion of developing countries in international tax cooperation result in protection of developing country interests?

The OECD's work on BEPS was carried out by 44 countries on an equal footing: all OECD members and the BEPS Associates (8-non-OECD G20 and OECD accession countries: Argentina, Brazil, China, Colombia, India, Indonesia, Latvia, Russia, Saudi Arabia and South Africa).[99] The parties reached consensus on solutions to eliminate BEPS. The 2013 OECD BEPS Action Plan notes, however, that international consensus on addressing BEPS would require incorporating the perspectives of developing countries.[100] Nevertheless, a number of Non-Governmental Organisations ("NGOs") and actors in developing countries argued that the initial BEPS 15 Point Action Plan was driven by the interests of developed countries and failed to take into account the interests of developing countries. The BEPS action agenda was criticised for having been set by only a few countries thus reinforcing a system that exacerbates global inequality.[101] The OECD's initial regional consultations with developing countries were also criticised for only serving as orientation to a pre-existing plan, and not representing equal global participation in the formulation of reforms.

[98] M Cadesky, R Rinninsland & K Lobo *The U.S. View on BEPS* paper presented at the AOTCA 2014 Conference on October 2014 available at <http://publications.ruchelaw.com/pdfs/2014-10/US_View_On_BEPS_AOTCA.pdf> (accessed 18-07-2016). With respect to Action 1 on the digital economy, the USA "is arguably a main economic beneficiary of e-Commerce, with a large number of major companies (Amazon, Google, Microsoft, Apple) being U.S. corporations. Instead of limiting the tax planning opportunities in the e-Commerce world, the U.S. may be more concerned with preventing the exportation of U.S. corporations out of the US … Although U.S. corporations engaged in e-Commerce activities have been able to benefit from international tax planning, this is perhaps of less significance to the U.S. than it might be for other countries given the dominance of certain U.S. corporations within this industry. The U.S. Government's main goal is to prevent other countries from taxing what it views as "its" tax base through BEPS".

[99] OECD/G20 "BEPS Project: Information Brief – 2014 Deliverables" (2014) *OECD* 4 <http://www.oecd.org/ctp/beps-2014-deliverables-information-brief.pdf> (accessed 17-05-2016).

[100] OECD *Action Plan on Base erosion and profit shifting* 25.

[101] Francophone LIC Finance Ministers Network *Press* Note, *LIC Ministers Demand Their Fair Share of Global Tax Revenues*, 9 October 2014 (Francophone LICs "require a more fundamental reform of the international tax system in order to get their fair share of global tax revenues … current G20/OECD initiatives against tax avoidance and evasion are not tackling the key practices which most reduce LIC revenues … The cause of these problems is the lack of decision making power for LICs in global tax discussions. Consultation by the IMF and OECD cannot be sufficient: LICs need an equal seat at the table").

The OECD does however assert that its "BEPS project marks a turning point in the history of international co-operation on taxation".[102] After the BEPS Action Plan was developed, the OECD made efforts to ensure the BEPS agenda takes into account the interests of developing countries. Examples include:

- When developing countries raised concerns about the transfer pricing of commodities (which were initially not on the BEPS agenda), the matter was co-opted into Action 10.
- In acknowledging that developing countries face particular administrative capacity challenges to address BEPS matters ably, the OECD committed to support developing country revenue authorities.[103] It pledged to assist in the funding of capacity development in African tax authorities through initiatives like "Tax Inspectors Without Borders".[104]
- The OECD and G20 countries (under the umbrella of the "G20 Developing Working Group on BEPS") acknowledged that many developing countries have limited capacity to implement global BEPS solutions[105] which will affect their ability to reap the full benefits of international tax reforms.[106] They pledged to assist developing countries to build effective tax systems that comply with international tax standards.
- The OECD and G20 countries recognised that developing economies need regular and proactive engagement in the G20/OECD BEPS process (particularly countries that are difficult to reach due to geography, capacity, size, or other reasons)[107] to enhance their ability to effectively implement and benefit from the BEPS Action Plan.[108] Such countries may require tailored approaches to implement the BEPS Action Plan, without undermining the integrity of the international tax system. For instance, the G20 Development Working Group on BEPS[109] has been actively involved in Africa, partnering with regional tax and economic

[102] OECD/G20 "BEPS Project: Information Brief – 2014 Deliverables" (2014) *OECD*.

[103] OECD "Strategy for Deepening Developing Country Engagement in the BEPS Project" (2014) *OECD* <www.oecd.org/ctp/strategy-deepeningdeveloping-country-engagement.pdf> (accessed 09-07-2015).

[104] OECD "Tax Inspectors Without Borders" (undated) *OECD* <http://www.oecd.org/tax/taxinspectors.htm> (accessed 07-07-2015).

[105] G20 Development Working Group Domestic Resource Mobilisation "G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Tax Information for Developing Economies" (undated) *G20* <http://www.g20.utoronto.ca/2014/16%20G20%20response%20to%202014%20reports%20on%20BEPS%20and%20AEOI%20for%20developing%20economies.pdf> (accessed 31-08-2016).

[106] G20 Development Working Group Domestic Resource Mobilisation "G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Tax Information for Developing Economies" (undated) *G20*.

[107] G20 Development Working Group Domestic Resource Mobilisation "G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Tax Information for Developing Economies" (undated) *G20* 8.

[108] G20 Development Working Group Domestic Resource Mobilisation "G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Tax Information for Developing Economies" (undated) *G20* 8.

[109] G20 Development Working Group Domestic Resource Mobilisation "G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Tax Information for Developing Economies" (undated) *G20* 15.

organisations to address BEPS issues.[110] The G20 members committed to take practical steps to support regional tax administration forums in fulfilling their role as a bridge between the international tax agenda and developing economies by facilitating capacity building though providing financial or in-kind support and participating in an advisory or knowledge-sharing capacity.

- The G20 also called on international organisations to work with regional tax administration forums to create practical "toolkits" for low-capacity developing countries, to assist them in implementing the BEPS Action Plan. The toolkits are essentially a side project intended to prioritise action items that have the greatest impact for developing economies.[111] For example, in October 2015, the G20 Development Working Group published its final "Toolkit for Tax incentives".[112] Although tax incentives are not part of the BEPS agenda, un-strategic tax incentives to foreign investors are a major harmful tax practice that lead to a "race to the bottom" for developing countries. Tax incentives were not addressed by Action 5 that deals with harmful tax practices but was relegated to toolkits for developing countries.

In the 2-year deliberations on BEPS (2013-2015), developing countries were invited to express their views on the Action Items relevant to them. When the final reports were released in 2015, developing countries expressed that the establishment of a more inclusive framework that includes international organisations and regional tax organisations should sustain their participation.[113] Acknowledging that globalisation requires global solutions and that a global dialogue should be established on BEPS, the OECD designed a more inclusive framework for monitoring BEPS implementation with interested countries participating on an equal footing.[114] The purpose of the inclusive framework is to consider the manner in which non-OECD and non-G20 countries could commit and implement the agreed BEPS minimum standards.[115] All countries, whether developing or developed, were invited to participate in the new inclusive framework on BEPS.[116] The first meeting was held in June 2016 in Kyoto, Japan where the OECD reiterated that the

[110] G20 Development Working Group Domestic Resource Mobilisation "G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Tax Information for Developing Economies" (undated) *G20* 17.

[111] G20 Development Working Group Domestic Resource Mobilisation "G20 Response to 2014 Reports on Base Erosion and Profit Shifting and Automatic Exchange of Tax Information for Developing Economies" (undated) *G20* 6.

[112] The G-20 Development Working Group by the IMF, OECD, UN and World Bank *Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment* (2015).

[113] OECD *Action Plan on Base Erosion and Profit Shifting* para 30.

[114] OECD/20 BEPS Project *Addressing the Tax Challenges of the Digital Economy: Action 1* (2015) 3.

[115] OECD *Action Plan on Base Erosion and Profit Shifting* para 30.

[116] OECD "Implementing the BEPS Packaged: Building an Inclusive framework" (2016) *OECD* <https://www.oecd.org/.../flyer-implementing-the-beps-package-building-an-inclusive-framework> (accessed 10-10-2016).

meeting marked a new era in international tax cooperation.[117] The meeting was attended by representatives from 82 countries[118] that pushed for ongoing efforts to update international tax rules for the twenty-first century, which is the latest step in the OECD/G20 BEPS Project. The OECD noted that the meeting marked the first time that a broad range of countries, representing varying levels of development, came together on an "equal footing" in the OECD's Committee on Fiscal Affairs, to inaugurate the new inclusive framework on BEPS implementation. Many developing countries have joined the inclusive framework. As at 30 June 2016, the African countries that are part of the 82 members of the Inclusive Framework on BEPS were: Burkina Faso, Cameroon, Congo, Democratic Republic of the Congo, Egypt, Eritrea, Gabon, Kenya, Liberia, Nigeria, Senegal, Sierra Leone and South Africa. A group of other countries attended the Kyoto meeting as invitees to the inclusive framework, while they considered whether or not to commit to the implementation of the BEPS Package. The invitee countries from Africa were: Côte d'Ivoire, Guinea-Bissau, Madagascar, Mauritius, Mauritania, Togo and Zambia. Pascal Saint-Amans, the director of the OECD Centre for Tax Policy and Administration, stated that "today we launch a new era in international tax" and affirmed that "through their participation in the decision-making as well as the technical working groups of the OECD's Committee on Fiscal Affairs, the members of the inclusive framework will now have a direct influence in shaping international tax rules to tackle BEPS and ensuring a level playing field".[119]

International organisations are also involved as Observers in the inclusive framework. This allows for a more coordinated and targeted capacity building in implementing the BEPS outcomes. In April 2016, the International Monetary Fund ("IMF"), the OECD, the UN and the World Bank Group announced the details of their joint effort to intensify their cooperation on tax issues. These organisations launched the "Platform for Collaboration

[117] OECD "First meeting of the new inclusive framework to tackle Base Erosion and Profit Shifting marks a new era in international tax co-operation" (undated) *OECD* <http://www.oecd.org/tax/beps/first-meeting-of-the-new-inclusive-framework-to-tackle-base-erosion-and-profit-shifting-marks-a-new-era-in-international-tax-co-operation.htm> (accessed 10-10-2016).

[118] The 82 members of the Inclusive Framework on BEPS as of 30 June 2016 are: Argentina, Aruba, Australia, Austria, Bangladesh, Belgium, Benin, Brazil, Brunei Darussalam, Bulgaria, Burkina Faso, Cameroon, Canada, Chile, China (People's Republic of), Colombia, Congo, Costa Rica, Croatia, Curaçao, Czech Republic, Denmark, Democratic Republic of the Congo, Egypt, Eritrea, Estonia, Finland, France, Gabon, Georgia, Germany, Greece, Guernsey, Haiti, Hong Kong (China), Hungary, Iceland, India, Indonesia, Ireland, Isle of Man, Israel, Italy, Japan, Jersey, Kenya, Korea, Latvia, Liberia, Liechtenstein, Lithuania, Luxembourg, Malta, Mexico, Monaco, Netherlands, New Zealand, Nigeria, Norway, Pakistan, Papua New Guinea, Paraguay, Poland, Portugal, Romania, Russian Federation, San Marino, Saudi Arabia, Senegal, Sierra Leone, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Turkey, UK, USA, Uruguay. See OECD "First meeting of the new inclusive framework to tackle Base Erosion and Profit Shifting marks a new era in international tax co-operation" (undated) *OECD* <http://www.oecd.org/tax/beps/first-meeting-of-the-new-inclusive-framework-to-tackle-base-erosion-and-profit-shifting-marks-a-new-era-in-international-tax-co-operation.htm> (accessed 10-10-2016).

[119] OECD "First meeting of the new inclusive framework to tackle Base Erosion and Profit Shifting marks a new era in international tax co-operation" (undated) *OECD*.

on Tax".[120] The Platform will facilitate regular discussions among the four international organisations on the design and implementation of standards for international tax matters; it will strengthen their capacity-building support; deliver jointly developed guidance; and share information on operational and knowledge activities.[121] The role of these international organisations will also be influential in providing capacity support for developing countries and advising on the design of international rules.[122] The Platform's first task is to deliver a number of "toolkits" designed to assist developing countries to implement the measures developed under the G20/OECD BEPS Project and other international tax issues. The first of these toolkits, focusing on tax incentives, was delivered in October 2015.[123] Platform members will hold regular meetings with representatives of developing countries, regional tax organisations, banks and donors. Furthermore, consultations with business and civil society will be organised as needed.[124]

Regional tax organisations, such as the African Tax Administration Forum ("ATAF"), the *Centre de rencontres et d'études des administrations fiscales*, and the *Centro Interamericano de Administraciones Tributarias*, will continue to play an important role in the BEPS Project. Regional tax organisations are central to the regional networks, and regional meetings play an important role in the inclusive framework. Regional networks will provide support to developing countries on the implementation of the BEPS Package.[125]

Developing countries should participate in this inclusive framework to ensure that they present a strong unified position on their concerns on implementing BEPS measures. Based on history, developing countries may need to temper their expectations of this new international tax order. They should assess whether their involvement in the inclusive framework is indeed on an equal footing and whether the OECD will address the fundamental international tax reforms needed to advance their interests.

The discussion below demonstrates that, despite the anti-avoidance measures suggested in the BEPS Project, MNEs may still exploit the inappropriate allocation of taxing rights and erode the tax bases of source countries.

[120] OECD "International organisations take major step to boost global co-operation in tax matters" (19-04-2016) *OECD* <http://www.oecd.org/tax/beps/international-organisations-take-major-step-to-boost-global-co-operation-in-tax-matters.htm> (accessed 10-10-2016).

[121] OECD "International organisations take major step to boost global co-operation in tax matters" (19-04-2016) *OECD*.

[122] OECD "International organisations take major step to boost global co-operation in tax matters" (19-04-2016) *OECD*.

[123] A Report to the G20 Development Working Group by the IMF, OECD, UN, and World Bank "Options for Income Tax Countries' Effective and Efficient use of Tax Incentives for Investment" (15-10-2015) *OECD* <https://www.oecd.org/tax/tax-global/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment.pdf> (accessed 19-12-2016).

[124] OECD "International organisations take major step to boost global co-operation in tax matters" (19-04-2016) *OECD*.

[125] OECD "About BEPS and the inclusive framework" (undated) *OECD*.

6 Inappropriate taxing rights between source and residence countries: A consideration of interest, service fees and royalty payments to multinational enterprises

6 1 Interest

If a parent company extends funding to its subsidiary in a country, the interest on the loan is normally treated as a tax-deductible expense for the subsidiary. As a result, MNEs often prefer funding their subsidiaries through loan capital as opposed to equity since dividend distributions are not tax deductible.[126] MNEs often enter into "thin capitalisation schemes" by funding their subsidiaries with disproportionate levels of debt to equity,[127] which reduces source country tax.[128] To protect their tax bases from excessive interest deductions, countries often apply provisions to prevent debt shifting to lower tax jurisdictions through intra-group loans.[129] Some countries use targeted anti-avoidance rules that disallow interest expense on specific transactions.[130] Other countries apply the arm's length principle ("ALP")[131] to determine whether the loan would have been made in an arm's length transaction[132] and whether the interest rate on the loan is an arm's length rate.[133] If the loan exceeds what would have been lent in an arm's length situation, then the lender must be taken to have had an interest in the profitability of the enterprise and so the loan, or interest rate that exceeds the arm's length amount, is considered as designed to procure a share in the profits.[134] Certain countries apply a fixed debt-to-equity ratio which is used as a "safe harbour" within which the ALP applies. Interest relating to debt exceeding the fixed ratio is then not deductible.[135] Other countries levy withholding taxes on interest to prevent tax base erosion.

[126] Arnold & McIntyre *International tax primer* 72-73.

[127] Olivier & Honiball *International tax* 649.

[128] G Richardson, D Hanlon & L Nethercott "Thin Capitalization: An Anglo-American comparison" (1998) 24 *The International Tax Journal* 36.

[129] IMF "Spillovers in International Corporate Taxation" (2014) *IMF* 30.

[130] For example, South Africa's Income Tax Act contains various anti-avoidance provisions to limit excessive interest deductions. Section 23N limits the deduction of an interest expense incurred by a company on a loan or debt raised to acquire assets or shares in reorganisations and acquisition transactions; section 23M imposes a limitation on the deductibility of interest in debt owed to persons in a controlling relationship; section 24O limits the deduction of interest in respect of share acquisitions; section 8E and 8EA deem a dividend declared by a company on a hybrid equity instrument as interest; section 8F and 8FA deem interest on a hybrid debt instrument to be a dividend *in specie* such that no deduction is allowed on the interest paid by the issuer of the instrument and section 45 deals with excessive debt transactions using debt pushdown structures in intra-group transactions.

[131] The ALP as set out in Article 9(1) of the OECD MTC provides that when conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

[132] In an arm's length transaction, each party strives to get the utmost possible benefit from the transaction. See Article 9 OECD Model Tax Convention on Income and on Capital (2014 condensed version).

[133] OECD *Issues in International Taxation No.2: Thin Capitalisation: Taxation of Entertainers, Artists and Sportsmen* (1987) para. 48.

[134] OECD/G20 BEPS Project *Limiting Base Erosion Involving Interest Deductions: Action 4* (2015) para. 12.

[135] ATAF 2nd Meeting "Cross border taxation technical committee" (3-4 March 2015) 1.

Even though a source country may have provisions to protect its tax base, a DTA may limit its right to tax. Article 11(1) of treaties based on the OECD MTC, gives the primary taxing right to interest arising in a source country to the state of residence of the recipient of the interest. Article 11(2) provides that the source country may tax the interest if the beneficial owner thereof is a resident of the other contracting state, but even then, the tax should not exceed 10% of the gross amount of the interest. Any favourable taxation that may arise is usually addressed by Articles 23A and 23B of the OECD MTC which provides that the resident state must give a tax credit to the recipient of the interest or exempt the interest from taxation. Thus, for the source state to tax interest, it must first prove the recipient's beneficial ownership thereof. However, proving beneficial ownership in an international context is a complex matter since the term is not fully defined in the OECD MTC. In terms of the OECD MTC, a nominee or agent who is a treaty country resident may not claim benefits if the person who has all the economic interest in, and all the control over, property (the beneficial owner) is not a resident. In addition, a conduit company is not regarded as a beneficial owner if, through the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties (such as the shareholders of the conduit company).[136] The OECD further explains that "beneficial ownership" means "the right to use and enjoy" the amount "unconstrained by a contractual or legal obligation to pass on the payment received to another person".[137] Proving beneficial ownership is very difficult as highlighted in international cases such as *Velcro Canada Inc. v The Queen*[138] and *Prevost Car Inc. v Her Majesty the Queen.*[139] In both cases, revenue authorities sought to reject the reduced withholding tax paid by taxpayers arguing that the recipients of the income were merely agents, nominees, or conduits in relation to the payments made. The courts held that the legal arrangements of the parties did not show that they were mere conduits, and that the recipients of the payments were beneficial owners.[140]

Even if a source country can prove beneficial ownership, Article 11(2) provides that the amount taxable shall not exceed 10% and that the competent authorities must settle the application of the limitation. In practice, the tax rate on interest of most African countries' tax treaties is often reduced below 10% (sometimes to zero), which opens such treaties to abuse, and is a major BEPS concern.[141] Treaty abuse often entails the use of treaty shopping schemes: the

[136] OECD *Report on the Use of Base Companies* (1987) para 14(b).

[137] OECD *Revised Proposals concerning the Meaning of "Beneficial Owner" in Articles 10, 11, and 12* (2012). See paragraph 12.1 of the Commentary on Article 10, paragraph 9.1 of the Commentary on Article 11, and paragraph 4 of the Commentary on Article 12.

[138] Tax Court of Canada, 2012 TCC 57.

[139] Tax Court of Canada, 2008 TCC 231.

[140] In *Prevost Car Inc. v Her Majesty the Queen*, Tax Court of Canada, 2008 TCC 231 the court ruled that the Dutch company met the tests for being considered the beneficial owner of the dividends. The judge held that the beneficial owner of the dividends is the person who receives the dividends for his own use and enjoyment and assumed the risks and control of the dividends received.

[141] OECD/G20 *BEPS Project Action 4* para 13.

use of double tax treaties by the residents of a non-treaty country in order to obtain treaty benefits (for example low withholding tax rates) that are not supposed to be available to them.[142] This is mainly done by interposing a "conduit company" in one of the contracting states so as to shift profits out of those states.[143] Such low or zero withholding taxes are one of the reasons why in June 2013, Malawi terminated its 1969 colonial treaty with the UK, Northern Ireland, and the Netherlands.[144] The renegotiated 2014 Malawi/Netherlands treaty contains an anti-treaty abuse provision[145] and higher withholding tax rates. Interest is taxed at 10%, royalties at 5% and dividends at 5% in the case of shareholdings of at least 10%, and the standard rates in both countries apply to other dividends. The Netherlands appears to have changed its stance on treaty abuse in its treaties with developing countries, as it has renegotiated tax treaties with 23 other developing countries, including Ethiopia, Ghana, Kenya, and Zambia, each of which with an anti-abuse provision and higher withholding tax rates.[146] Clearly, solving the BEPS problem is not only about including anti-avoidance provisions in the treaties, but also the taxation rates in the treaties must not be so low that they encourage treaty abuse. Although African countries tend to have high withholding tax rates in their domestic laws, in tax treaty negotiations they often come under considerable pressure from developed nations to reduce withholding tax rates to zero or near zero, and yet these developing countries also contribute to the earning of this income.[147] Tax officials from developing countries often find that withholding tax rates are one of the key areas on which they must fight when negotiating DTAs.[148]

It is recommended that in addition to providing ceilings above which tax must not be levied, MTCs should also contain lower limits below which the tax rate must not fall. MTCs could, for instance, set a range of between 5-10% within which countries can negotiate. Even though the 5% floor could still be used for treaty shopping purposes, source countries are more concerned about not being able to tax at all, due to limited treaty negotiation capacity. When the OECD released its BEPS Report, it did not address base erosion that results from low withholding tax rates. The OECD only recommended the use of anti-treaty abuse provisions to prevent treaty shopping in Action 6. To this end, the OECD recommends that if a person circumvents domestic tax law to gain treaty benefits, it must be addressed through domestic anti-abuse rules. If a person circumvents provisions in the treaty itself, countries should apply treaty anti-abuse rules, using a three-pronged approach. Firstly, the title

[142] S van Weeghel *The Improper Use of Tax Treaties with Particular Reference to the Netherlands and The United States* (1998) 119.

[143] FJ Wurm *Treaty Shopping in the 1992 OECD Model Convention Intertax* (1992) 658; E Tomsett *Tax Planning for Multinational companies* (1989) 149.

[144] Multinational Tax and Transfer Pricing News "Netherlands renegotiates tax treaties with developing nations to add anti-abuse clause" (23-06-2015) *MNE Tax*.

[145] IMF "Spillovers in International Corporate Taxation" (2014) *IMF* 28.

[146] Multinational Tax and Transfer Pricing News "Netherlands renegotiates tax treaties with developing nations to add anti-abuse clause" (23-06-2015) *MNE Tax*.

[147] ActionAid *Calling Time: Why SABMiller should stop dodging taxes in Africa* (2012) 132.

[148] 22.

and preamble of treaties should clearly state that the treaty is not intended to create opportunities for non-taxation or reduced taxation through treaty shopping. Secondly, a principal purpose test[149] should be included. Thirdly, a country could use the principal purpose test supplemented by a limitation-of-benefits provision[150] to address conduit company cases.[151] It is submitted that in addition to these recommendations, the OECD should provide some guidance and recommendations to countries regarding optimal rates and not leave it to competent authorities to negotiate the lowest rate, as this drives treaty shopping.

Article 11(3) of the OECD MTC gives exclusive taxing rights to the source country if the beneficial owner of the interest, resident in the other contracting country, carries on business in the source country through a PE and the debt claim in respect of which the interest is paid, is effectively connected with such PE. The PE concept (as defined in Article 5 of the OECD MTC) is designed to ensure that a source country does not tax the business activities of a foreign enterprise unless that enterprise creates a significant and substantial economic presence in that country.[152] Article 5(1) of the OECD MTC defines a PE as a fixed place of business through which the business of an enterprise is wholly or partly carried out. Examples of PEs are set out in Article 5(2). Article 5(3) sets out a special PE in respect of building and construction sites. Article 5(5) provides for a deemed PE where a dependent agent habitually enters into contracts on behalf of the enterprise in the other contracting country that bind the principal. Article 5(4) contains exclusions to the PE concept.

Action 4 of the BEPS Report only addresses BEPS concerns regarding the use of interest (in particular, related-party interest) as a profit-shifting technique that is commonly used in international tax planning.[153] Action 4 evaluates the effectiveness of methods[154] used by countries to limit excessive interest deductions, and concludes that the use of arm's length tests, withholding taxes, and rules to disallow a percentage of interest, are not effective.[155] The OECD recommended that countries limit excessive interest deductions by:

- Using a fixed-ratio rule which limits an entity's net interest deductions and payments economically equivalent to interest, to a percentage of its earnings before interest, taxes, depreciation and amortization

[149] In terms of the principle purpose test, treaty benefits are denied if one of the principle purposes of the transaction is to avoid taxation by taking advantage of treaty benefits. See OECD/G20 on Action 6 para 19; AW Oguttu "Tax Base Erosion And Profit Shifting - Part 2: A Critique of Some Priority OECD Action Points from an African Perspective - Preventing Excessive Interest Deductions And Tax Treaty Abuse" (2016) vol 49 Issue 1 CILSA 157.

[150] In terms of the limitation of benefits provision, treaty benefits (such as reduced withholding rates) apply only to companies that meet specific tests of having some genuine presence in the treaty country. See OECD/G20 on Action 6 para 19; Oguttu "Tax Base Erosion And Profit Shifting - Part 2": CILSA 156.

[151] OECD/G20 *BEPS Project on Action* 6 para 15.

[152] Vogel *Double Tax Conventions* para 4.

[153] Para 4.

[154] OECD, *Discussion Draft BEPS Action 4: Interest deductions and other financial payments*, (2014) para. 21.

[155] Para 21.

("EBITDA").[156] A debt to EBITDA fixed-ratio rule of between 10% and 30% is recommended.

- Since the fixed ratio is low, it may be supplemented with a worldwide group-ratio rule to offer relief to companies in groups that are highly geared for reasons other than tax.
- The fixed-ratio rule and the group-ratio rule may be supplemented with other provisions that reduce the impact of the rules on entities which pose less BEPS risks, for example:
  - a *de minimis* threshold which carves out entities with a low level of net interest expense;
  - an exclusion for interest paid to third-party lenders on loans used to fund public benefit projects; and
  - permitting carry forward of disallowed interest expense to future years.

Clearly, the OECD emphasises enacting legislation to limit excessive interest deductions, but this approach addresses only part of the problem. Even though countries may have such legislation in place, DTA income allocation rules (which normally override domestic rules) and negotiated rates can considerably reduce or even nullify the amount of interest that a source country can tax.

6 2 Royalties

Most jurisdictions include royalties derived from the use of intellectual property ("IP") in the gross income of the recipient, and such royalties are taxed.[157] The payer of the royalties can claim expenses incurred in the exploitation of the IP as a deduction against taxable income.[158] As a result, if a parent company invests in IP through a subsidiary based in another country, expenses incurred for exploiting the IP paid by the subsidiary company to the parent company may be claimed as a deduction. If these expenses are excessive, the source country's right to tax royalties paid to the parent company may be minimal.

To prevent tax base erosion, countries often rely on anti-avoidance provisions that limit excessive deductions of royalties paid to MNEs.

- In South Africa, for example, section 23I of the Income Tax Act 58 of 1962 ("Income Tax Act") prohibits a tax deduction of royalties in respect of IP which was previously owned by a South African resident or a person connected to that resident.
- Some African countries also apply exchange control regulations which limit the exportation of funds. The payment of royalties from South Africa requires exchange control approval if it is in respect of foreign

[156] OECD/G20 *BEPS Project on Action 4* paras 23, 78 and 99.

[157] For example in South Africa, paragraphs *(g)*(ii)*bis*, *(g)*(iii) and (*g*A) respectively of the definition of gross income in section 1 of the Income Tax Act.

[158] For example, research and development expenditure are contained in section 11D of South Africa's Income Tax.

owned IP.[159] Algeria has similar exchange control regulations on the outflow of royalties.[160]

- Transfer pricing provisions also apply in countries such as Tanzania[161] and South Africa[162] to regulate the taxation of royalties.
- Most African countries prevent tax base erosion in respect of royalties through withholding taxes levied on royalties paid to non-residents. South Africa[163] and Ghana,[164] for instance, levy a withholding tax on royalties at 15%, Nigeria at 10%,[165] and Algeria at 24%.[166]

Despite such provisions, DTAs limit the source country's right to tax royalties through treaty allocation rules. Article 12(1) of the OECD provides that royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State is taxable in the other state. In effect, the resident state of the beneficial owner of the royalties may tax. In terms of Article 12(3), the source state may tax the royalties if the beneficial owner of the royalties carries on business in the source state through a PE situated therein, and the right or property in respect of which the royalties are paid is effectively connected with the PE. It follows that for the source country to tax royalties, it needs to prove beneficial ownership. The challenges of proving beneficial ownership discussed above also apply here.

The next step is for the source country to demonstrate that the beneficial owner of the royalties carries on business in the source country through a PE. Unless the supplier of IP has a PE in the source country, that country does not have taxing rights.[167] The defined term PE (as discussed in part 6.1 above) contains exclusions for activities that are generally of a preparatory and auxiliary nature. An example of preparatory or auxiliary activities relevant to IP is Article 5(4)(e) of most DTAs, which excludes from the PE concept the maintenance of a fixed place of business solely for the purpose of advertising or the supply of information or for scientific research. However, in the modern world, real value can be created through scientific research and the development and testing of products. Innovation is key to the success of

[159] South African Reserve Bank "Exchange Control Manual" Regulation 4.3.2 <http://www.reservebank.co.za> (accessed 31-08-2016).

[160] United States Department of State *2015 Investment Climate Statement – Algeria* (2015).

[161] The Income Tax (Transfer Pricing) Regulations (2014) 95 *Gazette of the United Republic of Tanzania*, Supplement 5 § 11.

[162] S 13(4) of South Africa's Income Tax Act.

[163] S 49A-D in Part IVA of the South African Income Tax Act.

[164] S 115(1)(a) of Ghana's Income Tax Act 896 of 2015 read together with para 8 of the First Schedule to this Act; see also PWC "Worldwide Tax Summaries: Ghana: Corporate – withholding taxes" (16-07-2018) *PWC* <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Ghana-Corporate-Withholding-taxes> (accessed 13-07-2016). This rate is subject to modification by double taxation treaties.

[165] PWC "Worldwide Tax Summaries: Nigeria – Corporate withholding taxes" (16-07-2018) *PWC* <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Nigeria-Corporate-Withholding-taxes> (accessed 13-07-2016).

[166] PWC "Worldwide Tax Summaries: Algeria – Corporate withholding taxes" (18-06-2018) <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Algeria-Corporate-Withholding-taxes> (accessed 13-07-2016)

[167] K Holmes "International Tax Aspects of Income Derived from the Supply of Intellectual Property: Royalties vs. Business Profits" in A Lymer & J Hasseldine (eds) *The International Taxation System* (2002) 181, 190.

many businesses today. Under current rules, a MNE could potentially claim that its research and development activities are preparatory or auxiliary in nature. These activities would then not qualify as a PE and the source country would not be able to tax the royalties derived from its activities.

The above demonstrates that the source countries' ability to tax royalties in a treaty context may be constrained. The unfair allocation of taxing rights for royalties in favour of residence countries has been criticised.[168] In Action 7 of its BEPS Project, the OECD acknowledges that the true value of an MNE's profits cannot be determined without considering the value contributed through research and development or the creation of products in source countries.[169] Furthermore, in Action 7, the OECD notes that, depending on the circumstances, business activities that were previously considered merely preparatory or auxiliary in nature may nowadays be core business activities of an enterprise.[170] To ensure that profits derived from core activities performed in a country can be taxed in that country, Article 5(4) was modified in the 2017 version of the OECD MTC to ensure that each of the exceptions to the PE concept are restricted to activities that are of a preparatory or auxiliary character.[171] The Commentary on Article 5(4) now clarifies that a preparatory activity is one which precedes the main activity, one that is carried out for a short period of time, or an activity determined by the character of the main activity of the enterprise.[172] In contrast, an auxiliary activity would be one that is "supportive" in nature and not vital to the main activity being carried out. Thus, if conducting an activity requires a significant amount of assets or employees, such activity cannot be considered auxiliary in nature. Apart from this clarification, the OECD has not addressed the allocation of taxing rights for royalties that are pertinent to source countries. However, in Article 12 of the UN MTC, royalties may also be taxed in the Contracting State in which they arise subject to a maximum, mutually agreed percentage of the gross amount of the royalties.[173] Negotiating Article 12 (based on the UN MTC) is therefore more beneficial for source countries.

The OECD BEPS Project also addresses concerns arising from MNE involvement in the transfer pricing of intangibles (such as IP). The term transfer pricing describes the process by which related entities set prices at which they transfer goods or services between each other. It entails the systematic manipulation of prices in order to reduce profits or increase profits artificially or cause losses and avoid taxes in a specific country.[174] To curb transfer pricing abuses, the OECD recommends the use of the ALP in Article

[168] F Akunobera "The Relevance of the OECD and UN Model Conventions and their Commentaries for the interpretation of Ugandan Tax Treaties" in M Lang, P Pistone, J Schuch & C Staringer *The Impact of the OECD and UN Model Tax Conventions on Bilateral Tax Treaties* (2012) 1083.

[169] OECD/G20 BEPS Project *Preventing the artificial avoidance of permanent establishment status: Action 7* (2015) 9.

[170] 9.

[171] 10.

[172] 17.

[173] Holmes "International Tax Aspects of Income Derived from the Supply of Intellectual Property" in *The International Taxation System* 190.

[174] Arnold & McIntyre *International Tax Primer* 53; AW Oguttu "Transfer Pricing and Tax Avoidance: Is the Arm's Length Principle still relevant in the E-commerce Era?" (2006) 18 *SA Merc LJ* 139.

9(1) of the OECD MTC. The concern is that significant functions are often conducted in developing countries in the development of the IP, but not adequately remunerated. For example, an African research and development ("R&D") service provider may be contracted by a non-resident MNE to research an important aspect of the IP. Even though the MNE may be tax resident in a low tax jurisdiction where it has little substance, if the MNE owns the IP, provides the capital and assumes the contractual risks of the IP development, transfer pricing schemes may result in the African R&D service provider not being adequately remunerated for the functions performed and so the source country will only levy limited tax on their income.

The OECD acknowledges that transfer-pricing issues relating to intangibles are a key concern of governments and taxpayers, due to insufficient international guidance, in particular on the definition, identification, and valuation of intangibles.[175] Applying the ALP to intangibles is also particularly challenging due to their unique nature, which makes it difficult to find a market benchmark against which to conduct an objective comparability analysis. The OECD BEPS Report[176] recommended in Action 8 that a clearly delineated definition of intangibles be developed, clear transfer pricing rules for hard-to-value intangibles be developed, and that profits associated with the transfer and use of intangibles be appropriately allocated so as to correspond to value creation by MNE group members.

Consequently, the OECD developed international standards regarding the transfer pricing of intangibles by revising Chapter VI of its Transfer Pricing Guidelines. The Guidelines explain that the word "intangible" means "something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances".[177] An intangible need not be one for accounting, general tax, or treaty withholding tax purposes. It need not be legally protected or be separately transferable. Examples include patents, know-how and trade secrets, trademarks, trade names and brands, rights under contracts and government licences, licences, goodwill, and ongoing concerns.[178] Market conditions or other circumstances that are not capable of being owned or controlled, such as location savings, local market features, MNE group synergies, and market specific characteristics, are not intangibles. They are comparability factors which may affect the determination of an arm's length price and should be taken into account in a comparability analysis.[179] To ensure that the transfer pricing of intangibles is in line with value creation, Action 8 explains that legal ownership alone does not necessarily entail a right to all (or any) of the return from exploiting the intangible. The entities performing value-creating functions related to the development,

[175] OECD *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (2013) para 35.
[176] OECD *Action Plan on Base Erosion and Profit Shifting* 20.
[177] OECD/G20 BEPS Project *Aligning Transfer Pricing Outcomes with Value Creation: Actions 8-10* (2015) 67.
[178] 70-73.
[179] 70-73.

enhancement, maintenance, protection and exploitation ("DEMPE") of the intangibles should be entitled to an appropriate remuneration reflecting the value of their contributions.[180]

If these guidelines are followed, and an IP service provider or subsidiary based in an African country performs DEMPE functions, they should be taxable in the source country. However, most African countries may not easily benefit from this guidance as they may not have transfer pricing legislation. Applying the OECD Transfer Pricing Guidelines can also be quite challenging for some African countries. It is difficult to find African comparables as there are very few organised companies in any given sector, with limited African benchmarking databases.[181] In assessing arm's length criteria of related party transactions, African countries tend to accept European comparables, which often require adjustment to fit developing market businesses.[182] There is also a general lack of administrative capacity and technical expertise to process the data. Addressing transfer pricing of intangibles is often not high on the agenda of many African countries. African countries with no transfer pricing rules and limited administrative capabilities to apply the rules, will benefit from international tax reform efforts to address the skewed allocation of taxing rights of royalties between source and residence countries.

Many developing countries are concerned that most of the OECD's recommendations in the BEPS Project centre around ALP to resolve transfer pricing issues. Various commentators have emphasised the conceptual and practical difficulties in applying the ALP since it requires matching comparable transactions between non-arm's length entities and arm's length entities, even though the transactions of MNEs are often not comparable to those of arm's length parties. Modern MNEs do not normally operate as if their subsidiaries were separate enterprises. They operate as a single unified enterprise managed from a central location, responsible for the enterprise as a whole.[183] MNEs exist mainly because these interactions generate more income than separate domestic firms interacting at arm's length would generate.[184] Thus, taxpayers and tax authorities are left to reconstruct, from largely dissimilar transactions or entities, what parties at arm's length would have done in similar circumstances.[185] Since MNEs are becoming more integrated it is often not possible to find unrelated comparable transactions. Due to these concerns, various commentators[186] have advocated the use of a formula that apportions profits equitably to countries in which the MNE operates. However, the OECD BEPS Project rejects a radical switch to a formulary apportionment

[180] 74.
[181] Oguttu *International Tax Law* 263.
[182] 263.
[183] A Cockfield "Formulary Taxation Versus the Arm's Length Principle: The Battle Among Doubting Thomases, Purists, and Pragmatists" (2004) 52 *Canadian Tax Journal* 114 116.
[184] Oguttu *International Tax Law* 255.
[185] Oguttu (2006) *SA Merc LJ* 153.
[186] R Avi-Yonah & ZP Tinhaga "Unitary Taxation and International Tax Rules" *ICTD Working Paper 26* (November 2014) 6; M Durst "Beyond BEPS: A Tax Policy Agenda for Developing Countries" *ICTD Working Paper 18* (2014) 13; Arnold & McIntyre *International Tax Primer* 80.

system in resolving transfer-pricing problems, rather it advocates building on the ALP.

Nevertheless, the OECD has historically permitted the use of the "transaction profit split method" ("TPSM") in its Transfer Pricing Guidelines, as one of the methods to determine an arm's length price. Under TPSM, the combined profit is identified and split between the connected parties in a controlled transaction.[187] The use of some apportionment method was also permitted in Article 7(4) of the 2008 version of the OECD MTC (upon which many treaties are still based) to determine an arm's length price of profits attributable to a PE. This article was deleted from the OECD MTC in 2010.[188] Under Action 9 of the BEPS Project, the OECD has brought in aspects of formulary apportionment by acknowledging the importance of the profit split method in the context of global value chains. The OECD suggests that the method can provide solutions for highly integrated operations that cannot be evaluated separately and for unique intangibles.[189] Even though the use of the profit split method is traditionally considered as a last resort, since its effective application relies on access to world-wide group data that may be difficult to obtain,[190] the OECD notes that when properly applied, it has the potential to "align profits with value creation in accordance with the ALP"[191] and may be the most appropriate method if the other methods are problematic. Since experience indicates that this method may not be straightforward for taxpayers to apply and for tax administrations to evaluate, the OECD developed draft guidance on when it is appropriate to apply the profit split method.[192] It is hoped that this guidance will be instrumental in apportioning income among countries in respect of intangibles.

6 3 Service fees and management fees

MNEs normally arrange for a wide range of administrative, technical, financial, commercial, and other services for group members. If a parent company provides services to its subsidiary in a developing country, the subsidiary may have to pay fees for the services offered. The subsidiary will generally be entitled to claim the fees as a deduction against taxable income. The concern for source countries is that parent companies often charge excessive head office management, technical and service fees resulting in subsidiary companies claiming excessive deductions for fees in source countries.[193] To protect their tax bases against such excessive deductions, source countries often levy withholding taxes. For example, Uganda levies a withholding tax on management fees at a rate of 15% in section 83(1) of its Income Tax Act,

[187] OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators" (1994) *Intertax* 346, para 131.
[188] When the OECD adopted its current authorised approach in Article 7(2) of attributing profits to PEs.
[189] D Hay, F Horner, J Owens "Past and Present Work in the OECD on Transfer Pricing and Selected Issues' (1994) 10 *Intertax* 435, para 84.
[190] 435, para 84.
[191] OECD/G20 *BEPS Project on Actions 8-10* 55.
[192] 57.
[193] 57.

Chapter 340. Ghana levies a withholding tax on management and technical services fees/endorsement fees at a rate of 15% in its Internal Revenue Act 592 of 2000. In 2013 South Africa had enacted legislation to levy withholding tax on service fees paid to non-residents in respect of technical, managerial or consultancy services; which was to came into operation on 1 January 2017.[194] However this legislation was repealed in 2017.[195] Instead, a service fee in respect of consultancy, construction, engineering, installation, logistical, managerial, supervisory, technical or training services will be a reportable arrangement if the amount exceeds, or is expected to exceed, ZAR10 million.[196]

The OECD does not recommend the levying of withholding taxes on service fees by source countries. As a result, the OECD MTC does not have a specific article on service fees that allocate taxing rights. Instead, the OECD prefers to tax service fees under Articles 5 and 7 of the OECD MTC, in that a source country may only tax services fees of a foreign service provider if it has a PE in that country for more than six months. Since a PE is part of its head office and not a separate legal entity, only profits attributable to the PE are taxable in the source country, using the ALP.[197] However, this does not favour source countries because applying the ALP to service fees is cumbersome as it is difficult to verify whether the service fee payments are appropriate. The OECD's authorised approach in Article 7(2) of attributing profits to a PE that may be taxed by source countries is also problematic for these countries.[198] The basic rule for attributing profits to PEs requires the determination of the profits under the fiction that the PE is a separate enterprise independent from the rest of the enterprise of which it is a part as well as from any other person. The fiction requires that the ALP under Article 9, which is used for adjusting the profits of associated enterprises, be applied to PEs and their head offices. These are the profits that the PE might be expected to make if it was a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used, and risks assumed through the PE and the other parts of the enterprise.[199]

The concern though is that the OECD's authorised approach recognises the internal dealings of a PE and its head office and prices them on an arm's length basis without regard to the actual profits of the enterprise of which the PE is a part. This implies that non-actual management expenses, notional interest, and royalties from the head office may be charged to the PE. This approach differs from the "single entity" approach in the UN MTC and the 2008 version of the OECD MTC (upon which many treaties are still

[194] S 99(1) of the Taxation Laws Amendment Act 31 of 2013 introduced withholding tax on services fees in ss 51A-51H, Chapter II of South Africa's Income Tax Act 58 of 1962, but the provisions were repealed.
[195] See s 60(1) of Taxation Laws Amendment Act 15 of 2016, with effect from 1 January 2017.
[196] SARS "Public Notice Listing Arrangements for Purposes of Sections 35(2) and 36(4) of the Tax Administration Act, 2011" Government Gazette No. 38569 16 March 2015, para 2.6. Available at <http://www.gov.za/sites/www.gov.za/files/38569_gon212.pdf> (accessed 23-07-2018).
[197] AW Oguttu "The Challenges of Taxing Profits Attributed To Permanent Establishments: A South African Perspective'" (2010) 64 *Bulletin for International Taxation* 169.
[198] OECD *Action Plan on BEPS* 20.
[199] Article 7(2) of the OECD MTC 16.

based), in terms of which only the actual income and expenses of the PE are allocated. Deductions for notional expenses between the PE and its foreign head office are denied.[200] The OECD's authorised approach may detrimentally impact source countries as it may not only allow deductions for notional management fees but also allow financial service businesses deductions for notional payments on internal loans.[201] To preserve their tax bases a number of developing countries have reserved the right to use the 2008 OECD MTC version of Article 7.[202] These countries therefore do not endorse the OECD's authorised approach in Article 7(2). The South African Revenue Service has also reserved the right to use the version of Article 7(2) of the OECD MTC prior to the July 2010 update.

Due to the lack of fair allocation rules for service fees, some countries have signed treaties with articles on services, management, and technical fees that deviate from the OECD and the UN MTC (neither of which currently has an article on service fees). Generally, these fees are taxable in the resident country, but the source country may tax if the beneficial owner is a resident of the other contracting country. For example, Ghana has signed treaties with Germany and the Netherlands with combined provisions on "royalties and service" fees.[203] Uganda has signed treaties with South Africa and the UK which contain an article on "technical fees".[204] Provisions on services, management and technical fees do not only appear in treaties signed by African countries, but also in the USA-India tax treaty.[205] However there is no standard way of drafting these articles, which makes treaty negotiations very difficult and creates uncertainties for taxpayers. To address these concerns, the UN started work on a technical services article in 2012, which is now included in its 2017 MTC, to allow developing countries to levy tax on payments made to foreign

[200] Deloitte "ATO Paper on Profit Allocation to Bank Branches" (undated) *Deloitte* <http://www.deloitte.com/view/en_au/au/a79b8ba975c53310VgnVCM3000001c56f00aRCRD.htm> (accessed 14-06-2016).

[201] Deloitte "Transfer Pricing Law Reforms" (2013) *Deloitte* <http://www.deloitte.com/view/en_AU/au/insights/browse-by-job-title/cfos/f364b564daf7c310VgnVCM2000003356f70aRCRD.htm> (accessed 14-06-2016).

[202] Examples are Chile, Greece, Mexico and Turkey. See reservations to Article 7(2) of the OECD MTC.

[203] See Article 12 of the Double Taxation Agreement between Ghana and Germany, entered into force 14 December 2007. The treaty is available at <www.nyansa-africa.com/wp-content/uploads/2015/08/Ghana-Germany-DTA.pdf> (accessed 18-07-2016). See also Article 12 of the Double Taxation Agreement Convention between The Netherlands and Ghana, entered into force 10 March 2008. The treaty is available at <http://download.belastingdienst.nl/itd/verdragen/overige/belastingverdrag_ghana.pdf> (accessed 18-07-2016).

[204] Article 13 "Technical fees" of the Double Taxation Agreement between South Africa and Uganda, entered into force 9 April 2001. Available at <https://www.ura.go.ug/openFile.do?path=//webupload//upload//download//staticContent//RGTMENU//458//464___IBFD_-_SOUTH_AFRICA_-_UGANDA_INCOME_TAX_TREATY.pdf> (accessed 21-07-2016). See also Article 13 of the Double Taxation Agreement between the United Kingdom and Uganda Double Taxation Convention, entered into force on 21 December 1993. Treaty is available at <https://www.gov.uk/government/publications/uganda-tax-treaties> (accessed 18-07-2016).

[205] Article 12 of the Double Taxation Agreement between the US and India, effective 1 January 1991. The article deals with "royalties and Fees for Included Services". The latter are defined in Article 12(4) to *inter alia* mean payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel). The treaty is available at <https://www.irs.gov/pub/irs-trty/india.pdf> (accessed 21-07-2016).

providers of technical services even if there is no physical presence in their country.[206]

In its BEPS Project, the OECD chose to deal with these concerns from a transfer pricing perspective. Under Action 10 of the BEPS Project, the OECD proposed revisions to Chapter VII of the transfer pricing guidelines to guide taxpayers on how to benchmark cross-border services so as to protect against common base-eroding payments. The guidance entails a simplified elective method for determining arm's length charges for common, low value-adding intragroup services which require a very limited profit mark-up on costs.[207] The approach excludes the detailed transfer pricing benchmarking of the benefits received, thereby creating a low-cost methodology for pricing low value-added services. These are defined as services that are supportive in nature; not part of the core business of the MNE; do not require the use or creation of unique and valuable intangibles; and do not involve the assumption or control of significant risk.[208] Examples of such services are: accounting and auditing; processing and management of accounts; human resources; monitoring and compilation of data; information technology; public relations support; legal and tax obligations; and services of an administrative or clerical nature.[209] Excluded services are those constituting the core business of the MNE; research and development; manufacturing and production; purchasing raw materials used in manufacturing or production; sales, marketing and distribution activities; financial transactions; extraction, exploration, or processing of natural resources; insurance and reinsurance; and services of corporate senior management.[210] The OECD suggests that where excessive charges for intra-group management services are considered to be a major BEPS challenge, a threshold can be applied whereby, for services that exceed the threshold, a full transfer pricing analysis is performed.[211] The OECD notes that for this approach to work, many countries need to agree to adopt it. The OECD would then design the structure of the threshold and address other implementation issues.[212] Although this simplified approach may address some of the challenges faced by source or African countries in applying transfer pricing provisions to low value-adding intragroup services, it does not resolve their concerns regarding the allocation of taxing rights.

7 Conclusion

This article demonstrated that from the time treaty rules were developed, the appropriate balance of taxing rights between residence and source countries has been contentious and it has lately become an even more focal question. It is therefore important that international tax reform measures should address the issues relating to the allocation of taxing rights between source

[206] Article 12A of the UN MTC.

[207] OECD/G20 *BEPS Project on Actions 8-10* 141.

[208] 153.

[209] 154.

[210] 154.

[211] 159.

[212] 142.

and residence countries. Attempts to apply piecemeal solutions to individual tax avoidance issues while ignoring this underlying fundamental issue will only serve to reduce BEPS to some extent. Endeavours to ensure MNEs pay their fair taxes in the countries in which they transact, need to acknowledge that source countries (mainly developing countries seeking foreign direct investment from MNEs) and residence countries (mainly developed countries where MNEs are most often based) often have opposing interests.

For an international tax system to ensure fair allocation of taxing rights from cross-border transactions, it should not be skewed towards protecting only the interests of residence countries. International cooperation in tax matters and calls for a more inclusive approach that takes into consideration the interests of developing countries on an equal footing, must be reflected in the policies and decisions made by the major role-players in the international tax arena. An international tax reform agenda that is one-sided may result in international tax anarchy as developing countries in which the MNEs invest may choose to develop their own approaches to protect their tax bases, which will have negative impacts on international trade.

SUMMARY

This article analyses the international tax principles in double tax treaties regarding the allocation of taxing rights between residence states and source states. The article explains that from the early twentieth century when international tax principles to prevent double taxation were developed, due to the differing interest of developed/residence (largely capital exporters) and developing/source (largely capital importers), there has been a struggle between countries for treaty taxing rights in their favour. History seems to indicate that international tax developments for allocating treaty taxing rights; initially by the League of Nations and then by the Organisation for Economic Cooperation and Development, favoured developed countries and that efforts of the United Nations to champion the case of developing countries have over the years been hampered by under-funding and lack of strong support from developed countries. Even the OECD's 2013-2015 Base Erosion and Profit Shifting ("BEPS") Project that purported to reform the international tax arena, neglected to deal effectively with matters pertaining to the allocation of taxing rights between residence and source countries. This article places particular attention on the treaty allocation rules that apply to the three types of income pertinent to developing countries (interest, royalties, and service fees) and how these are skewed in favour of developed/residence countries; thus affecting the tax bases of developing/source countries. In response, developing countries have devised measures to preserve their tax bases, which, in certain respects, diverge from current tax treaty principles. This article asserts that this state of affair is not conducive for international trade. The article highlights the dangers of an international tax system that promotes the interests of developed countries and argues for the reform of tax treaty principles, especially the allocation of taxing rights, to ensure a more equitable and effective international tax system.