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Double tax treaties

Could it be the right time for tax treaty renegotiation?

Each country has its own sovereign right to raise taxes, and own set of rules with regards to who is taxed, on what and at what rate. The right of a state to tax income, profits or gains sourced within its territory is commonly referred to as "source taxation". Unfortunately, the jurisdiction to tax is not limited by the geographical limits of the state - other factors such as "residence" of a person determines whether a person is liable to tax in a particular jurisdiction.

Generally, residents of a particular jurisdiction are taxed on their worldwide income. That is to say, profits derived from Tanzania will be taxed in Tanzania on the basis of "source taxation", and if such profits are derived by a person that is a resident of another jurisdiction then the same will also be taxed in that other jurisdiction on the basis of "residence taxation". This results in juridical double taxation. This needs to be distinguished from economic double taxation, which is not the subject matter of this article.

Inward investments by Multinational Enterprises ("MNEs") is a key driver of economic growth. It is therefore important to attract more inward investments. However, there is often a conflict between the interest of multi-national taxpayers who are mostly concerned about minimizing their global tax cost by way of reducing exposure to juridical double taxation and the interest of tax authorities which are more concerned about eliminating double non-taxation, tax evasion or aggressive tax avoidance.

To avoid juridical double taxation and to prevent fiscal evasion with respect to taxes on income, one measure that a country can take is to conclude an agreement on a bilateral basis with other countries. Such an agreement is interchangeably referred to as Double Tax Treaty or Double Tax Agreement, and is hereinafter referred to as "the DTA".

DTAs are concluded on a "balance of concessions" basis, with an overall aim of avoiding double taxation and preventing fiscal evasion with respect to taxes on cross border transactions. Ultimately, this promotes cross-border investment through minimization of tax obstacles among the treaty partner countries and prevention of cross-border tax avoidance. This is generally achieved through allocation of exclusive taxing rights between the treaty countries, providing for common resolution of disputes, invariably decreasing the tax burden on foreign income, exchange of tax information and transfer pricing adjustments - so that the adjustments may take place in both jurisdictions.

Currently, Tanzania has double tax treaties with nine (9) countries. These treaties (and the respective years they became effective in brackets) are Canada (1998), Denmark (1977), Finland (1979), India (1981), Italy (1974), Norway (1979), South Africa (2007), Sweden (1977) and Zambia (1964). From this, it is clear many of these tax treaties were concluded many years ago, with some of them being over 50 years. This raises the question as to whether they are still relevant today.

Over the years, Tanzania has seen tremendous economic development including the recent transition to a lower middle income status. The domestic tax legislation is being amended every year to cater for new developments and the need for increased tax collection. However, the tax treaties concluded many years ago have remained unchanged, creating incompatibilities with current developments, especially in light of the general principle that the provisions of a tax treaty generally prevail over the provisions of domestic law in the event of a conflict.

Working for KPMG's tax line of service, my primary interaction is with both taxpayers and the TRA, and in my opinion, the contentious issues in relation to double tax treaties is a clear reflection of the fact that some of these treaties may need to be renegotiated.

By way of an example, these treaties provides that the withholding tax rates of the source country applies on investment returns (such as dividends, interest and royalties) unless the DTA rate is lower. With the exception of Zambia treaty which reduces the withholding tax rates to virtually nil, the rest of the treaties give no withholding tax benefits at all since most of these treaties do not provide for withholding tax rates that are lower than the rates in the domestic legislation. Many of these treaties were relevant when the domestic withholding tax rates were much higher hence calls for a renegotiation to cater for current needs.

Generally, DTAs prevent double taxation by giving exclusive taxing right to one of the contracting states, and in most cases the country of source is given limited taxing rights. Tanzania, like many other developing countries, is often the source country and thus surrenders its taxing rights to developed countries which are resident countries of MNEs. Whilst this may be intended to attract inbound investments, it may be viewed as a conduit for tax avoidance by MNEs across tax jurisdictions. Given the country's improved overall technical position, especially the TRA's practical experience with taxpayer behaviour, I believe Tanzania is now well equipped to effectively negotiate and administer tax treaties that encourage international investments while protecting and enhancing the tax base in the country's best interest.

Renegotiation should build on practical experience and be structured to bridge the application gaps that cause disputes between taxpayers and the TRA. It should also leverage on the work of international sources such as the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, which provides practical guidance to treaty negotiators in developing countries. If not properly negotiated, tax treaties can adversely impact domestic tax revenue – often at a scale that might not have been intended or foreseen when the treaty was signed.

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