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The Design of a Corporate Income Tax System and How to Protect it for the East African Federation

Afton Leandre Titus

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**The Design of a Corporate Income Tax System and
How to Protect it
for the East African Federation**

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aan de Universiteit van Amsterdam
op gezag van de Rector Magnificus
prof. dr. ir. K.I.J. Maex

ten overstaan van een door het College voor Promoties ingestelde
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Afton Leandre Titus

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Summary

The East African Federation currently is an ideal of the six Partner States of the East African Community regional integration project. This study is premised on the basis that the East African Federation does come into existence. Moreover, this research is focused on the hard law approaches adopted internationally to the issues identified in this dissertation. It is argued that the relative clarity and certainty that such law provides would be of more use to the East African Federation than the flexibility and often-times uncertainty of soft law sources.

In the light of this, this dissertation designs the most important features of a corporate income tax system for the East African Federation and proposes mechanisms by which such tax base may be protected both on a national and international level. The corporate income tax was chosen because it continues to be an important source of revenue for African developing countries.

This study designs a classical corporate income tax base inspired by the European Commission's proposed common consolidated corporate tax base for the European Union. Corporate tax rules such as an interest limitation rule and controlled foreign company rules, derived from the provisions of the European Union's Anti-Tax Avoidance Directive which itself represents the implementation of the Actions produced under the OECD Base Erosion and Profit Shifting ('BEPS') project, are included in order to protect the corporate income tax base.

Further protection measures are provided through the design of a general anti-avoidance rule (GAAR) and a tax treaty policy for the East African Federation. The GAAR proposed in this thesis is constructed through the combination of elements from the existing GAARs in the East African Community Partner States and from the GAARs in the European Union's ATAD, and the Income Tax Acts in Canada and South Africa. The proposed tax treaty policy is a derivation of international best practices, focusing on meeting the challenges most developing countries face when concluding double taxation agreements – an issue also dealt with under Action 6 of the OECD BEPS project.

While this research may be premised on a fictional supranational organization, this study has present-day value in that it proposes how an African regional integration project may offer possible solutions to the rest of the world on how to successfully integrate several corporate income tax bases into one coherent and functioning tax base, competently supported by mechanisms designed to protect it.

Samenvatting

De Oost-Afrikaanse Federatie is momenteel een toekomstideaal van de zes partnerlanden van het regionale integratieproject van de Oost-Afrikaanse Gemeenschap. Dit onderzoek is gebaseerd op de veronderstelling dat de Oost-Afrikaanse Federatie daadwerkelijk zal ontstaan. Bovendien is dit onderzoek gericht op de 'hard law'-benaderingen die internationaal worden toegepast op de in dit proefschrift genoemde kwesties. Er wordt betoogd dat de relatieve duidelijkheid en zekerheid die dergelijke wetgeving biedt, nuttiger zou zijn voor de Oost-Afrikaanse Federatie dan de flexibiliteit en vaak onzekerheid van 'soft law'.

In het licht hiervan ontwerpt dit proefschrift de belangrijkste elementen van een vennootschapsbelastingstelsel voor de Oost-Afrikaanse Federatie en stelt het mechanismen voor waarmee een dergelijke belastinggrondslag zowel op nationaal als op internationaal niveau kan worden beschermd. De vennootschapsbelasting is gekozen omdat deze een belangrijke bron van inkomsten blijft voor Afrikaanse ontwikkelingslanden.

Deze studie ontwerpt een klassieke grondslag voor de vennootschapsbelasting geïnspireerd op de door de Europese Commissie voor de Europese Unie voorgestelde gemeenschappelijke geconsolideerde heffingsgrondslag voor de vennootschapsbelasting. Ook maatregelen zoals een renteaftrekbeperking en regels voor gecontroleerde buitenlandse lichamen, afgeleid van de bepalingen van de anti-belastingontwijkingsrichtlijn van de Europese Unie, die zelf een vertaalslag is van de Actiepunten in het kader van het OESO-project ter voorkoming van grondslaguitholling en winstverschuiving ('BEPS'), zijn opgenomen om de grondslag van de vennootschapsbelasting te beschermen.

Verdere beschermingsmaatregelen worden geboden door het ontwerpen van een algemene anti-misbruikregel (GAAR) en een belastingverdragbeleid voor de Oost-Afrikaanse Federatie. De in dit proefschrift voorgestelde GAAR is opgebouwd uit de combinatie van elementen uit de bestaande GAAR's in de partnerstaten van de Oost-Afrikaanse Gemeenschap en uit de GAAR's in de ATAD van de Europese Unie, en de inkomstenbelastingwetgeving in Canada en Zuid-Afrika. Het voorgestelde belastingverdragbeleid vindt zijn herkomst in internationale best practices, gericht op het aangaan van de uitdagingen waarmee de meeste ontwikkelingslanden worden geconfronteerd bij het sluiten van overeenkomsten ter voorkoming van dubbele belasting - een kwestie die ook wordt behandeld in Actiepunt 6 van het BEPS-project van de OESO.

Hoewel dit onderzoek is gebaseerd op een fictieve supranationale organisatie, heeft deze studie actualiteitswaarde. Het stelt namelijk voor hoe een Afrikaans regionaal integratieproject mogelijke oplossingen kan bieden aan de rest van de wereld over hoe verschillende vennootschapsbelasting-

grondslagen succesvol kunnen worden geïntegreerd in een coherente en functionerende belastinggrondslag, ondersteund door mechanismen die zijn ontworpen om deze te beschermen.

CHAPTER ONE: INTRODUCTION

1. RELEVANCE AND IMPACT OF THIS THESIS

The East African Community (EAC) is a regional integration project and supranational body consisting of six countries in East Africa: Burundi, Kenya, Rwanda, South Sudan, Tanzania and Uganda. The EAC was formed in 1999 and one of its aims is to form a common market across the six Partner States. While the common market and other economic integration steps - such as a customs union and monetary union - are not yet completely in place the EAC is making steady progress towards deeper economic integration within the East African region.

Ultimately, however, the six Partner States of the EAC aim to form a political federation. The goal of this study is to design the main features of the corporate income tax system of the East African Federation, once such federation is formed.

It is generally accepted that in order for a tax system to be effective, it should embody certain principles. These principles were first enunciated by Adam Smith in 1776 as: equality; certainty; convenience and efficiency.¹ Since then, the international community has confirmed the continued relevance of these principles and have added neutrality; simplicity; effectiveness; fairness; flexibility.² The main features of the corporate income tax system proposed in this dissertation has been designed with these foundational principles in mind.

In doing so, this dissertation forms part of a growing research area on the proposed federation of the EAC. For instance, Ogola et al. write that the EAC regional integration project holds great promise provided that the countries address the challenges to deeper integration in the region.³ Moreover, Adar critically analyses some of the steps taken towards ensuring deeper integration and makes his own recommendations as to how the EAC may move closer to a political federation.⁴ Ugirashebuja et al. have produced a seminal work exploring the close relationship between EAC law and European Union (EU) law while also commenting on the prospects of success of deeper integration in the EAC.⁵

¹ A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Cannan ed Methuen, London 1904) vol 2, 310-311.

² Committee on Fiscal Affairs, 'A Borderless World: Realising the Potential of Electronic Commerce' (1998) ('Ottawa Taxation Framework Conditions').

³ FO Ogola and others, 'A Profile of the East African Community' (2015) 1 *Africa Journal of Management* 333.

⁴ KG Adar, 'Fast Tracking East African Political Federation: The role and limitations of the East African Legislative Assembly' (2008) 37 *Africa Insight* 76.

⁵ E Ugirashebuja, and others (eds), *East African Community Law: Institutional, Substantive and Comparative EU Aspects* (Brill 2017).

This study locates itself as contributing towards the literature on the proposed East African Federation while also situating itself as filling the gap in the literature on identifying and analysing the corporate income tax policy of developing countries. Corporate income tax is an important source of revenue for developing countries, despite its declining importance in developed countries.⁶ It has been noted that while extensive analysis exists on developed countries' corporate income tax policies, very little analysis has been conducted on the corporate income tax policies of developing countries.⁷ As far as the author is aware, the author is the only researcher designing a corporate income tax policy for the East African Federation.

This positioning may raise questions as to why others are not contributing to this field and whether the research conducted in this study is relevant. The author is of the view that many researchers have not considered what the tax implications may be for the East African Federation once it is formed because many believe that the political federation may never come into existence. As such, it may be argued that is unrealistic, far-fetched or even overly-ambitious to imagine that the East African Federation may be created given the significant challenges and obstacles to the political federation becoming a reality. These challenges include the continued armed conflict in South Sudan and its neighbouring Sudan which brings political instability to the East African region and the EAC;⁸ the growing political tension and distrust between Rwanda, Uganda and Burundi;⁹ and the unlikely prospect that sovereign countries would surrender their sovereignty in order to be subsumed in a political federation. Moreover, it may be argued that prioritising aspects of a political federation (namely, the design of a corporate income tax system) over the customs union, common market and monetary union, without which a political federation is arguably inconceivable, appears premature.

In response to this, the author argues: first, it is difficult to say what is 'far-fetched' or 'unrealistic' nowadays. No doubt many believed the prospect of a 'Brexit' to be far-fetched and unlikely and yet it came about. Likewise, many believed that the

⁶ AW Oguttu, 'Tax Base Erosion and Profit Shifting in Africa – Part 1: What Should Africa's Response be to the OECD BEPS Action Plan?' (2015) 48 *The Comparative and International Law Journal of Southern Africa* 516, 526.

⁷ PL Baker, 'An Analysis of the Corporate Income Tax Policy of Less Developed Countries' (2018) 120 *Scandinavian Journal of Economics* 400.

⁸ A Woodard, 'How Lust for Power is Fueling Armed Conflict in South Sudan' (29 November 2018) *African Liberty* < <https://www.africanliberty.org/2018/11/29/south-sudans-peace-deals/>> accessed 21 July 2019; A Yuhas, '100 Killed in Sudan and Dozens of Bodies Are Pulled From Nile, Opposition Says' (4 June 2019) *New York Times* < <https://www.nytimes.com/2019/06/04/world/africa/sudan-war-facts-history.html>> accessed 21 July 2019.

⁹ G Matsiko, 'Feud between Kagame, Museveni Takes Toll' (15 May 2019) *Mail & Guardian* < <https://mg.co.za/article/2019-05-15-feud-between-kagame-museveni-takes-toll>> accessed on 21 July 2019.

prospect of Donald Trump becoming the president of the United States of America was unlikely, and yet that happened. The author's view is that if researchers had perhaps devoted more time towards preparing for the 'far-fetched' and 'unlikely', perhaps the world would be enjoying more certainty in global affairs than it is now. Secondly, the author argues that the purpose of research generally is to interrogate the idea of what is 'far-fetched' and 'unlikely'. This thesis is undertaking exploratory research into the hypothetical or theoretical East African Federation and its possible tax implications. Moreover, the purpose of this dissertation is to create a foundation in terms of which the East African Federation could in reality be built.

Thirdly, the author is of the view that the focus on the tax aspects of the East African Federation is not premature. The comment above assumes that the political federation would be created as a result of a 'spillover'¹⁰ effect after the customs union, common market and monetary union has been created.¹¹ The customs union, common market and monetary union are all economic integration efforts while the formation of the federation would be political integration. The author is not alone in questioning how economic integration is to transform into political integration.¹²

However, the comment does have merit in so far as it highlights the fact that integration is slow in the region. The author is of the view that that economic integration is sluggish in the EAC because of a lack of political will. The author further argues that some of the reasons why such political will is lacking at the moment may be because of uncertainty regarding the loss of tax sovereignty along with the issue of where such tax sovereignty will reside in the proposed federation. The author acknowledges that a political federation cannot be formed without the required political will. The most effective integration efforts come about through a combination of political will and economic integration.¹³ This research seeks to spur on further integration efforts by providing recommendations to lessen the uncertainty around corporate income tax issues and the East African Federation. Moreover, it is hoped that this dissertation will spur deeper integration as this study argues that the East African Federation and the design of the corporate income tax system may benefit all stakeholders in the EAC through the possible collection of more corporate income tax. This could be done through the broadening of the corporate income tax base further than is currently the case in the EAC Partner States; reducing the informal sector and introducing a general anti-

¹⁰ HB Hamad, "'Neo-functionalism': Relevancy for East African Community Political Integration' (2016) 9 *Africology: The Journal of Pan African Studies* 69, 73.

¹¹ *Ibid.*

¹² *Ibid.*

¹³ *Ibid.*

avoidance rule (GAAR) to protecting the corporate income tax base.

This dissertation should therefore be seen as pure policy research in that it is the production of knowledge that is aimed at guiding practice while any possible changes to the reality (the reality being that the East African Federation does not currently exist) will occur independently of, and subsequent to, this research process.¹⁴ This study is therefore prospective in nature, and holds value in that it posits recommendations or steps which may yet bring about the reality which today may appear to be unlikely. The author is also of the view that given the forward-looking nature of this research, it is inappropriate to contain this work to the limitations of the present-day challenges facing the EAC regional integration project in its current form. Moreover, the author is not alone in the view that the discussion of the hypothetical East African Federation has value. Mshomba argues that there should be more discussion about a potential East African Federation and opines: ‘Making people aware of the proposed political integration, identifying fears and concerns, and suggesting ways to address them, as the EAC Secretariat does, is extremely important.’¹⁵

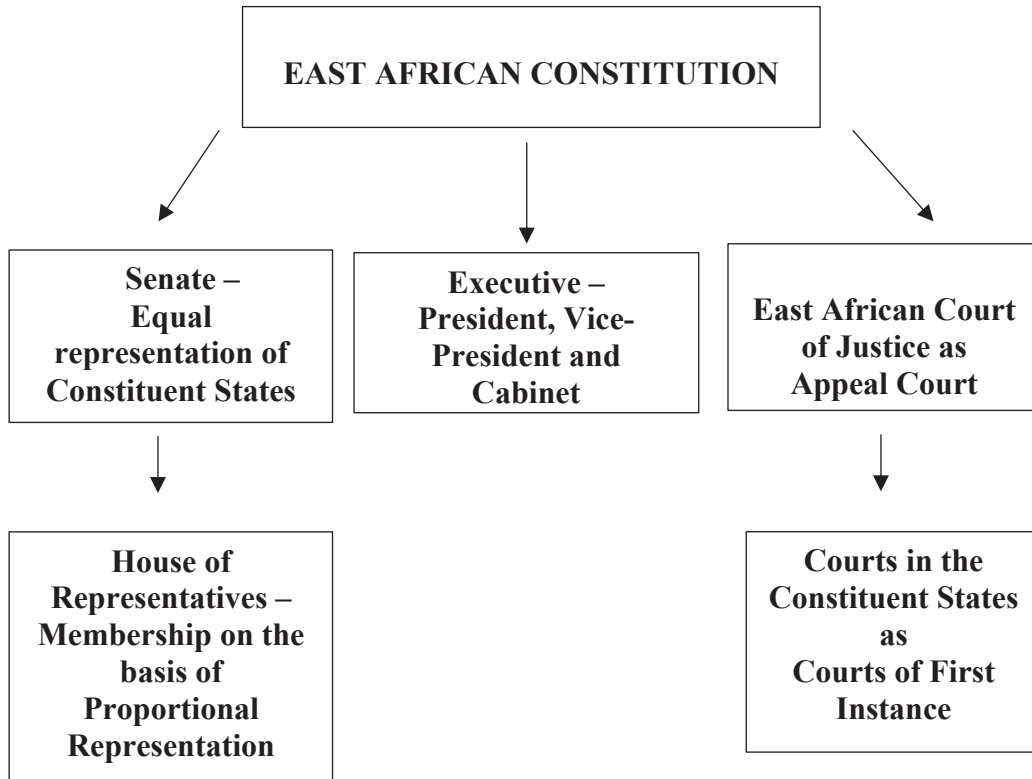
2. LIMITATIONS OF THIS STUDY

This dissertation is premised on the future position that the East African Federation has come into existence. The exact structure and positioning of authority of this federation, as based on the EAC vision of its federation,¹⁶ is represented in Figure 1 below:

¹⁴ P Oquist, ‘The Epistemology of Action Research’ (1978) 21 *Acta Sociologica* 143, 145.

¹⁵ R.E. Mshomba, *Economic Integration in East Africa: The East African Community in Comparative Perspective* (Cambridge University Press 2017) 175.

¹⁶ East African Community, *Towards Political Federation in the East African Community Achievements and Challenges* (EAC 2014) 12 – 15.

Figure 1: Proposed East African Federation

As indicated above, the East African Federation is to be governed by three powers – the Executive, the Judiciary and the Legislature. The existing Partner States are to become provinces of the East African Federation, called Constituent States. They are to be represented in the Legislature through the Senate. Moreover, the national courts of the Partner States are to become courts of first instance before matters are heard at the East African Court of Justice. It is envisaged that all laws of the East African Federation would be subject to the East African Constitution.

In terms of the limitations of this study, the analysis conducted in Chapter 3 is not intended to be a comprehensive study of the intricacies of the corporate income tax systems of the EU Member States. The author has selected aspects of these corporate income tax systems which would be most suited for the East African Federation context. In this regard, the author has provided justification for the selections made in the text of Chapter 3 as the selections arise. These justifications relate either to the objectives the corporate income tax is to achieve in the East African Federation and to the corporate rules geared towards the protection of the corporate income tax base. The author is aware that a myriad of further influences exist that shape the formation and operation of the corporate income tax systems in the EU Member States. These influences include the

effect of the EU state aid provisions,¹⁷ the Code of Conduct¹⁸ and the broad impact of the OECD BEPS project.¹⁹ A detailed analysis of these influences, however, is simply beyond the scope of this thesis.

Chapter 4 encompasses the use of South Africa and Canada as comparators for the purposes of designing a GAAR for the East African Federation. These countries do not feature as comparators in the rest of this thesis. The reason for the wider comparison analysis conducted in the GAAR design is because of the universal nature, design and purpose of GAARs as they are applied in many countries. GAARs all fulfil the same purpose in any country in which they are found – that is, to protect the tax base against the unintended consequences arising from the interpretation of fiscal legislation. GAARs are therefore different from other tax rules in that other tax rules cannot so easily be analyzed across jurisdictions because these tax rules must be understood in the context of the whole tax system of the country in which they are found.²⁰ The nature of a GAAR comparative analysis therefore allows the author to incorporate a wider selection of comparators than the other tax rules discussed in this thesis would allow. In the light of this argument, it may be countered that CFC rules are also universal in their purpose and application across countries and perhaps the author should at least have considered an analysis of South Africa's CFC rules in Chapter 3 given that South Africa is also a developing country. South Africa was not used as a comparator because its CFC rules are overly complex and restrain South Africa's competitiveness in attracting foreign direct investment.²¹ The author takes the view that there is no point in using comparator countries just for the sake of comparison and therefore South Africa – and also for that matter Canada – are not incorporated in the discussion in Chapter 3.

The discussions made in Chapter 5 are based on the assumption that the East African Federation would likely be a net capital exporter as many developing countries are,²² and thus it would be appropriate and likely that the East African Federation would implement measures to ensure capital import

¹⁷ Consolidated Version of the Treaty on the Functioning of the European Union, OJEU C 326/47 (2012), article 107.

¹⁸ *Code of Conduct for Business Taxation* [1998] OJ C 2/4, sections C & D.

¹⁹ OECD, *Executive Summaries 2015 Final Reports* OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2015).

²⁰ BJ Arnold, 'A Comparative Perspective on the U.S. Controlled Foreign Corporation Rules' (2012) 65 *Tax Law Review* 473, 474.

²¹ Davis Tax Committee, *Second and Final Report on Base Erosion and Profit Shifting for the Minister of Finance* (2016) 33 < <https://www.polity.org.za/article/davis-tax-committee-final-reports-2017-11-13> > accessed 22 July 2019.

²² ECCM Kemmeren, 'Legal and Economic Principles Support an Origin and Import Neutrality-Based over a Residence and Export Neutrality-Based Tax Treaty Policy' in M Lang and others (eds), *Tax Treaties: Building Bridges between Law and Economics* (IBFD 2010) 4.7.

neutrality.²³ Such a position would affect the East African Federation's decisions regarding withholding tax rates and any exemptions offered non-residents. Moreover, as the analysis in this chapter makes reference to the term 'source', the author is aware of that this term is an amorphous term and is capable of many meanings.²⁴ It is beyond the scope of this thesis to delve into all the possible meanings of 'source' and its interface with the 'origin' concept. When referring to source in Chapter 5, the author intends for the widest possible meaning to be attributed to the meaning of the term. Source is therefore taken to mean both that it encompasses 'the activity, right or property that generates, or may generate, income'²⁵ and 'income that physically appears from that State even though the income is not generated within that State.'^{26,27}

The author is aware that the discussions and recommendations regarding the administrative capacity challenges that feature throughout this thesis may be seen as conflicting with the earlier argument made that this thesis should not be limited by the present-day challenges that face the EAC regional integration project. The author takes the stance that there is no such conflict. The administrative capacity constraint is a challenge that would continue to test the East African Federation throughout its existence. Moreover, this challenge currently exists while the parties act as EAC Partner States and would continue to exist should the parties act as the East African Federation. As such, the author takes the position that administrative capacity constraints would most likely be as much a concern to a developing country in future as they are now. The other class of challenges discussed earlier, however, would have had to be resolved in order for the East African Federation to come into existence in the first place. These challenges therefore do not have a place in the discussions undertaken in this study.

With a view to the future, the author is of the view that the research conducted in this thesis may give rise to the following areas for further research: In terms of chapter 3, it may be interesting to consider what the East African Federation may

²³ Capital import neutrality seeks to provide neutrality in the way local and foreign investors are taxed - KJ Holmes, 'Chapter 1: International Tax Policy' in *International Tax Policy and Double Tax Treaties – An Introduction to Principles and Application* (2nd revised edn IBFD 2014) 1.4.2.

²⁴ JF Avery Jones, 'Tax Treaty Problems Relating to Source' (1998) 3 *British Tax Review* 222, 223.

²⁵ Andean Community, *Income and Capital Model Tax Treaty* (1971), art 2(e).

²⁶ Kemmeren (n22) 3.3.1.5.1.

²⁷ The illustrative example provided by Kemmeren (ibid) is useful here: A dividend is distributed by a company resident in country A from the profits generated from activities conducted in country B. In terms of this example, the dividend income physically appears in country A and is thus sourced there, but it was generated from activities conducted in country B which may be considered the origin of the income.

learn from other EU initiatives, such as the Code of Conduct and the EU implementation of the other BEPS Actions. Chapter 4 may give rise to further research regarding an analysis of how GAARs work in developing countries and what lessons this may hold for the East African Federation. The discussion in Chapter 5 may give rise to further research regarding what meaning of source would be best suited to the East African Federation context.

3. METHODOLOGY

This study answers the following research questions: What corporate income tax policy decisions should policy officials of the East African Federation make in designing a corporate income tax system for the federation? Moreover, what measures should the East African Federation adopt to protect the corporate income tax base?

In doing this, this dissertation focusses on the hard law approaches taken internationally in the design and protection of corporate income tax bases. Such a hard law focus would more readily assist the East African Federation in creating greater legal certainty and clarity as it legislates, something which would be vital for a new country. In such circumstance, the East African Federation cannot afford to offer the flexibility of soft law approaches as this would likely undermine legal certainty. However, this study will on occasion refer to soft law sources – such as OECD materials – in instances where the author is of the view that such materials may be useful in a developing country context and where it is of relevance to this study.

The following methodology has been adopted in this dissertation: Chapter 2 details the similarities between the EAC regional integration project and the regional integration project from which the EAC has drawn inspiration, the EU. This is done because the author is of the view that tax policy decisions cannot be made in a vacuum. It is therefore key to understand the workings of the EAC regional integration project – its past, future and aspirations – in order to understand the broader context in which the East African Federation's will operate.

Once this context is detailed, Chapter 3 sets out the policy analysis involved in the design of the key components of a corporate income tax system for the East African Federation.²⁸ This chapter is the foundational chapter of this research as it details the corporate income tax system that is to be protected through the mechanisms developed in Chapters 4 and 5. Moreover, the research in Chapter 3 directly contributes to

²⁸ Chapter 3 builds on ideas explored in research that has been pre-published and may be found at: A Titus, 'How Can the East African Community Guard Against Base Erosion and Profit Shifting While Working Towards Deeper Integration? Lessons from the European Union' (2017) 9 *World Tax Journal* 565.

towards the building of literature on the analysis of corporate income tax policy-making in a developing country. In doing this, the chapter details the policy objectives the corporate income tax in the East African Federation is to achieve and recommends how best these may be met.

The design of a corporate income tax system is, however, only the first step. The next step is to protect the corporate income tax base from the sometimes ingenious methods taxpayer's employ to take advantage of unintended consequences arising from the implementation of corporate income tax legislation. Some countries choose to protect the tax base through specific anti-avoidance rules. Such rules tend to be extremely technical and in so doing unintentionally leave further room for unintended consequences. Also, these rules often outgrow their usefulness as other legislative loopholes are discovered. This has led to the global phenomenon known as 'GAAR Rising' in which general anti-avoidance rules (GAARs) are ever increasingly being used by countries as a means to combat aggressive tax avoidance schemes.²⁹ In this spirit, Chapter 4 designs a GAAR for the East African Federation.³⁰ This GAAR is rooted in the legal context already in place in the EAC but is also current, modern and apace with international tax practices. A GAAR is important because it would be pointless to design a corporate income tax system without taking cognizance of the threats to such a system – both on a national and international level.

While the GAAR in Chapter 4 addresses the national concerns, Chapter 5 addresses the international concerns. A globalized world means that no corporate income tax system operates independently anymore. Instead, countries and their corporate income tax systems are becoming increasingly interconnected as cross border trade and investment grows. Because of this, the East African Federation should also have a tax treaty policy in place in order to further protect its corporate income tax base. Chapter 5 designs such a policy.

In conducting the above analysis, the author has adopted the comparative-functional approach.³¹ This approach has been adopted because the author is aware of the need to propose recommendations that would both address the legal aspects of

²⁹ Ernst and Young, *GAAR Rising: Mapping Tax Enforcement's Evolution* (2013); RE Krever, 'Chapter 1: General Report: GAARs' in M Lang and others (eds), *GAARs – A Key Element of Tax Systems in the Post-BEPS Tax World* (IBFD 2016).

³⁰ This chapter builds on the ideas explored in research that has been pre-published and may be found at: A Titus, 'Designing a General Anti-Avoidance Rule for the East African Community – A Comparative Analysis' (2019) 11 *World Tax Journal* 261.

³¹ C Garbarino, 'Comparative Taxation and Legal Theory: The Tax Design Case of the Transplant of GAARs' (2010) 11 *Theoretical Inquiries in Law* 765; J van der Pas, 'Improving the Chinese Anti-Avoidance Rule: A Comparative and Functional Approach' (2016) 8 *World Tax Journal* 79.

designing a corporate income tax system, GAAR and tax treaty policy for the East African Federation as well as the operational aspects which would consider the implementation of these measures. The EAC Partner States are all developing states, some of whom have been classified as some of the least developed states in the world. This thesis would therefore not be complete if the author did not specifically address how the East African Federation may tackle the significant capacity concerns and infrastructural drawbacks the region is facing.

Chapter 6 concludes this thesis by providing a summary of the main arguments made and identifying further areas for possible research. The chapter also details the contribution this thesis has made to the literature on how best to design and protect a corporate income tax system for a developing country.

CHAPTER TWO: INSTITUTIONAL DESIGN OF THE EUROPEAN UNION AND THE EAST AFRICAN COMMUNITY

1. INTRODUCTION

Although many would think that globalization and its effects is a modern phenomenon, it has been noted that this was a subject that was under discussion in ancient Greece as ancient historians described an inter-connected era when cross-border trade and investment would flourish.¹ The interconnected era in which the world currently operates has created an interdependence amongst people and amongst countries. Developing and developed countries have seen the necessity in harnessing the power of interdependence to form regional integration projects in a bid to encourage economic growth.² One of the purposes of the economic merging is to create larger markets, which brings benefits such as encouraging competition and creating diversity in goods and services.³ The European Union (EU) and the East African Community (EAC) are two regional integration projects who have the route of economic convergence to create larger, more accessible markets and thereby stimulate economic development within their regions.

The objective of this chapter is to analyze the European and East African integration projects in their current states in order to address the following questions: What prompted the integration in the EU and the EAC? How similar are the institutional steps taken in the EU and EAC to bring about meaningful integration? And, what is the way forward for these regional integration projects? These questions form an important backdrop to the deeper analyzes undertaken in the following chapters on the fiscal aspects of the European and East African Federation.

In meeting this objective, this chapter is structured as follows: The common factors which initiated the integration efforts in the EU and the EAC are determined in Part 2. This is followed by a discussion in Part 3 of the similarity and differences in the steps taken by the EU and EAC in forming the institutions that carry out the integration objective. Part 4 sets out the possible future prospects of the EU and EAC in

¹ AJ Cockfield, 'Introduction: The Last Battleground of Globalization' in AJ Cockfield (ed), *Globalization and Its Tax Discontents: Tax Policy and International Investments* (University of Toronto Press 2010); see RB Strassler (ed), *The Landmark Herodotus, The Histories* (AL Purvis (tr), Pantheon Books 2007).

² A Tharani, 'Harmonization in the EAC' in E. Ugirashebuja and others, *East African Community Law: Institutional, Substantive and Comparative EU Aspects* (Brill 2007), 486.

³ Ibid 487.

implementing their regional integration aims before the chapter concludes.

2. COMMON FACTORS THAT PROMPTED INTEGRATION IN THE EUROPEAN UNION AND EAST AFRICAN COMMUNITY

For both the EU and the EAC, integration is an old idea that features strongly in the history of both regional integration organizations. Both organizations are preceded by a litany of treaties seeking to create meaningful integration while also aiming to turn the proximity of the countries involved into a strength and not an encouragement for armed conflict. This section will draw out the similarities in the regional development strategies employed by the EU and the EAC as revealed by their histories.

One of the biggest drivers towards integration for the EU was the devastation brought to the region in the wake of two World Wars.⁴ The dire consequences of allowing nationalism, weapons and an absolutely sovereign country to meld together began to create the narrative that wars could be avoided through integration.⁵ Economic integration was chosen because it was believed that the economy is the driving force of an effective government.⁶ More practically, however, the amalgamation of important industries would most effectively dismantle a country's ability to wage war with its economic partner.⁷

This strategy saw the creation of the European Coal and Steel Community (ECSC) in 1952.⁸ This was soon followed by the creation of two supranational⁹ organizations – the European Atomic Agency (EAA)¹⁰ and European Economic Community (EEC) in 1957.¹¹ Even though these treaties initially had only six signatory countries, integration was growing apace as the idea of a common market had now expanded from coal and steel to the

⁴ S Kone, 'Is Economic Integration between Developing Countries a Singular Process?' (2012) 27 *Journal of Economic Integration* 386, 403; A Cuyvers, 'The Road to European Integration' in E Ugirashebuja and others, *East African Community Law: Institutional, Substantive and Comparative EU Aspects* (Brill 2017), 25.

⁵ Cuyvers (n4) 25.

⁶ P Allott, 'The European Community is Not the True European Community' (1991) 100 *Yale Law Journal* 2485, 2493.

⁷ Cuyvers (n4) 28.

⁸ Treaty establishing the European Coal and Steel Community (Paris, 18 April 1951).

⁹ The term 'supranational' refers to the 'centralized and centralizing features of the institutional structure of the European Union' as per R Goebel, 'Supranational? Federal? Intergovernmental? The Governance Structure of the European Union After the Treaty of Lisbon' (2013) 20 *Columbia Journal of European Law* 77, 82.

¹⁰ Treaty establishing the European Atomic Energy Community (Rome, 25 March 1957).

¹¹ Treaty establishing the European Economic Community (Rome, 25 March 1957).

entire economy.¹² Further integration was achieved, after a period of political stagnation brought about through the Luxembourg Accords,¹³ through the adoption of the Single European Act in 1986.¹⁴ This treaty placed a more economic focus on European integration; namely, the completion of the single market,¹⁵ which served to propel the forward momentum of the integration project.¹⁶

The Treaty of Maastricht in 1992¹⁷ was the next important step towards European integration.¹⁸ At this stage, integration encompassed more than just the economy and now also included the creation of a Common Foreign and Security Policy (CFSP) and Justice and Home Affairs (JHA) – two intergovernmental¹⁹ organizations. On the economic front, the EEC was replaced with the European Community (EC) which continued to operate as a supranational organization. These three organizations worked together to create the European Union. The Maastricht Treaty also began the path towards the formation of the European Monetary Union.²⁰ This steady forward momentum was abruptly curtailed some twelve years later through the spectacular failure of the Treaty Establishing a Constitution for Europe in 2005.²¹ Despite the reluctance of Europeans to create a European Constitution, the European integration project moved forward in 2009 through the adoption of the Treaty of Lisbon.²² The current European Union and its framework was created through this treaty and replaced the former EC.²³ The Lisbon Treaty saw the removal of the CFSP, JHA and EC that had previously worked together to form the European Union and the collapsing of their functions into largely one organization.²⁴

Similar to the initial driver of integration for the EU, armed conflict also brought home the need for the EAC Partner

¹² D Vataman, 'History of the European Union' (2010) 2 *Lex Et Scientia*, Juridical Series 107, 116.

¹³ For more on this see: Cuyvers (n4) 29.

¹⁴ The Single European Act (Luxembourg, 17 February 1986) [SEA Treaty].

¹⁵ Art 13 SEA Treaty.

¹⁶ Cuyvers (n4) 29.

¹⁷ Treaty on the European Union (Maastricht, 7 February 1992) [Maastricht Treaty].

¹⁸ Cuyvers (n4) 30.

¹⁹ The term 'intergovernmental' refers to the 'retention and exercise by Member States of their autonomous sovereign power in acting upon legislation, setting policies or taking decisions' as per Goebel (n9) 82.

²⁰ EMU provision in Maastricht Treaty.

²¹ Treaty Establishing a Constitution for Europe (Unsigned, 16 December 2004).

²² Treaty of Lisbon (Lisbon, 13 December 2007).

²³ Cuyvers (n4) 32.

²⁴ Although external policy is still governed by the Common Foreign and Security Policy under Title V of the TEU. For more on this, see A Cuyvers, 'External Relations and the EU' in E Ugirashebuja and others, *East African Community Law: Institutional, Substantive and Comparative EU Aspects* (Brill 2017), 196.

States to integrate in order to encourage economic development and in so doing bring about peace. The history of the East African region is marred by both civil wars and interstate wars. Uganda and Tanzania were at war with each other from 1978 to 1979 which saw the removal of Idi Amin from power.²⁵ More recently, Rwanda was racked by internal armed conflict from 1990 to 1994²⁶ and South Sudan has just emerged from its bloody civil war which raged from 2013 to 2018.²⁷ With the signing of the Treaty Establishing the East African Community in 1999,²⁸ a strategy similar to that of the EU was adopted. This was to seek meaningful regional integration through economic integration. Also similar to the EU, the formation of a common market is an important component of the EAC's regional integration project.²⁹ Integration within the EAC was initially moving at some pace. It signed its custom union protocol in 2005,³⁰ which became operational in 2010.³¹ Then, it signed its common market protocol in 2009,³² which came into effect in 2010.³³ This was followed by the signing of its monetary union protocol in 2013,³⁴ which entered into force in 2014.³⁵ However, none of these integration steps have actually been fully completed yet. At present, the EAC seems to be losing some its momentum.³⁶

The establishment of its common market has had only partial success in that the free movement of capital has been widely implemented while the free movement of persons across the EAC is still to be realized.³⁷ Also, political tensions continue to

²⁵ For more on this see G Roberts, *The Uganda–Tanzania War, the Fall of Idi Amin, and the Failure of African Diplomacy, 1978–1979* (2014) 8 *Journal of Eastern African Studies* 692.

²⁶ A Lema (2000) 'Causes of Civil War in Rwanda: The Weight of History and Socio-Cultural Structures' in E Braathen, M Bøås and G Saether (eds), *Ethnicity Kills?* (Palgrave Macmillan 2000), 68.

²⁷ J Young, *South Sudan's Civil War: Violence, Insurgency and Failed Peacemaking* (Zed 2019).

²⁸ Treaty establishing the East African Community (Arusha, 30 November 1999) [EAC Treaty].

²⁹ Art 76 EAC Treaty.

³⁰ Protocol for the Establishment of the East African Community Customs Union (2 March 2004).

³¹ East African Community, *East African Community Vision 2050: Regional Vision for Socio-Economic Transformation and Development* (EAC 2015) 15.

³² Protocol on the Establishment of the East African Common Market (20 November 2009).

³³ East African Community *Vision* (n31) 16.

³⁴ Protocol on the Establishment of the East African Monetary Union (30 November 2013).

³⁵ East African Community *Vision* (n31) 16.

³⁶ J Rwagatare, 'Is East African integration slowing down?' (21 March 2017) *The New Times* <<http://www.newtimes.co.rw/section/article/2017-03-21/209247/>> accessed 27 June 2019.

³⁷ B Biyers, J Vanheukelom and CKM Kingombe *A Five Lens Framework for Analysing the Political Economy in Regional Integration* (2015) Discussion Paper No. 178, European Centre for Development Policy

simmer between Kenya and Tanzania amid fears that Kenya may once again reap the lion's share of benefits from the integration project.³⁸ Some have commented that the EAC integration has been slow and that the EAC has failed to integrate as it had hoped.³⁹ Some Partner States are more eager to integrate than others. This has led to smaller groupings being formed within the EAC as political agendas diverge. A "Coalition of the Willing" was formed between Kenya, Rwanda and Uganda as these Partner States sought to fast-track integration.⁴⁰ Tanzania has been tagged as seeking to slow down the integration process along with Burundi.⁴¹ Tanzania's current stance is particularly ironic given its fervour in the 1960's to push for the formation of a federation in East Africa between the initial members of the EAC – itself, Kenya and Uganda.

Political tensions continue to simmer between Kenya and Tanzania amongst fears that Kenya will once again dominate the regional integration project.⁴² Kenya is pushing for deeper regional integration now that it has found a destination for the exportation of its goods in the other EAC Partner States.⁴³ Tanzania, on the other hand, would much prefer a more superficial integration effort so as to accommodate its commitments to other regional projects.⁴⁴ The power dynamics within the EAC may also be set to change in future as Tanzania devotes more resources to developing its gas industry,⁴⁵ Kenya works towards realizing its aim of becoming a global oil

Management 16; C Kago and W Masinde, 'Free Movement of Workers in the EAC' in E Ugirashabuja and others (eds), *East African Community Law: Institutional, Substantive and Comparative EU Aspects* (Brill 2017) 352.

³⁸ E Verhaeghe and C Mathison, *Understanding the East African Community and its Transport Agenda: Informal Adaptation in Regional Trade and Transport Cooperation* (2017) Discussion Paper, European Centre for Development Policy Management <<http://ecdpm.org/wp-content/uploads/EAC-Background-Paper-PEDRO-Political-Economy-Dynamics-Regional-Organisations-Africa-ECDPM-2017.pdf>> accessed 28 June 2019.

³⁹ Ibid; PR Masson, C Pattillo and X Debrun, 'The Future of African Monetary Geography' in C Monga and JY Lin (eds), *The Oxford Handbook of Africa and Economics – Volume 2: Policies and Practices* (Oxford University Press 2015) 92.

⁴⁰ Biyers (n37) 13.

⁴¹ HB Hamad, "'Neo-functionalism': Relevancy for East African Community Political Integration' (2016) 9 *Africology: The Journal of Pan African Studies* 69, 76.

⁴² Verhaeghe and Mathison (n38).

⁴³ Ibid 10.

⁴⁴ Ibid.

⁴⁵ See D Ledesma, *East Africa Gas – Potential for Export*, Discussion Paper, Oxford Institute for Energy Studies (2013) <<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2013/03/NG-74.pdf>> accessed 28 June 2019; B Rwegasira, 'Why Liquefied Natural Gas Will Enhance Business in Tanzania' *Daily News* (14 July 2017) <<https://dailynews.co.tz/news/2018-07-145b49d6f1017e6.aspx>> accessed 28 June 2019.

producer,⁴⁶ and Uganda grows its own oil industry.⁴⁷ It is predicted that these developments may make these three States net energy exporters and possibly even place them as middle-ranked global energy exporters.⁴⁸ Should this happen, it would be interesting to see whether these successes would draw the EAC Partner States closer together or drive them further apart.

The East African region, however, cannot afford to have yet another regional integration project fail. Similar to the EU and its history, the EAC is the latest attempt at meaningful regional integration in a long line of such attempts. Historically, Kenya, Uganda and Tanzania have been tied together for some time. These countries were initially connected through the efforts of the British colonialists in 1902 who coordinated the systematic exploitation of the region.⁴⁹ In so doing, infrastructural development in Kenya was prioritized because of Kenya's link to the sea.⁵⁰ As a result, the infrastructure in Uganda and Tanzania became inextricably linked to Kenya.⁵¹

In the post-colonial era, the three countries remained linked and formed the East African Co-operation in 1967. Uganda and Tanzania had hopes that this regional integration project would result in a more even spread of benefits amongst the nations.⁵² However, this was not to be, and this integration effort dissolved ten years later. The reasons for the dissolution include the three Heads of State failing to reach agreement on key issues with no provision in place to resolve disputes;⁵³ dissatisfaction that Kenya continued to benefit the most from integration;⁵⁴ and Uganda and Tanzania still being used mainly as conduits to the marketplaces in Kenya.⁵⁵

⁴⁶ See KM Agade, 'Ungoverned Space' and the Oil Find in Turkana, Kenya' (2014) 103 *The Round Table: The Commonwealth Journal of International Affairs* 497; J Kiplang'at & S Lutta, 'Kenya Beats All Odds to become the First EA Nation to Export Oil' *Daily Nation* (4 June 2018) <<https://www.nation.co.ke/news/Kenya-beats-odds-to-become-the-first-EA-nation-to-export-oil/1056-4594216-jb6glmz/index.html>> accessed 28 June 2019.

⁴⁷ See A Witte, *An Uncertain Future – Anticipating Oil in Uganda* (Göttingen University Press 2018); 'Uganda Targets New Oil Storage Facility' *Business Day* (13 July 2018) <<https://www.businesslive.co.za/bd/world/africa/2018-07-13-uganda-targets-new-oil-storage-facility/>> accessed 28 June 2019.

⁴⁸ Masson and others (n39) 105.

⁴⁹ A Awori, 'Seeking Regional Economic Cooperation in Africa' (1992) 46 *Journal of International Affairs* 119, 120.

⁵⁰ DAK Mbogoro, 'The East African Community: An Economic Analysis of the Integration Scheme' (1978) 8 *African Review* 54, 55.

⁵¹ S Fitzke, 'The Treaty for East African Co-Operation: Can East Africa Successfully Revive One of Africa's Most Infamous Economic Groupings?' (1999) 8 *Minnesota Journal of Global Trade* 127, 132.

⁵² Mbogoro (n50) 54.

⁵³ Fitzke (n51) 139.

⁵⁴ N Mwase, 'Regional Economic Integration and the Unequal Sharing of Benefits: Background to the Disintegration and Collapse of the East African Community' (1978) 8 *African Review* 28, 31.

⁵⁵ Fitzke (n51) 138.

While the three countries broke off from formal integration efforts in 1977, they continued to develop close relations. In 1999, the three countries again formed a commitment to seek deep regional integration with the signing of the EAC Treaty. This integration plan is different to its predecessors in that it aims to eventually form a federation – an ambitious endeavour that is likely driven by the costly dissolutions of the previous integration efforts.

The EAC Treaty also bears indicators that the EAC has learned from the shortcomings of the 1967 integration attempt. This is reflected in the following: a) the staggered approach adopted towards integration; b) the decentralization of powers to the Council of Ministers from the Summit in order to avoid the concentration of decision-making power in the Summit; c) a focus on the co-ordination of policies in order to avoid imbalances in development and benefits; d) recognition that unity cannot be achieved without the people and accordingly provision is made for people-focused integration and the inclusion of civil society; and e) a rigorous withdrawal process.⁵⁶ However, some of the shortcomings of the 1967 treaty are carried forward into the EAC Treaty in that the East African people are not granted the opportunity to actively participate in the EAC Treaty at all.⁵⁷ The EAC is aware of this shortcoming, and in the East African Legislative Assembly Strategic Plan 2011-2018, the Legislative Assembly committed to improving the participation of East Africans through measures including the enhancing of inter-parliamentary links within the region, more effective representation of East African citizens and through adhering to parliamentary democracy.⁵⁸

The membership of the EAC was later broadened to include Rwanda, Burundi and South Sudan. These memberships were granted despite the concerns the initial Partner States had regarding the political and economic instability of the three countries.⁵⁹

The history of the EU and EAC reveals that both regional integration projects have chosen to use their proximity to each other, the devastating aftermath of armed conflict and the waning relevance of the sovereign country to propel the idea to unite.

⁵⁶ W Masinde and CO Omolo, 'The Road to East African Integration' in E Ugirashebuja and others (eds) *East African Community Law: Institutional, Substantive and Comparative EU Aspects* (Brill 2017) 18; EF Ssempebwa, *East African Community Law* (LexisNexis 2015) 8.

⁵⁷ KG Adar, 'Fast Tracking East African Political Federation: The Role and Limitations of the East African Legislative Assembly' (2008) 37 *Africa Insight* 76, 89.

⁵⁸ East African Community, *East African Legislative Assembly Strategic Plan 2011-2018* <http://www.eala.org/uploads/EALA_strategic_plan_2013_2018.pdf> accessed 28 June 2019, 28.

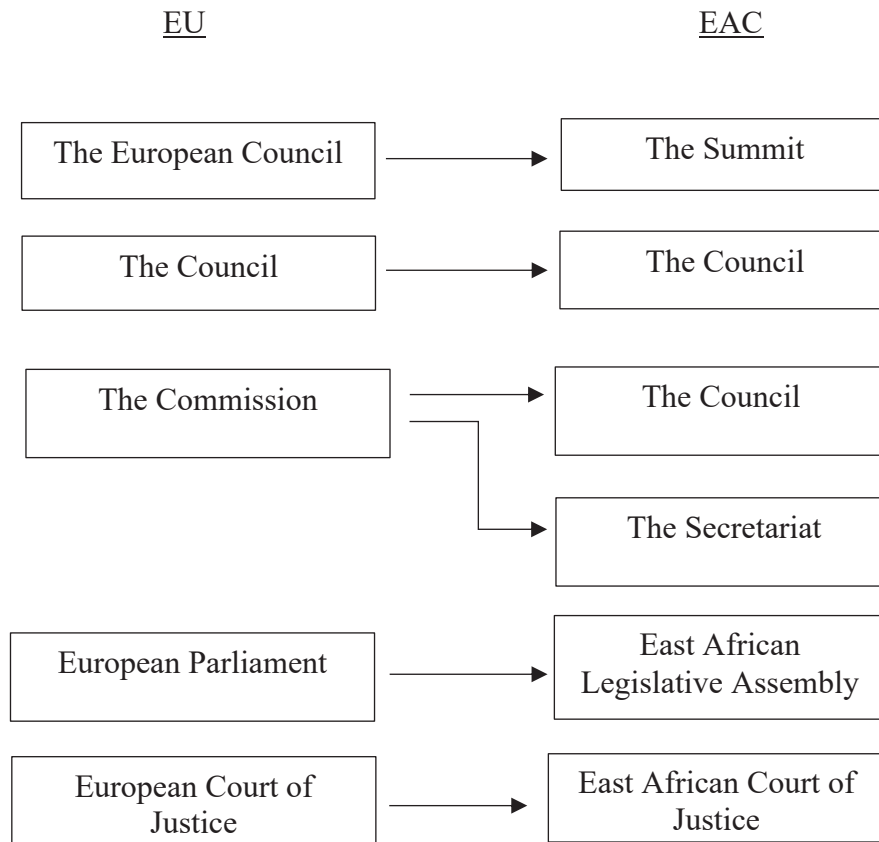
⁵⁹ Society for International Development, 'Burundi: How Well Integrated Is It in the EAC?' (2012) 26 *The Greater Horn Outlook* 5 <http://www.sidint.net/docs/RF26_burundiEAC.pdf> accessed 28 June 2019.

Moreover, both projects have chosen the path of economic integration to drive their ideals forward. The EAC, however, hopes to gain more from its efforts to unite and ultimately aims to form a political federation while the EU does not have this aim. Overall, the history of the EU and EAC point towards more similarities than differences between the two regional integration projects. More similarities are evident when evaluating the design of the EU and EAC institutional structures, as is discussed in the next section.

3. SIMILARITY IN THE INSTITUTIONAL STEPS TAKEN TO IMPLEMENT MEANINGFUL INTEGRATION

The institutions created in the EAC bear marked similarities to those created in the EU to the extent that it is clear that the EU has been used somewhat as a template for the creation of the EAC’s institutions.⁶⁰ Visually, this similarity may be represented as follows:

Table 1: Similarities in functions of the organizations in the current EU and EAC



⁶⁰ Cuyvers (n4) 24.

Table 1 indicates the extent to which the current organizational structure of the EAC has been modelled on the EU structure. These points of similarities are discussed in more detail below:

3.1. EU: THE EUROPEAN COUNCIL / EAC: THE SUMMIT

The European Council consists of the Heads of State of the Member States, the President of the European Council and the President of the Commission.⁶¹ Its function is to provide political direction for the EU,⁶² and has been described as the ‘most powerful body in the EU’.⁶³ The European Council makes decisions by way of consensus, unless otherwise provided in the TEU and TFEU.⁶⁴

The Summit in the EAC mirrors the composition of the European Council in that it is also composed of the Heads of State of the Partner States.⁶⁵ The language used to describe the function of the Summit is almost exactly the same as that describing the European Council in that the ‘Summit shall give general direction and impetus as to the development and achievement of the objectives of the Community.’⁶⁶ The Summit is also tasked with ensuring the peace and security within the EAC along with reviewing the progress towards the creation of the political federation.⁶⁷ The Summit shall make its decisions by way of consensus.⁶⁸

Similar to the European Council, the Summit is the political organ of the EAC. The two organs share other similarities in that their composition, main function and method of decision-making are the same.

3.2. EU: THE COUNCIL / EAC: THE COUNCIL

The Council in the EU consists of one Minister representative from each Member State.⁶⁹ It is tasked with policy-making and coordinating functions while also sharing with the European Parliament executive and budgetary functions.⁷⁰ The Council is to make decisions by qualified majority voting unless otherwise provided in the TEU and TFEU.⁷¹ It has been noted that the Council occupies a peculiar position in that it is intergovernmental in so far its members continue to act according to the best interest of their home governments while

⁶¹ Consolidated Version of the Treaty on European Union, OJEU C326/13 (2012), art 15(2) [TEU].

⁶² Art 15(1) TEU.

⁶³ Goebel (n9) 123.

⁶⁴ Art 15(4) TEU.

⁶⁵ Art 10(1) EAC Treaty.

⁶⁶ Art 11(1) EAC Treaty.

⁶⁷ Art 11(3) EAC Treaty.

⁶⁸ Art 12(3) EAC Treaty.

⁶⁹ Art 16(2) TEU.

⁷⁰ Art 16(1) TEU.

⁷¹ Art 16(3) TEU.

at the same time striving for better market integration and common EU rules.⁷²

The body most similar to the Council in the EU is a body also called the Council in the EAC. The EAC's Council consists of Ministers responsible for EAC Affairs from each Partner State; such other Ministers as necessary and the Attorney General of each Partner State.⁷³ The Council in the EAC is the policy-making body⁷⁴ and is tasked with ensuring the proper functioning and development of the EAC.⁷⁵ More specifically, its duties include initiating and submitting draft legislation to the East African Legislative Assembly; directing Partner States and other EAC institutions; considering the EAC budget; issuing binding directives and making recommendations; and implementing the decisions of the Summit.⁷⁶ While the EAC Treaty may describe the Council as its policy-making organ, it would seem that its functions go well behind just the making of policy. The Council largely takes action on the basis of consensus.⁷⁷ This is problematic as it may result in the stagnation of decision-making at this level, as was the case historically for the EEC after the Luxembourg Accords.⁷⁸

The Council of the EU and EAC share the same name and ostensibly the same function as constituting the policy-making organ of their respective organizations. The Council of the EAC, however, has much broader functions than that of its EU counterpart. The EAC Council not only makes policy but also plays a key role in the implementation of such policy across the EAC institutions and Partner States.

3.3. EU: THE COMMISSION / EAC: THE SECRETARIAT AND THE COUNCIL

The Commission has been described as the 'core executive' of the EU.⁷⁹ This stems from the nature of the functions the Commission fulfills. According to article 17(1) of the TEU, the Commission is tasked with the broad function of advancing the general interest of the EU and taking actions towards that goal. Moreover, the Commission has coordinating and management functions; it executes the EU budget, and in some instances, it may act as the EU's external representative.⁸⁰ Its most vital executive function, however, is its ability to initiate the

⁷² Goebel (n9) 109.

⁷³ Art 13 EAC Treaty.

⁷⁴ Art 14(1) EAC Treaty.

⁷⁵ Art 14(2) EAC Treaty.

⁷⁶ Art 14(3) EAC Treaty.

⁷⁷ Art 15(3) and (4) EAC Treaty.

⁷⁸ See earlier discussion in Part 2 above.

⁷⁹ D Curtin, *Executive Power of the European Union: Law, Practices, and the Living Constitution* (Oxford 2009) 91.

⁸⁰ Art 17(1) TEU.

legislative process through the making of proposals.⁸¹ The award of this function to the Commission has been described as deliberately made in order to ensure that, as an independent body, the Commission is able to draft law while bearing the interest of the Union in mind.⁸² The independence of the Commission and its officers is protected by article 17(3) of the TEU which provides that the Commission shall not take or seek instructions from any of the Member States. A further important power afforded the Commission is its ability to sue Member States on the grounds that such Member States are not fulfilling their obligations under Union law.⁸³ As such, the Commission has been described as the ‘guardians of the treaties’.⁸⁴ The Commission has played such an important role in the integration of Europe that it has been described as the reason for the success of the European integration project.⁸⁵

In terms of the fulfilling the executive function of the EAC, article 66 of the EAC Treaty defines the Secretariat as being the executive organ of the EAC. Despite this description, the functions ascribed to the Secretariat by article 71 of the EAC Treaty may largely be described as administrative rather than executive. These include: the initiating and forwarding of recommendations to the Council; the initiation of studies and research related to programmes for achieving EAC objectives; the strategic, planning and monitoring of such programmes; the general promotion and dissemination of information on the EAC to its stakeholders and the general public; and the general administration and financial management of the EAC.⁸⁶ The Secretariat does exercise some executive power through its power to coordinate and harmonize the development policies and strategies of the EAC; submit the budget to the Council; propose draft agenda of all the organs of the EAC; and implement the Summit and the Council’s decisions.⁸⁷ Moreover, the independence of the Secretariat is protected by article 72(1) of the EAC Treaty which states that the Secretariat shall not seek or take instructions from Partner States or any external parties while article 72(3) also restrains Partner States from interfering with the Secretariat and its functions.

A further evaluation of the EAC Treaty, however, reveals that the core executive functions of the EAC are actually carried out by the Council. The Council makes the policy decisions of

⁸¹ Art 17(2) TEU.

⁸² A Dashwood and others, *Wyatt and Dashwood’s European Union Law* (6th ed, Hart Publishing 2011) 72.

⁸³ Art 17(1) TEU.

⁸⁴ European Commission, *What the European Commission Does in Law* <https://ec.europa.eu/info/about-european-commission/what-european-commission-does/law_en> accessed 27 June 2019.

⁸⁵ European Commission, COM/2000/0200final, *White Paper on Reforming the Commission* (1 March 2000), White Paper – Part 1.

⁸⁶ Art 71 EAC Treaty.

⁸⁷ Art 71 EAC Treaty.

the EAC, in terms of article 14(1). The Council is also the only body within the EAC which may make binding directives and regulations, under article 14(3)(b). The Council therefore has the means to enforce its policy decisions. The Council is also involved in the enforcement of the EAC laws under article 143, and it is involved in the budget approval process under article 14(3)(e). The argument may therefore be made that it is the Council that is the de facto executive of the EAC.

3.4. EU: THE EUROPEAN PARLIAMENT / EAC: THE EAST AFRICAN LEGISLATIVE ASSEMBLY

The European Parliament jointly exercises legislative and budgetary functions with the Council.⁸⁸ It is composed of representatives of the EU's citizens.⁸⁹ Interestingly, it has been noted that while the European Parliament plays a key role in the legislative process it does not have the power to initiate legislation – a power which is given to the Commission.⁹⁰ Its East African counterpart is the East African Legislative Assembly.⁹¹ It consists of nine members elected by each Partner State; the Minister responsible for EAC Affairs of each Partner State and the Assistant Minister; the Secretary General and the Counsel to the EAC.⁹² Unlike the European Parliament, its members do not reflect the representatives of its citizens in that the general public is not able to vote for the members of Legislative Assembly as this is done at the Partner State level. The EAC legislative body therefore seems to evidence a disjuncture between acting as the representative of the EAC people in so far as passing laws which affect them, without allowing for any form of direct representation of such people in the legislative organ.

3.5. EU: THE EUROPEAN COURT OF JUSTICE / EAC: THE EAST AFRICAN COURT OF JUSTICE

The European Court of Justice (ECJ) is tasked with ensuring that in the interpretation and application of the TEU and TFEU European Union law is observed consistently and uniformly.⁹³ The ECJ consists of one judge from each Member State as assisted by Advocates-General.⁹⁴ According to article 19(3) of the TEU, the ECJ has the power to give rulings on actions initiated by Member States, institutions, natural or legal persons; provide preliminary rulings on the interpretation of Union law; provide preliminary rulings on the validity of institutional acts;

⁸⁸ Art 14(1) TEU.

⁸⁹ Art 14(2) TEU.

⁹⁰ Goebel (n9) 117.

⁹¹ Art 49(1) EAC Treaty.

⁹² Art 48(1) EAC Treaty.

⁹³ Art 19(1) TEU.

⁹⁴ Art 19(2) TEU.

and provide rulings on all other cases as provided for in the TEU and TFEU.⁹⁵ The ECJ has been credited with playing a significant role in furthering integration in the EU.⁹⁶

The EAC has also done well to establish a strong court of justice. The East African Court of Justice (EACJ) is entrusted with the interpretation and application of the EAC Treaty together with ensuring the adherence and compliance with the EAC Treaty.⁹⁷ The court may sit as a court of first instance or an appeal court.⁹⁸ The EACJ is open to all within the EAC – the EAC Treaty provides that Partner States,⁹⁹ the Secretary General,¹⁰⁰ and all natural and legal persons¹⁰¹ may institute proceedings in the EACJ. The EAC Treaty specifically provides for the supremacy of the jurisprudence of the EACJ.¹⁰² Judgments of the EACJ shall take precedence over the judgments of national courts on the interpretation and application of the EAC Treaty.¹⁰³ Moreover, Partner States and the Council are specifically obligated under article 38(3) to implement the EACJ judgments as timeously as possible.

The EACJ has already proven itself of withstanding intense political pressure in order to deliver impartial and independent judgments. In *Prof. P. Anyang' Nyong'o et al. vs Attorney General of the Republic of Kenya et al*¹⁰⁴ the EACJ produced a ruling that the rules passed by the Kenyan National Assembly regulating the election of members to the Legislative Assembly infringed article 50 of the EAC Treaty.¹⁰⁵ The EACJ

⁹⁵ Art 19(3) TEU.

⁹⁶ Cuyvers (n4) 29; Goebel (n9) 85;

⁹⁷ Art 23(1) EAC Treaty.

⁹⁸ Art 23(2) EAC Treaty.

⁹⁹ Art 28 EAC Treaty.

¹⁰⁰ Art 29 EAC Treaty.

¹⁰¹ Art 30 EAC Treaty.

¹⁰² Art 33(2) EAC Treaty.

¹⁰³ Ibid.

¹⁰⁴ *Prof. P. Anyang' Nyong'o et al. vs Attorney General of the Republic of Kenya et al* (2007) Ref No 1. of 2006 (East African Court of Justice, Tanzania).

¹⁰⁵ Article 50 of the EAC Treaty provides as follows: '1. *The National Assembly of each Partner State shall elect, not from among its members, nine members of the Assembly, who shall represent as much as it is feasible, the various political parties represented in the National Assembly, shades of opinion, gender and other special interest groups in that Partner State, in accordance with such procedure as the National Assembly of each Partner State may determine.*

2. *A person shall be qualified to be elected a member of the Assembly by the National Assembly of a Partner State in accordance with paragraph 1 of this Article if such a person:*

(a) *is a citizen of that Partner State;*

(b) *is qualified to be elected a member of the National Assembly of that Partner State under its Constitution;*

(c) *is not holding office as a Minister in that Partner State;*

(d) *is not an officer in the service of the Community; and*

(e) *has proven experience or interest in consolidating and furthering the aims and the objectives of the Community.'*

ruled that because Kenya's election rules did not allow for the election to be open to Kenyan citizens nor for a debate to be conducted in the Kenyan Parliament in order to vet the nominees, Kenya's election rules did not ensure that its elected officials were properly representative as required by article 50. The EACJ later confirmed this ruling in a later appeal judgment despite the EAC Partner States speedy action to amend the EAC Treaty so as to broaden the scope to remove judges serving on the EACJ.¹⁰⁶ Moreover, in *East African Law Society et al. vs The Attorney General of Kenya et al*¹⁰⁷ the EACJ ruled that these amendments to the EAC Treaty were void and contravened the EAC Treaty.

The roles and functions of the court of justices in the EU and EAC are very similar. While the EACJ is much younger than the ECJ, the EACJ does have the makings to become as an important part of the EAC as the ECJ is to the European integration project. However, concerns have been expressed that the EAC Partner States are not as respectful of the EACJ's authority as they should be.¹⁰⁸ Moreover, the EACJ does not have the assistance of the 'direct effect' doctrine as is the case in the EU.¹⁰⁹ According to article 8(2) of the EAC Treaty, in order for EAC law to become part of the national law of the EAC Partner States such law must be ratified by the EAC Partner States.

4. FUTURE OF THE EUROPEAN UNION AND EAST AFRICAN COMMUNITY REGIONAL INTEGRATION PROJECTS

4.1. THE EUROPEAN UNION

Many have commented that the European Union is in crisis.¹¹⁰ In the wake of the European sovereign debt crisis, the refugee crisis and the impending Brexit, the European integration project seems to be at a crossroads as it becomes clear that the status quo cannot be sustained in future.

¹⁰⁶ *Prof. P. Anyang' Nyong'o et al. vs Attorney General of the Republic of Kenya et al* (2010) Appeal No. 1 of 2009 (East African Court of Justice, Tanzania).

¹⁰⁷ *East African Law Society et al. vs The Attorney General of Kenya et al* (2008) Ref No. 3 of 2007 (East African Court of Justice, Tanzania).

¹⁰⁸ AP van der Mei, 'Regional Integration: The Contribution of the Court of Justice of the East African Community' (2009) 69 *ZaöRV* 69, 403.

¹⁰⁹ JE Ruhangisa, 'The Scope, Nature and Effect of EAC Law' in E Ugirashebuja and others, *East African Community Law: Institutional, Substantive and Comparative EU Aspects* (Brill 2007) 139, 150.

¹¹⁰ KE Lehmann, 'The Crisis of the European Union as a Complex Adaptive System' (2018) 56 *Journal of Common Market Studies* 971; PR Lane, 'The European Sovereign Debt Crisis' (2012) 26 *Journal of Economic Perspectives* 49; J Habermas (C Cronin (tr)), *The Crisis of the European Union: A Response* (Polity Press 2012).

Several suggestions have been made as to how Europe may move forward. One such suggestion for EU reform that has gained media attention is the ‘Treaty of Democratisation’ proposed by Professor Piketty.¹¹¹ Piketty proposes that a new supranational body be created, the European Assembly, which together with the Euro Group is to have legislative and budgetary capacity to create European taxes, half of which are to be transferred to the contributing Member States and the other half is to be used to finance specified social-upliftment programmes.¹¹² These proposed European taxes are: a common tax on corporate profits with larger companies to bear more of the tax burden; a progressive income tax on high income earners; a progressive wealth tax; and a carbon emissions tax.¹¹³ The rationale for the common tax on corporate benefits (or sometimes referred to as corporate ‘benefits’) appears to be a movement towards a benefit theory of taxation as opposed to the ability-to-pay principle on which the classical corporate income tax system is based.¹¹⁴ It is envisaged that the new European Assembly and ‘democratisation budget’ is to work alongside the existing EU institutions and budget.¹¹⁵

Piketty’s proposal has met some criticism. Bershidsky notes that the Piketty proposal fails to address the current obstacles to an effective corporate income tax system; namely, the avoidance tactics employed by multinational companies and the ineffective means of ensuring that companies pay their fair share of taxes in the jurisdictions in which they operate.¹¹⁶ Moreover, Bershidsky notes that Piketty’s proposal would unfairly target the middle-income taxpayers and ‘modest entrepreneurs’ would simply flee the EU.¹¹⁷ Mitchell labels Piketty’s proposal as ‘absurd’, and merely serves to add more bureaucracy and more taxes to a system that is already

¹¹¹ T Piketty, *Draft Treaty on the Democratization of the Economic and Social Government of the European Union* <http://tdem.eu/wp-content/uploads/2018/12/TRAITE_EN.pdf> accessed 28 June 2019 [Draft TDEM].

¹¹² T Piketty, *A Budget for Europe* <http://tdem.eu/wp-content/uploads/2018/12/BUDGET_EN.pdf> accessed 28 June 2019.

¹¹³ Art 10(2) Draft TDEM.

¹¹⁴ Benefit theory of taxation means that taxpayers should pay taxes based on the benefits they receive from government – see JM Dodge, ‘Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles’ (2005) 58 *Tax Law Review* 399. For further reading, see GS Cooper, ‘The Benefit Theory of Taxation’ (1994) 11 *Australian Tax Forum* 397; WH Oakland and WA Testa, ‘The Benefit Principle as a Preferred Approach to Taxing Business in the Midwest’ (2000) 14 *Economic Development Quarterly* 154.

¹¹⁵ Piketty (n112) 9.

¹¹⁶ L Beshidsky, ‘Piketty Should Take Off That Yellow Vest: Higher Taxes for Not-so-Rich Won’t ‘Save Europe from Itself’ *Bloomberg* (10 December 2018) < <https://www.bloomberg.com/opinion/articles/2018-12-10/piketty-manifesto-won-t-save-europe-from-itself>> accessed 28 June 2019.

¹¹⁷ *Ibid.*

overburdened and ineffective.¹¹⁸ It has also been suggested that Piketty's proposal is 're-inventing the wheel' instead of working within existing EU institutions and laws.¹¹⁹

Other more suggestions for EU reform includes that the EU should give up its desire to form an 'ever closer union'.¹²⁰ It has been argued, however, that this option would be difficult to implement given the difficulty in unravelling the Eurozone and the free movement of persons.¹²¹ Another suggestion is that the EU should focus on what the EU does best – finding common ground.¹²² It is suggested that the EU embark upon some self-reflection in order to identify its shortcomings.¹²³ This should be followed by discussions with those critical of the EU so as to find some sort of common ground to address the problems.¹²⁴ Perhaps in so doing, the EU may come across new strategies to more effectively further its integration objective.¹²⁵ One suggested strategy is to facilitate economic development through the removal of some bureaucracy by allowing EU funds to directly reach small businesses in debt-stricken countries such as Greece.¹²⁶

What is clear is that the EU and its integration project has become mired in diplomacy and consensus-building rather than development-creating. Lehmann aptly notes that the EU today 'does whatever generates the least resistance, rather than what is necessary'.¹²⁷ Moreover, the EU has been described as merely reacting to crisis rather than proactively rising to meet the anticipated challenges.¹²⁸ Also, the EU only seems to bring about change in the wake of a crisis.¹²⁹ At the EU's current rate of attracting crisis, the wait should not be too long before the EU is forced to change. As it would be too costly for the European integration project to regress, perhaps the only option for EU reform is to move towards deeper integration. If this does become an option, the EU may well be able to learn some lessons from the East African regional integration project.

¹¹⁸ DJ Mitchell, 'Piketty Urges Higher Taxes in Response to French Tax Revolt' Mises Institute (13 December 2018) <<https://mises.org/power-market/piketty-urges-higher-taxes-response-french-tax-revolt>> accessed 28 June 2019.

¹¹⁹ J Ramkin, 'Group Led by Thomas Piketty Presents Plan for a "Fairer" Europe' *The Guardian* (9 December 2018) <<https://www.theguardian.com/world/2018/dec/09/eu-brexite-piketty-tax-google-facebook-apple-manifesto>> accessed 28 June 2019.

¹²⁰ Y Mounk, 'Pitchfork Politics: The Populist Threat to Liberal Democracy' (2014) 93 *Foreign Affairs* 27, 36.

¹²¹ Lehmann (n110) 984.

¹²² *Ibid.*

¹²³ *Ibid.*

¹²⁴ *Ibid.*

¹²⁵ *Ibid.*

¹²⁶ *Ibid.*

¹²⁷ *Ibid.* 982.

¹²⁸ *Ibid.* 983.

¹²⁹ Ramkin (n119).

4.2. THE EAST AFRICAN COMMUNITY

The EAC has some difficult decisions to make before it can form its federation. In identifying these difficult decisions, it is useful to determine a checklist of features that would classify a form of government as being federal:

- a. There should be at least two levels of government;¹³⁰
- b. Such levels of government should be constitutionally protected;¹³¹
- c. The levels of government should share jurisdiction or authority;¹³²
- d. The federal law should be supreme to the law created by the provinces, and citizens of the federal country should be able to sue their province for any infringements of their rights;¹³³
- e. Diversity should be tolerated and protected;¹³⁴
- f. Most decisions should be made by majority vote;¹³⁵
- g. A court should be appointed to adjudicate any disputes;¹³⁶
- h. A parliament should be directly elected;¹³⁷
- i. The federal government should have tax capacity in that it has its own tax resources sufficient to carry out its functions;¹³⁸ and
- j. The federation should have a Constitution that does not allow the provinces to be the ‘masters of the treaties’¹³⁹ in that the provinces may alter it by mere agreement.¹⁴⁰

In the light of these factors, it would be useful to determine exactly what the EAC is yet to do in order to become a federation. At present, the EAC has many – but not all – of the features of a federation. Article 8(4) of the EAC Treaty provides that Community law takes precedence over the national laws of the Partner States. Moreover, article 30(1) of the EAC Treaty

¹³⁰ J Law, ‘How Can We Define Federalism?’ (2013) 5 Perspectives on Federalism 88, 91; R Boadway and A Shah, *Fiscal Federalism: Principles and Practice of Multiorder Governance* (Cambridge University Press 2009), 5.

¹³¹ Law (n130) 91; K Wheare, *Federal Government* (Oxford University Press 1946) 11; DJ Elazar, *Exploring Federalism* (The University of Alabama Press 1991) 5.

¹³² Elazar (n131) 5.

¹³³ Law (n130) 91.

¹³⁴ Elazar (n131) 5.

¹³⁵ Law (n130) 91.

¹³⁶ M Burgess, *Federalism and European Union: The Building of Europe, 1950-2000* (Routledge 2000) 29.

¹³⁷ Ibid.

¹³⁸ T Börzel and T Risse ‘Who is Afraid of a European Federation?’ (2000) *Paper to the Symposium: Responses to Joschka Fischer* <<http://www.jeanmonetprogram.org/papers/00/00f0101.htm>> accessed 28 June 2019, 45, 53.

¹³⁹ Ibid.

¹⁴⁰ Ibid.

provides that residents of the Community may litigate against his/her Partner State in the event of any action or directive, regulation, Act or decision of the Partner State being unlawful or constituting an infringement of the provisions of the Treaty. The EAC Treaty does ensure the protection of diversity by ensuring that each Partner State is adequately represented at the Community level. And, the EACJ is appointed as the adjudicator of disputes. However, aside from the decisions taken in the Legislative Assembly, which is undertaken by way of majority vote, many of the decisions under the EAC Treaty are by consensus. Also, members to the East African Legislative Assembly are not directly elected by the people but are instead elected by the National Parliaments of the Partner States.

In its quest to form its federation, the EAC has made further details available on the structure of its planned federation. The EAC envisages that the federation is to be a two-tier structure with a Federal Government and Constituent States.¹⁴¹ The Federal Government is to have power over the following areas: foreign affairs, international trade, national defence and security, infrastructure, immigration and the Federal public service.¹⁴² It is envisaged that the Constituent States are to remain autonomous on all non-federal matters.¹⁴³ These matters are to include domestic trade, land, matters of personal law, and local government.¹⁴⁴ The Federal Government and the Constituent States are to have concurrent power over education, health, agriculture, justice and constitutional affairs, citizenship, statistics and census.¹⁴⁵ It is immediately noticeable that the power of taxation has been omitted from the list of powers.

Moreover, the East African Federation is to be composed of three federal organs: The Executive, the Legislature and the Judiciary.¹⁴⁶ The Executive is to consist of a President and Vice-President supported by a cabinet.¹⁴⁷ The Legislature is to consist of two chambers: a Senate and a House of representatives.¹⁴⁸ The Constituent States are to be equally represented in the Senate whose function will be to promote the interest of the federation.¹⁴⁹ The Members of the House of representatives will be elected on the basis of a proportional representation of the

¹⁴¹ East African Legislative Assembly, *Report of the Committee on Legal, Rules and Privileges on the Assessment of Adherence to Good Governance in the EAC and the Status of the EAC Political Federation* (2 – 6 September 2013) <<http://www.eala.org/documents/view/adherence-to-good-governance-in-the-eac-and-the-status-of-the-eac-political>> accessed 28 June 2019, 10.

¹⁴² Ibid 11.

¹⁴³ Ibid.

¹⁴⁴ Ibid.

¹⁴⁵ Ibid.

¹⁴⁶ Ibid 10-11.

¹⁴⁷ Ibid 10.

¹⁴⁸ Ibid.

¹⁴⁹ Ibid.

population and will be tasked with representing the interest of the Federation's citizens.¹⁵⁰ It is proposed that the Federal Judiciary will be independent and headed by a Chief Justice.¹⁵¹

While the EAC already has many of the features of a federation and has made some decisions regarding the structure of its federation, the following is nonetheless lacking: Firstly, it is not clear which EAC institutions will form the Federal Executive and Federal Legislature. Secondly, in terms of article 150(1) of the EAC Treaty, the Partner States have the power to amend any provision of the EAC Treaty by agreement. Thirdly, there is no provision granting the Federal Government taxing capacities. It is submitted that these shortfalls exist because the EAC is still in the process of creating a federation.

The second omission above is relatively easy to remedy once the EAC forms a Constitution and removes the power of the EAC Partner States to amend the EAC Treaty. The first and third omissions would require some discussion.

In terms of the question as to which EAC organs are to be adapted for the purposes of forming the Federal Legislature, it is recommended that Legislative Assembly form the proposed House of representatives while the Summit form the proposed Senate. It is submitted that the Summit is well suited for this role because it already fulfils the functions of the proposed Senate. The functions of the Summit are detailed in article 11 of the EAC Treaty and include providing the general direction and impetus of the EAC with respect to its development and achieving of its objectives. It also reviews the progress towards the establishment of the political federation between the Partner States.

Moreover, it is argued that the Council of the EAC should become the Federal Executive. Article 13 of the EAC Treaty states that the membership of the Council consists of the Ministers responsible for the EAC affairs of each Partner State, such other Ministers of the Partner States and the Attorney-General of each Partner State. The Council is the policy organ of the EAC, according to article 14 of the EAC Treaty. The Council has a number of functions, including making policy decisions for the efficient and harmonious functioning and development of the EAC; initiating and submitting Bills to the Assembly; and considering measures that should be taken by Partner States in order to promote the attainment of the objectives of the EAC.

The Council is also well placed to assume the tax authority of the East African Federal Government, when considering the third omission in the formation of the East African Federation. The membership of the East African Federal Government could easily encompass the Ministers of Finance of each Partner State. Also, the Council is already empowered

¹⁵⁰ Ibid.

¹⁵¹ Ibid 11.

under article 135 of the EAC Treaty to make the financial rules and regulations of the EAC. The exercising of the tax authority of the East African Federation would therefore fall within the ambit of article 135. Moreover, as the policy organ of the EAC it is well placed to consider the tax policy decisions of the East African Federation.

At this juncture, the argument may be made that perhaps the Secretariat of the EAC would be best placed to form the executive of the federation – not least because article 66 of the EAC Treaty states that the Secretariat is the executive organ of the Community.¹⁵² As discussed above, the Council is in reality the EAC's executive organ while the Secretariat is more like the administrative arm of the EAC. Moreover, there are other significant obstacles to the Secretariat fulfilling the important task of exercising the fiscal authority of the East African Federation. Firstly, commentators note that the Secretariat does not have the capacity or resources to undertake the task of exercising the tax sovereignty of the EAC.¹⁵³ Secondly, the directives of the Secretariat are not binding under the EAC Treaty.¹⁵⁴ Thirdly, should the Secretariat be tasked with exercising the tax authority of the EAC, significant amendments are required to be made to its mandate. Moreover, such a revamped Secretariat would also require significant technical and financial resources. The composition of the Secretariat would have to be altered to include both the Ministers of Finance and the Ministers of EAC Affairs of the Partner States.¹⁵⁵ Alternatively, the Ministers could form part of a separate sectoral committee that is to report to the Secretariat. Given the significant obstacles to the Secretariat being the executive branch of the East African Federal Government, it is suggested that it would be more organic to have the Council decide on tax policy issues as the Federal Executive rather than to specifically create such competence under the Secretariat.

In making this suggestion, it is not recommended that all tax sovereignty be removed from the Partner States as the Constituent States of the East African Federation. If the Constituent States are not given any tax authority there is little incentive for them to practice fiscal discipline in their spending of the funds transferred to them from the Federal Government.¹⁵⁶

¹⁵² C Mutsotso, *Harmonisation of EAC Tax Policies and Laws: Proposals for Taxation Regime for Fostering Small Business Development and Regional Economic Growth* (CUTS International and GTZ 2010), 4; HG Petersen (ed), *Tax Systems and Tax Harmonisation in the East African Community (EAC): Report for the EAC/GTZ Program "Support to the EAC Integration Process"* (University of Potsdam 2010) 90.

¹⁵³ Mutsotso (n152) 4-5; Petersen (n152) 89-90; Verhaeghe and Mathison (n38) 7.

¹⁵⁴ Petersen (n152) 89.

¹⁵⁵ *Ibid* 90.

¹⁵⁶ Q Li, 'Fiscal Decentralization and Tax Incentives in the Developing World' (2016) 23 *Review of International Political Economy* 232, 254.

It is therefore important that the Constituent States have the capacity to raise their own financial resources from taxes. Following on this, it is recommended that the East African Federation properly implement a federal prerogative when allocating such taxing powers and it should not fall short thereof by implementing a system of fiscal decentralization.

‘Fiscal decentralization’ is defined by Rubin and Feeley as a form of government in which the central government is always able to override the decisions of the sub-governments should the intended purpose of the central government not be fulfilled.¹⁵⁷ A federal government, on the other hand, is one in which the federal government must abide by the decisions of the local government in some areas, although the federal government may have scope to influence such decisions either by inducement or threat.¹⁵⁸

In choosing the federation route rather than mere decentralization, the EAC should avoid most of the concerns brought about from the division of government authority amongst several tiers. For instance, Li argues that often fiscal decentralization leads to increased interregional competition and a prevalence of tax incentives that detract more from government coffers than they add.¹⁵⁹ This is exasperated in instances where sub-governments rely on central government transfers and grants to cover the shortfall between the sub-government’s spending and income.¹⁶⁰ On the other hand, fiscal discipline is often implemented where sub-governments are required to finance their own expenditure through own-source taxes.¹⁶¹ These findings are echoed in the earlier works which find that grant-funded decentralization governments enable governmental misconduct, and wasteful expenditure.¹⁶² This is while tax autonomy encourages sub-governments to use their own revenues rather than the common pool of national revenue.¹⁶³

However, in order to ensure that fiscal discipline is properly rooted and unassailable in a federal government, Liberati and Sacchi argue that tax separation – rather than tax-base sharing – amongst different tiers of government is more conducive to improving accountability, distinguishing between the responsibilities of different levels of government, and making it easier for voters to track government expenditure.¹⁶⁴

¹⁵⁷ EL Rubin and MM Feeley, ‘Federalism and Interpretation’ (2008) 38 *Publius* 167, 172.

¹⁵⁸ *Ibid.*

¹⁵⁹ Li (n156) 255.

¹⁶⁰ *Ibid.*

¹⁶¹ *Ibid* 254.

¹⁶² RW Bahl and J Linn, *Urban Public Finance in Developing Countries* (Oxford University Press 1992).

¹⁶³ A Shah, ‘Fiscal Federalism and Macroeconomic Governance: For Better or Worse?’ (1999) Policy Research Working Paper No 2005, World Bank.

¹⁶⁴ P Liberati and A Sacchi, ‘Tax Decentralization and Local Government Size’ (2013) 157 *Public Choice* 183, 185.

In order to ensure that the East African Federation brings about the necessary fiscal discipline, it is recommended that a tax separation model be implemented across the Federal Government and Constituent State levels. As corporate income tax is an important source of revenue and one which may be structured to meet the redistribution function of the Federal Government, as further discussed in Chapter 3, it is recommended that the corporate income tax be collected and administered at Federal Government level before being redistributed in full to the Constituent States so as to meet their budgetary requirements. It is further recommended that the Federal Government be funded through other taxes such as personal income tax and value added tax.

Bird, however, cautions that while revolutionary change – as proposed above – may bring about a clean break, often such change is not implemented as it should.¹⁶⁵ Instead, Bird advocates for a more ‘evolutionary approach’.¹⁶⁶ In the context of the EU and as it applies to the important tax base of corporate tax, Bird suggests that an evolutionary approach would have Member States agree to a common base while allowing each Member State to modify this base by excluding factors it considers appropriate.¹⁶⁷ Flexibility is key to bringing about speedy agreement, Bird recommends.¹⁶⁸ In a similar fashion, an agreement regarding an apportionment formula and its constituent elements may be reached with perhaps minimum rates agreed for each element.¹⁶⁹ The purpose of the flexibility here, Bird explains, is to allow for each Member State to become invested in the system with the ultimate aim of each Member State regarding the system as their own.¹⁷⁰ Finally, Bird suggests that a review should be implemented regularly, perhaps every five or ten years, so as to enable adjustments which may bring the system closer to harmonization across the Member States.¹⁷¹

In an East African Federation context, Bird’s evolutionary approach may be implemented as a transitional measure. This would entail the corporate tax base being agreed in principle while allowing the Constituent States to adjust the base according to their policy concerns. Similarly, while the elements and workings of the apportionment formula might be agreed, the Constituent States would be at liberty to adjust the weights and mix of the formula elements while adhering to the minimum rates as agreed. From an administrative perspective, this recommendation would entail the federal corporate income

¹⁶⁵ R Bird, ‘Tax Coordination in the European Union: A View from Outside’ (2019) Preliminary Draft for Conference on Tax Design for the Netherlands (forthcoming).

¹⁶⁶ *Ibid.*

¹⁶⁷ *Ibid.*

¹⁶⁸ *Ibid.*

¹⁶⁹ *Ibid.*

¹⁷⁰ *Ibid.*

¹⁷¹ *Ibid.*

tax being administered and collected at the Constituent State level with each Constituent State applying the its own variation of the apportionment formula. In so doing, each Constituent State would determine what it regards to be its fair share of the federal corporate income tax before releasing the balance to the Federal Government to meet its budgetary needs. Upon a review of the system – every five years would probably be most appropriate here – adjustments may be made to allow the Federal Government more control over the administration, collection and distribution of the corporate income tax until the Federal Government eventually becomes solely responsible for the design, administration, collection and distribution of the corporate income tax in the federation.

Bird's evolutionary approach may work in the East African Federation context in so far as it would make it easier for agreement to be reached amongst the Constituent States regarding important decisions such as the design of the corporate income tax base and the apportionment formula. However, it is a concern that the Constituent States may use the liberties afforded them under this system to create a culture of harmful tax competition amongst them. Such a culture already exists. For instance, four of the six Partner States (Burundi,¹⁷² Kenya,¹⁷³ Tanzania¹⁷⁴ and Uganda¹⁷⁵) have zones which offer significant tax holidays while Rwanda offers significant corporate tax holidays independent of zones.¹⁷⁶ It is therefore suggested that the review process include an evaluation of whether the Constituent States are using their discretion in adjusting the agreed base and formulary apportionment formula in order to conduct harmful tax competition with the other Constituent States. In the event that such harmful competition is found, the Federal Government should be given the right to accelerate the harmonization process by removing more or all of the liberties afforded Constituent States and by centralizing the design, administration, collection and distribution of the corporate income tax.

It is not certain whether the EAC will be able to achieve its ambitious aim of forming a political federation. The East African region is still racked by political tensions and armed conflict in neighbouring region, particularly in Sudan. These constitute significant obstacles towards achieving deeper regional integration in East Africa. Having said that, however, it is

¹⁷² Decree 1/30 of 31 August 1992 as revised by Free Zone Law No. 1/015 of July 2001 (Loi sur le Régime de Zone Franche, FZL), articles 12, 14 and 18 of the Free Zone Law (Burundi).

¹⁷³ Export Processing Zones Act, Chapter 517 of the Laws of Kenya, section 29 (Kenya); and Special Economic Zones Act 16 of 2015, section 35(1) (Kenya).

¹⁷⁴ Export Processing Zones Act 2002 (Tanzania).

¹⁷⁵ Free Zones Act, 2014, section 48 (Uganda).

¹⁷⁶ Law No. 6/2015 of 28 March 2015 on Relating to Investment Promotion and Facilitation; Item I (Rwanda).

important that the EAC continue to move towards making its political ideal a reality – despite how slowly meaningful change seems to be taking place.

5. CONCLUSION

This chapter has shown that the history of the EU and EAC are similar in that both regional integration projects have been spurred on by the devastating effects of armed conflict. The EU was brought to the realization that economic integration would be the most effective means to prevent the reoccurrence of the two World Wars, while the internal and interstate wars in the East African region drove the EAC Partner States towards economic convergence in order to encourage development in the region. From an institutional design perspective, it is clear that the EAC has looked to the EU for inspiration in the design of the organs making up the EAC.

While the EAC and EU are both regional integration projects, they may not both be headed towards the same destination. It has been noted that the destiny of the EU does not include it becoming a federal nation.¹⁷⁷ However, it has also been noted that with each successive treaty entered into over the course of the EU's history, Member States have been moving closer towards a more centralized institutions.¹⁷⁸ For the EAC and its ambitious aim of forming a political federation, many would speculate that this aim will never come to realization. Nonetheless, stranger things have become a reality in modern times. The EU offers the EAC useful lessons in what pitfalls to avoid in its path towards deeper integration while the EAC may offer the EU lessons should the EU in future seek more rather than less integration. Given this potential for synergies, a deeper analysis of the fiscal aspects of these regional integration projects is justified.

¹⁷⁷ Goebel (n9) 142.

¹⁷⁸ Ibid.

CHAPTER THREE: DESIGNING A CORPORATE INCOME TAX SYSTEM FOR THE EAST AFRICAN FEDERATION

1. INTRODUCTION

This chapter seeks to identify the policy concerns that would be relevant to that East African Federation in designing its corporate income tax system. In doing so, this chapter aims to address the lack of available literature on the corporate income tax policy concerns of developing countries. It has been recognised that the economies of developing and developed countries are vastly different, and therefore the factors that would influence tax policy design in a developed country would – and should – be different in a developing country.¹ It is therefore vital that more analysis be done of the corporate tax policy design that would be best suited for a developing country. This chapter seeks to illustrate the intricacies of such design for the East African Federation.

In doing this, it is noted that corporate tax policy design cannot take place in a vacuum. It is important to consider the circumstances that are peculiar to the country implementing the tax – such as that country’s policy goals along with its economic strengths and weaknesses.² Moreover, countries operate within a global economy that makes more interconnected than they have ever been before. In this respect, it would be prudent for the East African Federation to consider the experiences of other regional integration projects when designing its corporate income tax policy.

This chapter will consider the European Union (‘EU’) experience in this regard. Such a comparison would make sense given how closely the foundational treaties of the EU and EAC resemble each other. Moreover, noteworthy corporate income tax developments are taking place in the EU which would be relevant for the EAC and its own regional integration project. The most important of such developments is the adoption of the Anti-Tax Avoidance Directive (ATAD)³ by the Council of the EU on 12 July 2016, which itself is an implementation of the Actions produced by the OECD Base Erosion and Profit Shifting

¹ PL Baker, ‘An Analysis of the Corporate Income Tax Policy of Less Developed Countries’ (2018) 120 *Scandinavian Journal of Economics* 400.

² M Rider, ‘Should Jamaica Tax Corporate Income?’ (2007) 35 *Public Finance Review* 103.

³ Council Directive 2016/1164 of 12 July 2016 Laying down Rules against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, OJ L 193/1 (2016), EU Law IBFD [ATAD].

(BEPS) project,⁴ and the ongoing discussion around the adoption of a common consolidated corporate tax base for the EU.⁵ These developments are key for the East African Federation because together they embody a blueprint for the design of a coherent corporate income tax base and mechanisms by which to protect such a tax base.

This chapter will consider how the East African Federation may design and protect its corporate income tax base in the following order: Part 2 will set out the corporate income tax systems currently in operation in the EAC Partner States. This will be followed by Part 3 which will detail the proposed design of the East African Federation's corporate income tax system as considered in the light of the EU's proposed directives for a common consolidated corporate tax base. Part 4 will propose mechanisms that are most appropriate for the East African Federation context in protecting its corporate income tax base before the chapter concludes with Part 5.

2. CURRENT CORPORATE INCOME TAX SYSTEMS IN THE PARTNER STATES OF THE EAST AFRICAN COMMUNITY

It is useful to analyse the manner in which the six Partner States of the EAC currently tax corporate profits before considering a proposal designed for the East African Federation. All six Partner States employ the classic corporate income system in taxing corporate profits. The key element of the classical corporate income tax system, as initially described by Van den Tempel,⁶ is the tax treatment of companies as separate legal entities and the economic double taxation of dividends in the hands of the companies and shareholders.⁷ Table 1 below indicates the budgetary performance of this tax in the six Partner States for the three financial years 2015/16, 2016/17 and 2017/18.

⁴ See OECD, Press Release, *Closing Tax Gaps – OECD launches Action Plan on Base Erosion and Profit Shifting* (19 July 2013).

⁵ Proposal for a directive on a Common Corporate Tax Base (CCTB), COM(2016)685 final [CCTB Proposal], and the Proposal for a directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2016) 683 final [CCCTB Proposal].

⁶ AJ Van den Tempel, *Corporation tax and individual income tax in the European Communities* (Commission of the European Communities 1970).

⁷ S Cnossen, 'Corporate Taxes in the European Union: Slowly Moving Toward Comprehensive Business Income Taxation?' (2018) 25 *International Tax Public Finance* 808, 820.

*Table 1: Corporate Income Tax Performance in the EAC Partner States**

Country	Corporate Income Tax 2015/16	Corporate Income Tax 2016/17	Corporate Income Tax 2017/18	Percentage of Corporate Tax to Total Tax 2015/16	Percentage of Corporate Tax to Total Tax 2016/17	Percentage of Corporate Tax to Total Tax 2017/18
Kenya (in KSh billions)	651 988	732 199	743 742	23,6%	23,4%	22,4%
Rwanda (in RWF billions)	63,2	190,5	235,9	6,3%	17,3%	18,8%
South Sudan (in SSP millions)	334	1 295	1 753	6,3%	14,0%	12,5%
Tanzania (in Tsh billions)	1 379,7	1 450,3	1 778	11,1%	10,3%	11,7%
Uganda (in Shs billions)	732	764	742	6,6%	6,1%	5,3%

*Author's own calculations based on country budget information. Budget information for Burundi is not currently available.

As Table 1 indicates, the corporate income tax is more important to some Partner States (such as Kenya) than others (such as Uganda). In terms of trends, this tax has increased over the three year period across the board in all Partner States (except Uganda). This is interesting because both Rwanda and Kenya introduced corporate tax holidays over the 2015-2018 period as a mechanism to encourage foreign direct investment.⁸ Rwanda has seen a substantial increase in its collections over the three year period.

The corporate income tax's performance varied across the other Partner States over the period. Despite the variance in performance, Table 1 does indicate that corporate tax collection is an important source of revenue across the EAC as it is the case in the rest of Africa.⁹

The collection of corporate tax in the EAC Partner States must also be considered against the general fiscal budget of the Partner States. All of the Partner States have recorded a fiscal deficit for the 2017/2018 financial year. The deficits are quite

⁸ See Item I of the Annex to the Law No. 6/2015 of 28 March 2015 on Relating to Investment Promotion and Facilitation (Rwanda) and Export Processing Zones Act, Chapter 517 of the Laws of Kenya (Kenya) section 29.

⁹ AW Oguttu, 'Tax Base Erosion and Profit Shifting in Africa – Part 1: What Should Africa's Response be to the OECD BEPS Action Plan?' (2015) 48 *The Comparative and International Law Journal of Southern Africa* 516, 526.

dire but varied across Partner States with Kenya reflecting a deficit of 7.2% of Gross Domestic Product (GDP)¹⁰ while at the lower end of the scale, Tanzania reflected a deficit of 2.1% of GDP for the same period.¹¹ Moreover, aside from Rwanda, all of the Partner States failed to meet their budgeted targets for the collection of corporate tax. As a result, Partner States like Tanzania, Kenya and Uganda have prioritized in their budget announcements the improvement of the tax administration in their respective countries.¹²

In terms of economic growth, while the EAC region generally has shown good growth in 2017,¹³ Uganda, Tanzania and Rwanda have been affected by a prolonged drought in 2016 and 2017.¹⁴ Moreover, South Sudan and Burundi are still affected by ongoing political conflict. The EAC region has also produced good performance indicators with Rwanda ranked second in Africa of the 2017 World Bank's Doing Business Report.¹⁵ The EAC region was also the biggest recipient of foreign direct investment in Africa for 2017 with Kenya receiving the most foreign direct investment projects.¹⁶

Bearing this context in mind, the corporate tax base of the six Partner States will now be analysed. All six Partner States employ the classical corporate income tax system with corporate profits being taxed in the hands of the corporate while the distributed profits are taxed in the hands of the shareholders as dividends. The taxable income of companies is the result of the formula income less deductions.

In terms of the definition of income, Kenya, Rwanda, Tanzania and Uganda have a comprehensive definition of income in their respective income tax legislation which includes under income business profits, rental income and investment income with a long list of specifically included amounts. On the other hand, the definition of income is rather minimal in the fiscal legislation of Burundi and South Sudan.

The general rule for the deductions is rather similar across Kenya, Tanzania and Uganda with the requirements for an expenditure or loss to have been incurred in the production of income. Rwanda and Burundi, however, require a more methodical approach to deductions likely with a view to identify

¹⁰ Kenya, '2018 Budget Policy Statement: Creating Jobs, Transforming Lives – the "Big Four" Plan' (2018), 14.

¹¹ Tanzania, 'Speech by the Minister for Finance and Planning, Hon. Dr. Philip I. Mpango (MP), Presenting to the National Assembly, the Estimates of Government Revenue and Expenditure for 2018/19' (2018), 27.

¹² Tanzania Speech (n11) 28; Kenya Budget Policy Statement (n10) 14, Uganda, 'Budget Speech for Fiscal Year 2018/19' 42.

¹³ Ernest & Young, 'Turning Tides: EY Attractiveness Program Africa' (2018), 16.

¹⁴ Kenya Budget Policy Statement (n10) 3.

¹⁵ World Bank, 'Doing Business 2017: Equal Opportunity for All' (World Bank 2017) 7.

¹⁶ Ernest & Young (n13) 16.

real economic activity. These Partner States require that the expenditure must be incurred for purposes related to business; must result in the reduction of net assets; must correspond to real expenditure and must be related to the particular financial year. In terms of specific deductions, a deduction for research and development related expenditure is allowed in Burundi, Kenya, Rwanda, Tanzania and Uganda. Moreover, while all six Partner States allow for capital allowances and depreciation deductions the rates and capital projects differ across the Partner States.

A possible area for tax leakage lies in the rules for the carry forward of losses across the Partner States. An indefinite carry forward of losses is allowed in Tanzania and Uganda while in Kenya it is only allowed for extraction industry. On the other hand, Burundi, Kenya (in all other industries), Rwanda and South Sudan place a restriction on the number of years which a loss may be carried forward.

While the EAC region did undergo a tax rate harmonization to 30% after the production of a report on tax harmonization in the region some years back,¹⁷ this tax rate harmonization is now more of an illusion than a reality nowadays. Now, the only Partner State who does not offer a special corporate income tax rate for an identified sector or taxpayer is Uganda. All the other Partner States have made significant inroads into the standard corporate income tax rate with South Sudan and Tanzania's reduced rate sinking to 10% for certain sectors.

However, the tax incentives offered by most Partner States has the effect of reducing the varying tax rates to relative insignificance. The only Partner State which does not offer corporate income tax holidays is South Sudan, and that is because it is embroiled in political conflict and not on principle. Burundi, Kenya, Rwanda, South Sudan and Tanzania all offer exemptions from the payment of corporate tax some for 5 years and others for 10 years, as discussed further in Part 3.2.2 below. These tax incentives are all offered with the aim of attracting foreign direct investment, and in the hopes of differentiating themselves from other EAC Partner States. While the EAC region has performed well in terms of attracting more foreign direct investment than other countries in Africa, it is nonetheless questionable whether the EAC would not perhaps have won such investment without the deep cuts into the possible corporate tax the Partner States could have collected.

Given that for some companies corporate tax is not a cost they have to bear when doing business in the EAC Partner States at the moment, the design of a corporate income tax system for the East African Federation should bear the role of tax incentives in mind when determining the objectives it hopes to achieve with its corporate income tax. The next part will discuss this aspect of

¹⁷ HG Petersen (ed.), *Tax Systems and Tax Harmonisation in the East African Community (EAC): Report for the EAC/GTZ Program "Support to the EAC Integration Process* (University of Potsdam 2010).

the design of a corporate income tax system for the East African Federation, along with other relevant factors for the East African context.

3. DESIGN OF THE NEW CORPORATE INCOME TAX SYSTEM FOR THE EAST AFRICAN FEDERATION

3.1. THE EAST AFRICAN FEDERATION AND THE CLASSICAL CORPORATE INCOME TAX SYSTEM

The debate around the suitability of corporate income tax as a system came into the mainstream media recently with a proposal made in the United States to replace the federal corporate income tax with a destination-based cash flow tax (DBCFT).¹⁸ While many alternatives to corporate income tax have been offered, the DBCFT is presently attracting a great deal of debate in the context of the discussion around the EU's C(C)CTB. The DBCFT was first proposed by Bond and Devereux in 2002¹⁹ and has more recently been the subject of discussion.²⁰ The DBCFT basically envisages that tax on corporate income or profits should be levied at 'destination', that is the country in which the final sales to customers is made should be allowed to levy the tax.²¹ This prospect produces an alternative to 'residence' and 'source' paradigms.²²

Cui notes that there are two versions of the DBCFT currently in the literature.²³ The first is the taxation of corporate income through a sales-only formulary apportionment.²⁴ The second is a destination-based value added tax (VAT) with deductions for labour costs and refundable losses.²⁵ The sales-

¹⁸ 'A Better Way: Our Vision for a Confident America' (24 June 2016) <http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf> accessed 19 July 2019.

¹⁹ S Bond and MP Devereux, 'Cash Flow Taxes in an Open Economy' [2002] CEPR Discussion Papers, No. 3401.

²⁰ AJ Auerbach, MP Devereux and H Simpson, 'Taxing Corporate Income' in Stuart Adam and others (eds), *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press 2010) 837; AJ Auerbach, 'Demystifying the Destination-Based Cash-Flow Tax' (2017) Brookings Papers on Economic Activity 409; AJ Auerbach, MP Devereux, M Keen, and J Vella, 'International Tax Planning Under the Destination-Based Cash Flow Tax' (2017) 70 *National Tax Journal* 783; R.S. Avi-Yonah and K. Clausing, 'Problems with Destination-Based Corporate Taxes and the Ryan Blueprint' (2017) 8 *Columbia Journal of Tax Law* 229.

²¹ W Cui, 'Destination-based Cash-flow Taxation: A Critical Appraisal' (2017) 67 *University of Toronto Law Journal* 301, 303.

²² *Ibid.*

²³ *Ibid.*

²⁴ Auerbach and others *Taxing Corporate Income* (n20) 883, MF de Wilde, 'Chapter 2: The CCCTB Relaunch: A Critical Assessment and Some Suggestions for Modification' in P Pistone (ed), *European Tax Integration: Law, Policy and Politics* (IBFD 2018).

²⁵ Cui (n21) 305.

only formulary apportionment envisages that the corporate income should be divided amongst the countries where the goods or services are sold.²⁶ This method was suggested by initially proposed by Auerbach, Devereaux and Simpson in 2010²⁷ before being discussed by de Wilde in the context of the EU's CCCTB proposal.²⁸ In terms of this destination-based VAT method, no interest or depreciation would be deductible while investment expenses would be deductible.²⁹ In this way, this method seeks to exclude the normal return on investment and only tax economic rents.³⁰ Moreover, a border adjustment is to be made such that income arising from exports are exempted while no deduction is allowed for imported inputs.³¹

The sales-only formulary apportionment method may be attractive, but the complications which would arise from intermediate sales and the administrative difficulties involved in keeping track of where the final consumers are located may be beyond the administrative capacity of both the participants in the East African market and the East African Federation's revenue authority. There is the real risk that even with the adoption of a sales-only formulary apportionment method some of the same issues which currently plague the residence and source paradigm may remain despite the switchover. It is therefore doubtful whether it would be worth the East African Federation making the normative and administrative leap to adopt a sales-only formulary apportionment method of taxing corporate income.

Similarly, adopting a destination-based VAT method with a deduction for labour and allowing for immediate loss refunds would not be feasible for the East African Federation. Administratively, allowing for the immediate refund of losses would create too great a risk for fraud when such administrative measures are not accompanied by strong and swift institutional revenue authority capacity. Moreover, given the questionable normative difference between this method and the residence paradigm regarding who and what is ultimately subject to tax, the East African Federation may be better placed to adhere to the current system based on residence and source.

The author is of the view that the only real advantage the East African Federation may possibly gain from a switch to a DBCF system – in whatever form – would be to capitalize on the 'novelty' aspect of such a change. It could possibly benefit from mobile capital attracted by the shift in method of taxation. However, if the spillover effects would be as significant as some

²⁶ Cui (n21) 303.

²⁷ Auerbach et al *Taxing Corporate Income* (n20) 883.

²⁸ De Wilde (n24).

²⁹ Auerbach *Demystifying the DBCFT* (n20) 410.

³⁰ *Ibid.*

³¹ *Ibid.*

suggest,³² this ‘novelty’ would be short-lived as other countries adopt similar methods. Once this happens, the East African Federation would be exactly in the same position as it is now – competing with other countries and regional blocks on the basis of non-tax related factors.

Moreover, if the East African Federation were to adopt a destination-based VAT system adjusting for labour and while allowing for immediate loss refunds, it may yet be in a worse position at that future point. In this situation, the federation would be constrained in taxing non-resident resource-exploiting companies;³³ it would be dealing with a method that is volatile on account of investment cycles;³⁴ the method would be heavily reliant on domestic sales;³⁵ and the East African Federation would be dealing with the increased risk of fraud arising from the immediate loss refund aspect.³⁶

It would not be politically feasible for the East African Federation to overhaul the current classical corporate income tax system in the region to a different system. An overhaul would require the East African Federation to convince investors to invest and in so doing, trust the tax system that would seek to tax that investment. Aside from the initial gains which the federation could possibly gain from being the one of the first to implement a DBCFT system, the East African Federation would have little to gain from such a drastic change.

3.2. OBJECTIVE OF THE CLASSICAL CORPORATE INCOME TAX SYSTEM IN THE EAST AFRICAN FEDERATION

As discussed above and in Part 2, the EAC Partner States currently have classical corporate income tax systems in place and it is advised that such a system be implemented in the East African Federation. Tax policy cannot be conceived in a vacuum. In order for tax policy to be effective, it is necessary for the social, economic and political realities of the country in which the policy is to operate to be taken into account.³⁷ From an East African Federation perspective, therefore, it is important for the corporate income tax policies to be formulated while bearing in mind the reality in which the policies are to operate.

In order to do this, it is important to identify what the East African Federation hopes to achieve from a corporate income tax. The critical objective of the corporate income tax in

³² Auerbach *Demystifying the DBCFT* (n20) 410; S Hebous, A Klem and S Strausholm, ‘Revenue Implication of Destination-based Cash-flow Taxation’ [2019] IMF Working Paper WP/19/7, 15.

³³ Hebous, Klem and Strausholm (n32) 15.

³⁴ *Ibid.*

³⁵ *Ibid.*

³⁶ *Ibid*; Cui (n21) 336.

³⁷ H Bullock, J Mountford and R Stanley, ‘Better Policy-Making’ (2001) Centre for Management and Policy Studies <www.policyhub.gov.uk/better_policy_making/> accessed 23 July 2019.

the East African Federation would be to increase government revenues. Corporate income tax is an amenable policy tool towards achieving this revenue-raising aim. Bowler Smith notes that the corporate income tax as a regulatory instrument is cost-effective, flexible and efficient.³⁸ The corporate income tax is especially effective in promoting the more efficient use of resources.³⁹ However, as a system the corporate income tax does have some drawbacks. These include questions about the fairness of corporate income tax in taxing the income from capital both in the hands of the company and the shareholder,⁴⁰ and the manner in which the complexity of the corporate income tax system distorts investment decisions.⁴¹

In practical terms, however, the great disparity between the rates of corporate income tax to total tax across the Partner States indicates that corporate income tax is a potential growth factor on which the East African Federation should focus. Moreover, the fact that all of the Partner States are presently in dire budget deficits – some are critical – adds impetus to the need to realise the growth potential of the corporate income tax. It is therefore key that the East African Federation take measures to broaden the tax base of the corporate income tax. This could be done by evaluating the EU's proposed common consolidated corporate tax base, and is further discussed under part 3.2.1.

The second manner in which the corporate income tax could raise more revenue is by ensuring that the East African Federation is competitive within the global market. Like many other developing countries, the East African Federation would seek to attract foreign direct investment. Tax incentives are typically used to fulfil this function, and it is therefore key for the East African Federation to determine whether it will use such mechanisms and how best to use them to suit the East African context. This will be further discussed under part 3.2.2.

A third manner of raising more corporate income tax system is to reduce the large informal sector in the East African region. The informal sector or shadow economy here is understood to mean 'all economic activity – and income earned from it – that circumvent government regulation, taxation or observation.'⁴² The manner in which the East African Federation may reduce the informal sector is discussed under part 3.2.3.

³⁸ M Bowler Smith, 'Chapter 3: Corporate Tax Objectives' in *The Taxing Road to Sustainable Growth, Resource Productivity and Corporate Taxation* (IBFD 2013).

³⁹ Ibid.

⁴⁰ DL Weimer, 'A Better Corporate Tax?' (2002) 21 *Journal of Policy Analysis and Management* 693.

⁴¹ Ibid.

⁴² A Buehn, R Dell'Anno, and F Schneider, 'Exploring the Dark Side of Tax Policy: An Analysis of the Interactions between Fiscal Illusion and the Shadow Economy' (2018) 54 *Empirical Economics* 1609, 1630.

3.2.1. BROADEN THE CORPORATE INCOME TAX BASE IN THE EAST AFRICAN FEDERATION

3.2.1.1. The EU's Proposed CCCTB

The idea of establishing a common corporate income tax base in the EU has been the subject of debate for decades. It has been recognised that the corporate income tax systems across Member States vary greatly, and that great costs to taxpayers are involved in conducting cross-border trade within the EU.⁴³

The idea of developing meaningful commonality in the corporate tax base in the EU was first posited in 1992 by the Committee of Independent Experts in Company Taxation (the Ruding Committee),⁴⁴ followed by further action taken in 1999 through the Council inviting the Commission to present a study on company taxation in the EU.⁴⁵ Van de Streek comments that this invitation was pivotal in that the Common Consolidated Corporate Tax Base concept would probably have never emerged as a policy objective for the Commission.⁴⁶ The Commission duly made presentations including the Company Tax Study in 2001, in which the idea of a common consolidated corporate tax base was identified as a promising policy objective.⁴⁷ In 2004, a technical working group of experts was established to discuss this concept. This was followed by the Commission tabling its formal proposal for a Common Consolidated Corporate Tax Base in 2011. It proved too difficult to obtain the necessary Member State consensus to pass the proposal, and the proposal was later replaced with a relaunched two-part proposal in 2016. The first part of this proposal envisages a directive on a Common Corporate Tax Base⁴⁸ (CCTB proposal) to be later followed by a directive on a Common Consolidated Corporate Tax Base (CCCTB proposal).⁴⁹

The CCTB/CCCTB proposals have two general policy objectives: encouraging growth and investment within the EU and making the corporate income tax more fair within the EU.⁵⁰ Van de Streek points to the move to harmonize the tax base; the super deduction for research and development for start-up companies; and the allowance for corporate equity as measures

⁴³ M Helminen, *EU Tax Law – Direct Taxation* (IBFD 2018) 4.4.1.

⁴⁴ J van de Streek, 'Chapter 11: A Common (Consolidated) Corporate Tax Base (C(C)CTB)' in PJ Wattel, O Marres and H Vermeulen (eds), *Terra/Wattel – European Tax Law* (7th edn Wolters Kluwer 2019) 429.

⁴⁵ *Ibid.*

⁴⁶ *Ibid.*

⁴⁷ *Ibid.*

⁴⁸ Proposal for a directive on a Common Corporate Tax Base (CCTB), COM(2016)685 final [CCTB Proposal].

⁴⁹ Proposal for a directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2016) 683 final [CCCTB Proposal].

⁵⁰ Paragraph 2 Preamble CCTB Proposal.

within the CCTB/CCCTB proposals to meet the first policy objective.⁵¹ Moreover, the second objective is met through the introduction of measures that counter cross-border tax avoidance (such as the CFC rules, for instance); the mandatory application of the CCTB/CCCTB proposals to groups of companies with consolidated global turnover of more than €750 million;⁵² and arguably the proposed sharing mechanism in terms of the CCCTB proposal.⁵³

The essence of the proposal is that the taxable income of companies and permanent establishments within the EU are to be determined according to uniform rules applied across the Member States. Moreover, the financial performance of group companies is to be consolidated and such consolidated taxable income is to be apportioned amongst the group member companies according to an apportionment formula comprised of the production factors sales, labour and capital. The taxable income so apportioned to each member of the group is to be subject to tax at the rate determined by the Member State in which the group member companies are operating. On a practical level, this development would result in only one tax return being filed by the parent company of the group on behalf of the entire group. This tax return would be filed in the Member State in which the parent company is resident.

Determining the tax base of companies and permanent establishments under the CCTB proposal involves determining revenues, excluding exempt revenue, followed by the deduction of expenses.⁵⁴ 'Revenues' is broadly defined in article 4(5) and includes: monetary or non-monetary proceeds derived from a sale or any other transaction (net of value added tax and other taxes); proceeds from the disposal of rights and assets; interest; dividends and other profit distributions; proceeds of liquidations; royalties; gifts received and ex gratia payments. Revenues does not, however, include receipts arising from the repayment of a debt or the raising of equity.⁵⁵ Despite its inclusion in revenues, income which is to be exempted includes: the profits of foreign permanent establishments; the proceeds from the disposal of shares where the taxpayer has maintained a minimum holding of 10% in the shareholding or voting rights of the company during the twelve months preceding the disposal; profit distributions from companies where the taxpayer has a minimum holding of 10% in the shareholding or of the voting rights of the distributing company for twelve consecutive months; proceeds from the disposal of pooled assets; and subsidies directly related to the acquisition, construction or

⁵¹ Van de Streck (n44) 432.

⁵² Ibid 434.

⁵³ Paragraph 1 Explanatory Memorandum to the CCTB/CCCTB Proposals.

⁵⁴ Art 7 CCTB Proposal.

⁵⁵ Art 4(5) CCTB Proposal.

improvement of depreciable assets.⁵⁶ Moreover, while interest and royalty income are to be subject to tax, the withholding tax paid on such receipts are to be credited.⁵⁷

Article 9 of the CCTB Proposal allows for the deduction of expenses to the extent that they are directly incurred in the business interest of the taxpayer. Such deductible expenses may include research and development costs and also costs arising from the raising of debt or equity for the purpose of business.⁵⁸ The term ‘expenses’ is further defined in article 4(6) as meaning ‘decreases in net equity of the company during the accounting period in the form of outflows or a reduction in the value of assets or in the form of a recognition or increase in the value of liabilities, other than those related to monetary or non-monetary distributions to shareholders or equity owners in their capacity as such’.

In terms of specifically allowed deductions, the CCTB Proposal allows for the super-deduction of research and development costs by way of an additional deduction of 50% of such costs up to a maximum of €20 million and a further 25% deduction for costs over €20 million.⁵⁹

The CCTB Proposal also includes a special research and development deduction for ‘small starting companies’.⁶⁰ In addition to the deduction of research and development costs in full under article 9(2), article 9(3) allows companies to deduct a further 100% of their research and development costs if the following conditions are met: The company is unlisted with fewer than 50 employees; it has an annual turnover and/or annual balance sheet total that is less than €10 million; it is not the result of a merger; it has been registered for no longer than 5 years or its economic activity has endured for a period of five years or less; and it has no associated enterprises.⁶¹

The CCTB also attempts to work towards the elimination of the debt-equity bias through the allowance for growth and investment, which allows for the cost of equity to be deductible in instances of an incremental increase in equity as compared to a reference point; initially for the first ten years, this will be the first day of the first year of the application of the CCTB rules.⁶² After ten years, the reference year is annually moved forward one year.⁶³ The CCTB also provides that should there be a decrease in the equity base, however, an amount equal to the defined yield calculated in terms of article 11(5) shall become taxable. The defined yield shall be calculated with reference to

⁵⁶ Art 8 CCTB Proposal.

⁵⁷ Art 55 CCTB Proposal.

⁵⁸ Art 9(2) CCTB Proposal.

⁵⁹ Art 9(3) CCTB Proposal.

⁶⁰ *Ibid*; Explanatory Memorandum to the CCTB Proposal, 10.

⁶¹ *Ibid*.

⁶² Art 11(4) CCTB Proposal.

⁶³ *Ibid*.

the Euro Area 10-year government benchmark bond in December of the year preceding the relevant year along with a risk premium increase of 2 percentage points.⁶⁴

The CCTB continues in the calculation of the tax base by detailing a list of non-deductible expenses in article 12. Non-deductible items include: profit distributions and repayments of equity or debt; 50% of entertainment costs (up to an amount still to be determined); transfers of retained earnings to an equity reserve; taxes on profits and corporate tax; bribes and other illegal payments; fines and penalties; expenses incurred in the deriving of exempt income; gifts and donations; capital costs related to fixed assets which are deductible elsewhere in the CCTB rules; and losses of a permanent establishment situated in a third country. The CCTB Proposal further allows for losses to be carried forward indefinitely.⁶⁵

The CCCTB Proposal, on the other hand, provides the rules for the consolidation of profits of group companies, and the allocation of such profits across the group members operating in different Member States according to the apportionment formula. Article 7(1) provides that the tax bases of all group members are to be added together while article 7(2) states that should such consolidation result in a negative tax base, this is to be carried forward for set off against a positive consolidated base. Only a positive consolidated tax base may be apportioned.

Such apportionment is set out in articles 28 to 42 and details the formulary apportionment with its three equally weighted factors of sales, capital and labour. The formula to determine the share of the tax base for a particular group member (Company A) is set out in article 28(1) as follows:⁶⁶

$$\text{Share A} = \left(\frac{1}{3} \frac{\text{Sales}^A}{\text{Sales}^{\text{Group}}} + \frac{1}{3} \left(\frac{1}{2} \frac{\text{Payroll}^A}{\text{Payroll}^{\text{Group}}} + \frac{1}{2} \frac{\text{No of employees}^A}{\text{No of employees}^{\text{Group}}} \right) + \frac{1}{3} \frac{\text{Assets}^A}{\text{Assets}^{\text{Group}}} \right) * \text{Con'd Tax Base}$$

In terms of the calculation of the above figures, the CCCTB Proposal provides special rules for the oil and extractive industry. Article 42 states that the sales amount of the group member actually conducting the exploration or production of oil or gas business shall be attributed to the group member situated in the Member State where the business is conducted. Moreover, in the event that the group member conducts the exploration or production of oil or gas business in a third country where such group member does not have a permanent establishment, the sales amount arising from such business shall nonetheless be attributed to such group member.⁶⁷ However, should there be no group member situated in the Member State where the exploration or production of oil or gas business is conducted, the

⁶⁴ Art 11(5) CCTB Proposal.

⁶⁵ Art 41 CCTB Proposal.

⁶⁶ Formula detailed in art 28(1) CCCTB Proposal.

⁶⁷ Art 42 CCCTB Proposal.

sales amount is to be attributed to all the other group members in proportion to their labour and assets factors.⁶⁸

Once the consolidated tax base has been apportioned in terms of the above formula, article 45 provides that such apportioned tax base is to be subject to tax according to the varying tax rates of the Member States involved. Administrative provisions are set out in articles 46 to 68 and set out details such as the notice to form a group and the information that is to be included in such notice; the obligation of the principal taxpayer to file the consolidated return; the information to be included in such return; the failure to file a tax return; and the procedures to follow should a dispute arise between the Member State and taxpayer.

More recently in May 2018, the Commission has proposed that once the relevant CCCTB legislation is in place, a 3% call rate should be applied to the CCCTB to bolster the EU's own resources.⁶⁹ Moreover, in March 2018 the European Parliament passed a resolution approving recommendations to the CCCTB Proposal as proposed by the Economic and Monetary Affairs Committee.⁷⁰ These recommendations include:

- i) The introduction of a fourth factor, the data factor, to the formulary apportionment;
- ii) While initially the CCCTB should be mandatory for groups of a certain size, this threshold should be lowered to zero over seven years;
- iii) The introduction of digital permanent establishment concept;
- iv) Losses in respect of a consolidated tax base shall be carried forward for a period of five years;
- v) A compensation mechanism shall be introduced to weather the transitional sudden shock to tax revenues of Member States who implement the CCCTB. This mechanism is to be financed by the fiscal surpluses of Member States to experience gains in fiscal revenues. This mechanism is to remain in place for an initial period of seven years;
- vi) As a transitional measure, the Commission is to draft guidelines on how the formulary apportionment method may co-exist with other allocation methods employed by the non-EU States;

⁶⁸ Art 42 read with arts 38(4) and (5) CCCTB Proposal.

⁶⁹ Commission, Press Release, *EU Budget: Commission Proposes A Modern Budget for a Union that Protects, Empowers And Defends* (2 May 2018).

⁷⁰ European Parliament, *European Parliament legislative resolution of 15 March 2018 on the proposal for a Council directive on a Common Consolidated Corporate Tax Base (CCCTB) (COM(2016)0683 – C8-0471/2016 – 2016/0336(CNS))* (15 March 2018).

- vii) A dispute resolution mechanism should be put in place when the formulary apportionment produces a result which does not fit the actual economic activity;
- viii) The CCCTB should be implemented as one and should the Council fail to reach unanimous consensus on this, article 116 of the TFEU should be invoked in terms of which the European Parliament and the Council act under the ordinary legislation procedure. As a last resort, the enhanced cooperation procedures may be used by Member States wishing to participate in the implementation of the CCCTB;
- ix) The CCCTB regime is to be evaluated by an interparliamentary conference and the European Parliament shall report its findings to the Commission and the Council. Moreover, five years after the implementation of the CCCTB, the Commission is to conduct an assessment of its implementation and report to the European Parliament and the Council;
- x) The provisions are to apply from 1 January 2020.

The recent proposed recommendations to the CCCTB Proposal indicate a more decisive attitude than those proposed in the two-part CCTB/CCCTB proposals. The idea of a compensation mechanism is a novel way to ensure that arguments cannot be raised of a loss to revenues as a result of the implementation of the CCCTB. Moreover, the recommendation of the CCCTB to take into account the digital economy is a necessary change to make the CCCTB more relevant to the modern reality.

The recommendations seem to indicate an awareness of the possibility of factor manipulation of the formulary apportionment by the provision acknowledging that the formulary apportionment method may result in an outcome which does not match the economic activity actually undertaken. In order to overcome this result, the amendments propose that this be resolved through a dispute resolution mechanism. While this proposal is not ideal in that one would prefer that mechanisms be put in place to ensure that the workings of the formulary apportionment mirrors the economic reality, the proposed resolution of disputes via dispute resolution is a workable solution under the circumstances.

Moreover, it is a prudent measure to have the CCCTB regime and its implementation evaluated to determine whether the policy objectives of the CCCTB are actually being achieved. Most importantly, perhaps, the recommendations include a planned way forward in the event of the Council failing to reach consensus on the CCTB/CCCTB Proposals. In the author's view, this is a bold step forward towards making the CCCTB a reality.

The CCTB/CCCTB Proposals and its predecessor have been the subject of much criticism.⁷¹ While the recent amendments to the CCTB/CCCTB Proposals would serve to address some of the criticisms levelled against the CCCTB concept, particularly the concern that the CCCTB fails to cater for the digital economy, some of the broader criticisms still remain. These include that Member States will lose their tax sovereignty over corporate tax;⁷² that the formula remains unbalanced;⁷³ that there is no compensation for minority shareholders of individual group companies involved in the consolidation;⁷⁴ and the fact that multinational companies could still locate the formulary apportionment factors in low-tax jurisdictions.⁷⁵ Moreover, concern has been raised that the AGI may be counter-productive in encouraging the raising of equity in so far as an additional tax liability would arise in the event of equity decreases.⁷⁶ Spengel and others argue that a ‘pure’ allowance for corporate equity would have had decreases in equity merely attract a lower equity allowance rather than an additional tax burden.⁷⁷

⁷¹ See for example: JC Borg, ‘The Tax Treatment of Losses under the Proposed Common Consolidated Corporate Tax Base Directive’ (2013) 41 *Intertax* 584; MF De Wilde, ‘Tax Competition within the European Union – Is the CCCTB Directive a Solution?’ (2014) 7 *Erasmus Law Review* 24; M Erasmus-Koen, ‘Common Consolidated Tax Base: A Fair Share of the Tax Base?’ (2011) 18 *International Transfer Pricing Journal* 245; MJGT Fernández, ‘Corporate Tax Harmonization: Key Issues for Ensuring an Efficient Implementation of the CCCTB’ (2012) 40 *Intertax* 601; ECCM Kemmeren, ‘CCCTB: Enhanced Speed Ahead for Improvement, (2011) 5 *EC Tax Review* 210; E Röder, ‘Proposal for an Enhanced CCTB as Alternative to a CCCTB with Formulary Apportionment’ (2012) 4 *World Tax Journal* 125; M Temme, E Sporcken and R Okten, ‘Why Re-Invent the Wheel in the European Union? The Common Consolidated Corporate Tax Base Proposal’ (2011) 18 *International Transfer Pricing Journal* 330; E Traversa and CA Helleputte, ‘Taxation of EU-resident companies under the current CCCTB Framework: Descriptive and Critical Approach to Selected ‘Extraterritorial’ Aspects’ in M Lang (ed), *Corporate Income Taxation in Europe: The Common Consolidated Corporate Tax Base and Third Countries* (Edward Elgar 2013); M Vascega and S van Thiel, ‘The CCCTB Proposal: The Next Step towards Corporate Tax Harmonization in the European Union’ (2011) 51 *European Taxation* 379.

⁷² Vascega and van Thiel (n71); De Wilde (n24).

⁷³ Vascega and van Thiel (n71).

⁷⁴ Borg (n71).

⁷⁵ De Wilde *Tax Competition* (n71); L Bettendorf and others, *Corporate Tax Reform in the EU: Weighing Pros and Cons* (Oxford Centre for Business Taxation 2011) < http://eureka.sbs.ox.ac.uk/3532/1/Corporate_tax_reform_in_the_EU_weighing_pros_and_cons.pdf> accessed 23 July 2019.

⁷⁶ C Spengel and others, ‘Addressing the Debt-Equity Bias within a Common Consolidated Corporate Tax Base (CCCTB) – Possibilities, Impact on Effective Tax Rates and Revenue Neutrality’ (2018) 10 *World Tax Journal* 165, 171.

⁷⁷ *Ibid.*

3.2.1.2. Recommendations for the East African Federation

From an East African Federation perspective, the CCTB Proposal and its recommendations offer the East African Federation the opportunity to align and simplify the varied corporate tax bases of the current Partner States.

In particular, the East African Federation may find the comprehensive definition of revenues in article 4 of the CCTB Proposal useful given that South Sudan, for instance, has a minimal definition of income or revenue. According to section 64 of the Taxation Act in South Sudan, gross income means ‘all income earned or accrued, including, but not limited to, income from production, trade, financial investment, professional or other economic activities within the tax period’.⁷⁸ These categories are very broad, and the CCTB definition of ‘revenues’ would serve to clarify the exact scope of income that is to fall within the tax base.

Moreover, the CCTB Proposal’s definition of expenses in article 4 ties in with the definition adopted in Rwanda and Burundi which focusses on the objective indicators of an expense such as the reduction of asset values or a decrease in net equity.⁷⁹ Rwanda’s Law Establishing Taxes on Income, for instance, provides at article 25 that expenses may be deducted if the following conditions are met: The expenses are directly chargeable to income and are directly incurred for the purpose of business; the expenses are real expenses which can be substantiated with proper documentation; the expenses result in a decrease in net assets; and the expenses are incurred in the same tax year as the activities to which they relate.⁸⁰

All of the Partner States already account for research and development deductions in full in the year in which they are incurred,⁸¹ therefore the deduction for such expenditure under the CCTB Proposal would not be out of place within the East African Federation. However, the extent of the deduction would have to be carefully considered by the federation as to whether the East African Federation should allow a super-deduction for research and development as the CCTB Proposal has done. Given that a super-deduction has not been a trend in the East

⁷⁸ Taxation Act 2009 (South Sudan), section 64 [Taxation Act (South Sudan)].

⁷⁹ Income Tax Act, Law No. 1/02 of 24 January 2013, as amended (Burundi) art 53 [Income Tax Act (Burundi)]; Law No.16/2018 of 13 April 2018 Establishing Taxes on Income (Rwanda) art 25 [Law Establishing Taxes on Income (Rwanda)].

⁸⁰ Law Establishing Taxes on Income (Rwanda) art 25.

⁸¹ Income Tax Act (Burundi) art 68; Income Tax Act, 1973, Chapter 470 (Kenya) section 15(2)(n) [Income Tax Act (Kenya)]; Law Establishing Taxes on Income (Rwanda) art 30; Income Tax Act, revised edition 2008, Chapter 332 (Tanzania) section 15(1) [Income Tax Act (Tanzania)]; Income Tax Act, 1997, Chapter 340 of the Laws of Uganda (Uganda) section 32(1) [Income Tax Act (Uganda)].

African region and that such a super-deduction would narrow the tax base (albeit in a bid to encourage research and development in the region), it is recommended that the East African Federation not incorporate a super-deduction immediately upon the implementation of its corporate income tax system. The East African Federation may wish to revisit this decision after some years once its corporate income tax system has been in place for a number of years.

Having said that, there is a point of similarity between the allowances offered under the CCTB Proposal and Uganda's income tax laws for small, start-up companies. While the CCTB Proposal offers a research and development super-deduction of 100% of relevant costs for small companies who meet the specified requirements under article 9(3), Uganda offers a deduction of 25% per annum for four years of the costs incurred in starting up a business to produce income.⁸² While the CCTB Proposal deduction allows for a greater amount of qualifying expenditure to be deducted, Uganda's deduction allows for a broader spectrum of expenditure to be deducted other than just research and development expenditure. In order to encourage small business, it is recommended that the East African Federation incorporate a deduction for small, start-up companies similar to that implemented in Uganda. It would be more feasible to encourage the growth of small business in any industry in the East African Federation rather than just in the one which incurs research and development expenditure.

The CCTB Proposal would also allow the East African Federation to create unity across its corporate income tax base by aligning the varying rates of depreciation currently allowed within the Partner States.⁸³ Moreover, the CCTB Proposal offers the East African Federation the opportunity to create more symmetry across the tax treatment of debt and equity through its Allowance for Growth and Investment ('AGI'). Should the East African Federation implement provisions similar to the AGI in the CCTB Proposal, it would allow the federation to move towards the elimination of the debt-equity bias in the tax treatment of interest and equity. An AGI may also encourage more taxpayers to incorporate companies which would increase the number of taxpayers subject to corporate income tax in the federation. It is therefore advisable for the East African Federation to consider implementing an AGI-like provision in its corporate income tax system. Having said, it is not recommended that the federation follow the CCTB Proposal in

⁸² Income Tax Act (Uganda) section 30.

⁸³ As an illustration of some of the differences in depreciation rates currently implemented in the Partner States, for instance, industrial buildings are depreciated at a rate of 20% per annum in Uganda (Part I, Sixth Schedule to the Income Tax Act (Uganda)) while Rwanda and Tanzania use a rate of 5% per annum (Law Establishing Taxes on Income (Rwanda) art 28; Third Schedule to the Income Tax Act (Tanzania) item 3(6)).

determining that decreases in equity should result in a further tax liability for the taxpayer company. Such a provision would likely deter taxpayers from forming companies.

In terms of the consolidation aspect proposed in the CCCTB Proposal, this would be particularly useful to the East African Federation in so far as it would enable it to deal more effectively with situations of corporate failures. One of the reasons for the dismantling of a previous regional integration attempt in the East African region was the lack of participation of other Partner States when a corporate failed.⁸⁴ It was left to one Partner State, the country in which the entity was registered, to account for and deal with the consequences of a corporate failure. If the East African Federation were to implement a system similar to the CCCTB, it would mean that, in the event that the group realizes a loss, such loss would result in no tax being paid by the group. Such loss would then be allowed to be carried forward to the next year in a coordinated fashion until the group is once again profitable. It is more likely that a group would turn a profit at some point in the future than a single company. Therefore, the East African Federation would more likely be in a position to receive the group's tax portion in a shorter time once the group is again profitable than would be the case if one Partner State were waiting for a single company operating within its borders to turn its losses into profits.

It is important, however, that the carry forward of losses be limited in order to encourage the group's return to profitability. As many of the Partner States already limit the carry forward of losses,⁸⁵ the similar provision in the most recent recommendations to the CCCTB Proposal would work well within the East African Federation.

The purpose of applying an apportionment-like formula in the East African Federation would be to allow the corporate income tax collected at the Federal Government level to be redistributed to the Constituent States according to the operations conducted there by the group company members. Redistribution on such terms would foster more efficiency amongst the Constituent States because apportionment would incentivise Constituent States to find non-tax related reasons that would encourage companies to operate within their province. Having said that, an apportionment based only the location of group company operations may result in the lesser developed Constituent States being in a worse off position than their more developed Constituent States as companies would be more inclined to operate from the more developed Constituent State.

⁸⁴ DAK Mbogoro, 'The East African Community: An Economic Analysis of the Integration Scheme' (1978) 8 *African Review* 55, 61.

⁸⁵ Income Tax Act (Burundi) art 75; Income Tax Act (Kenya) section 15(4); Law Establishing Taxes on Income (Rwanda) art 32; Taxation Act (South Sudan) section 78(2).

In order to avoid the least developed Constituent States from losing out on an allocation of the corporate income tax, it is proposed that the East African Federation supplement the apportionment formula with a macro-economic element that is tied to the gross domestic product (GDP) of the Member States, as suggested by Kellerman and others.⁸⁶ Such macro-economic element would address the need to ensure regional development through redistributing resources to the Constituent States who need it most. In practical terms, this would mean that a portion of the tax base calculated by an application of the CCCTB rules should be retained and then redistributed to all Constituent States, irrespective of whether such Constituent State has any tie to the companies involved. The amount each Constituent State is then to receive from such distributed tax base would accordingly depend on the Constituent State's GDP.⁸⁷ Constituent States with the lowest GDP would receive a greater proportion of the retained and redistributed tax base.⁸⁸

In an East African Federation context, this would mean that each of the Constituent States of the East African Federation would always receive a portion of the tax base collected through a system similar to the CCCTB. This would mean that where a group has located its factors in the Constituent States formerly known as Kenya and Uganda, for instance, the majority of the CCCTB tax base would be allocated to the Constituent States formerly known as Kenya and Uganda because they are the Constituent States housing the apportionment factors – let's say an allocation of 70%. The other 30% of the tax base would accordingly be divided amongst all the Constituent States, with the lowest GDP generating Constituent State receiving the largest portion of the redistributed 30% tax base. Such redistribution would allow the less developed Constituent States, such as the Constituent States formerly known as South Sudan and Burundi, an opportunity and the means to catch up with the more developed Constituent States in the East African Federation.

In terms of the above discussion, it is envisaged that the total corporate income tax collected at the Federal Government level would be redistributed to the Constituent States. This is based on the understanding that the Federal Government would be funded by other taxes, as discussed at 4.2.

The East African Federation would not be hindered by some of the political sensitivities that surround the Member States at the moment. Therefore, it would be possible for it to implement a regime similar to the CCCTB in one phase and also to have the regime apply to all companies and permanent establishments

⁸⁶ C Kellerman, T Rixen and S Uhl, 'Europeanizing Corporate Taxation to Regain National Tax Policy Autonomy' (2007) International Policy Analysis 3 <<http://library.fes.de/pdf-files/id/04760.pdf>> accessed 13 August 2019.

⁸⁷ Ibid.

⁸⁸ Ibid.

within the East African Federation. Moreover, it is recommended that the East African Federation emulate the checks to be built into the CCCTB regime, as proposed in the recommendations, in order to ensure that the CCCTB regime actually achieves the objectives it is intended to bring about.

It is questionable whether the East African Federation should consider implementing the data factor and the concept of a digital permanent establishment. While doing so would certainly place the federation at the vanguard of navigating the digital economy and all its implications for the effective taxation of corporate profits, the author has some concern that including this digital component would complicate the implementation of a CCCTB regime to the extent that more resources would be devoted to the complexities of a CCCTB at the expense of implementing the simpler aspects well. The author would therefore suggest that the East African Federation should initially implement the three-factor formulary apportionment, with the digital components to be introduced later after it has settled into implementing and administering a CCCTB system.

In making this suggestion, the author is aware of the growing importance of the service industry within the East African region and that it is forecast that the service industry will constitute 51.3% of the EAC's GDP by 2050.⁸⁹ The figures suggest that the East African Federation must therefore account for intangibles at some point. The author is of the view that notwithstanding the projected importance of intangibles to the East African Federation, it would have much to gain from a prudent, staggered approach to a CCCTB regime implementation than an 'everything-at-once' approach for which the East African Federation may not yet have the institutional capacity to support.

The East African Federation should seriously consider implementing a regime similar to the CCCTB proposed in the EU. This would allow for the East African Federation to replace the varied corporate tax bases across the Partner States with a system that has some synergies with the existing corporate income tax bases of the Partner States while allowing it to make some difficult decisions in reforming the corporate income tax regime in the federation. It is encouraged that difficult decisions such as substantially narrowing the number of capital and depreciation allowances currently on offer in the Partner States and implementing one corporate income tax rate. Overall, the CCCTB regime even in its proposed form holds a great deal of promise for the East African Federation.

⁸⁹ East African Community, *East African Community Vision 2050: Regional Vision for Socio-Economic Transformation and Development* (EAC 2015).

3.2.1.3. Example of CCCTB-Like Calculations in the East African Federation

The author envisages that a CCCTB-inspired system, along with the macro-economic GDP-related element, to be implemented in the East African Federation would operate in terms of the following example:

Companies A, B and C form a CCCTB group. Company A operates in the formerly Kenya Constituent State, Company B in the formerly Tanzania Constituent State and Company C in the formerly Uganda Constituent State. The consolidated group profit is 9 000 East African Shillings.

Company A = Assets of 100, Wages of 100 and 1000 employees, Sales in formerly Kenya Constituent State of 10 000.

Company B = Assets of 200, Wages of 200 and 2000 employees, Sales in formerly Tanzania Constituent State of 20 000.

Company C = Assets of 300, Wages of 300 and 3000 employees, Sales in formerly Uganda Constituent State of 30 000.

Application of CCCTB-like, macro-economic system in the East African Federation would be as follows:

Consolidated group profits of 10 000 would be subject to federal-level corporate income tax at the rate of 30%, and would result in 3000 in taxes.

Portion retained for redistribution to all Constituent States: 30% of 3000 = 900.

Portion for redistribution to the Constituent States involved in group business activities: 3000 – 900 = 2100.

CCCTB-like Redistribution:

Kenya Constituent State's share based on Company A's activities = 117 + 58 + 58 + 117 = **350**

Assets: $(\frac{1}{3} \times 2100) \times (100/600) = 117$

Labour: $\frac{1}{2}$ of $(\frac{1}{3} \times 2100) \times 100/600$ and $\frac{1}{2}$ of $(\frac{1}{3} \times 2100) \times 1000/6000 = 58 + 58$

Sales: $(\frac{1}{3} \times 2100) \times 10\,000/60\,000 = 117$

Tanzania Constituent State's share based on Company B's activities = 233 + 117 + 117 + 233 = **700**

Assets: $(\frac{1}{3} \times 2100) \times (200/600) = 233$

Labour: $\frac{1}{2}$ of $(\frac{1}{3} \times 2100) \times 200/600$ and $\frac{1}{2}$ of $(\frac{1}{3} \times 2100) \times 2000/6000 = 117 + 117$

Sales: $(\frac{1}{3} \times 2100) \times 20\,000/60\,000 = 233$

Uganda Constituent State's share based on Company C's activities = $350 + 175 + 175 + 350 = \mathbf{1050}$

Assets: $(\frac{1}{3} \times 2100) \times (300/600) = 350$

Labour: $\frac{1}{2}$ of $(\frac{1}{3} \times 2100) \times 300/600$ and $\frac{1}{2}$ of $(\frac{1}{3} \times 2100) \times 3000/6000 = 175 + 175$

Sales: $(\frac{1}{3} \times 2100) \times 30\,000/60\,000 = 350$

Kenya Constituent State = 350

Tanzania Constituent State = 700

Uganda Constituent State = 1050
2100

Redistribution to all Constituent States – Macro-Economic Element

900 taxes to be redistributed to all Constituent States.

GDP Ranking in US dollars:⁹⁰

Burundi	3,078,029.93
Kenya	87,908,262.52
Rwanda	9,509,003.20
South Sudan	3,070,885.01
Tanzania	57,437,073.93
Uganda	27,476,945.53

Calculation of redistribution of 900 taxes:⁹¹

	GDP Rounded to:	Ratio to 187 as %	Distance from 100	Ratio to 500	Ratio applied to 900
Burundi	3	1,60	98,40	0,20	177,11
Kenya	87	46,52	53,48	0,11	96,26
Rwanda	9,5	5,08	94,92	0,19	170,86
South Sudan	3	1,60	98,40	0,20	177,11
Tanzania	57	30,48	69,52	0,14	125,13
Uganda	27,5	14,71	85,29	0,17	153,53
	187		500		900

⁹⁰ Based on World Bank national accounts data and OECD National Accounts data files, 2018 < <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=BI-KE-RW-SS-TZ-UG>> accessed 13 August 2019.

⁹¹ Author's own calculations.

In terms of the above calculations, the total corporate income taxes would be distributed amongst the Constituent States as follows:⁹²

	Macro-economic Distribution	CCTB Distribution	Total Redistribution
Burundi	177,11		177,11
Kenya	96,26	350	446,26
Rwanda	170,86		170,86
South Sudan	177,11		177,11
Tanzania	125,13	700	825,13
Uganda	153,53	1050	1203,53
	900	2100	3000

3.2.2. Be competitive in order to attract foreign direct investment

3.2.2.1. Tax incentives

Tax incentives are commonly used in developing countries, and usually take the form of tax holidays, base-reducing incentives (such as accelerated depreciation), tax rate deductions and ‘zones’ which typically offer tax holidays in order to attract export-related investment.⁹³ The principal aim of these incentives is to attract foreign direct investment. However, there is great debate about whether tax incentives in fact serve to increase foreign direct investment and thereby increase economic growth.⁹⁴ Some argue that tax incentives only serve to distort the investment decisions of investors;⁹⁵ they fail to attract

⁹² Author’s own calculations.

⁹³ Y Brauner, ‘The Future of Tax Incentives for Developing Countries’ in Y Brauner and M Stewart, *Tax, Law and Development* (Edgar Elgar Publishing 2013) 25, 27-29.

⁹⁴ MB Obwona, ‘Determinants of FDI and Their Impact on Economic Growth in Uganda’ (2001) 13 *African Development Review* 46, 59; RL Wellhausen, ‘Innovation in Tow: R&D FDI and Investment Incentives’ (2013) 15 *Business and Politics* 467; FR Root & AA Ahmed, ‘The Influence of Policy Instruments on Manufacturing Direct Foreign Investment in Developing Countries’ (1978) 9 *Journal of International Business Studies* 81; A Klemm and S Van Parys, ‘Empirical Evidence on the Effects of Tax Incentives’ (2009) Working Paper No. 2009-2136, International Monetary Fund.

⁹⁵ EM Zolt, ‘Tax Incentives: Protecting the Tax Base’ in A Trepelkov, H Tonino And D Halka, *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (United Nations 2015) 451, 452.

foreign direct investment⁹⁶ and they allow opportunities for corruption.⁹⁷

Despite the doubt in the true efficacy of tax incentives, tax incentives feature strongly in the tax policies of the EAC Partner States. Kenya offers corporate income tax holidays under both its Special Economic Zones Act ('SEZ Act')⁹⁸ and Export Processing Zones Act (EPZ Act).⁹⁹ Section 29 of the EPZ Act provides for a ten-year exemption from corporate income tax for EPZ enterprises,¹⁰⁰ while section 35(1) of the SEZ Act provides a complete exemption from several taxes, including corporate income tax, for all SEZ enterprises on SEZ-related transactions.¹⁰¹ Uganda offers exporters an exemption from income tax for a period of ten years provided that certain conditions are met, including that the exporter export at least 80% of the completed goods.¹⁰² Aircraft operators in Uganda are also offered an exemption from corporate income tax.¹⁰³ Rwanda offers two corporate income tax incentives to investors. The first is a corporate income tax holiday in terms of Rwanda's headquarter company regime.¹⁰⁴ An international company with its headquarters or regional office in Rwanda will not pay corporate income tax provided that certain investment thresholds are met, such as investing at least USD 10 million in assets in Rwanda.¹⁰⁵ Secondly, investors are offered a corporate income tax holiday for seven years provided that they meet certain investment thresholds, such as investing at least USD 50 million in certain sectors.¹⁰⁶

3.2.2.2. Recommendations for the East African Federation

In the light of the doubts as to whether tax incentives actually do bring in greater foreign direct investment, it is recommended that the East African Federation carefully consider whether to make use of tax incentives. In making this decision, it would be useful to evaluate whether the tax incentives used in the current Partner States were actually effective in meeting their objective of attracting foreign direct investment. This evaluation should weigh the incoming foreign direct investment against the cost of

⁹⁶ Ibid.

⁹⁷ Ibid.

⁹⁸ Special Economic Zones Act 16 of 2015 [SEZ Act, 2015 (Kenya)].

⁹⁹ Export Processing Zones Act, Chapter 517 of the Laws of Kenya [EPZ Act, Cap 517 (Kenya)].

¹⁰⁰ Section 29 of the EPZ Act, Cap 517 (Kenya).

¹⁰¹ Section 35(1) of the SEZ Act, 2015 (Kenya).

¹⁰² Section 21(1)(y) of the Income Tax Act, Chapter 340 of the Laws of Uganda [Income Tax Act, Cap 340 (Uganda)].

¹⁰³ S21(1)(x) of the Income Tax Act, Cap 340 (Uganda).

¹⁰⁴ Law No. 6/2015 of 28 March 2015 on Relating to Investment Promotion and Facilitation [Investment Code, 2015 (Rwanda)].

¹⁰⁵ Item I of the Annex to the Investment Code, 2015 (Rwanda).

¹⁰⁶ Item III of the Annex to the Investment Code, 2015 (Rwanda).

corporate income tax not collected from the qualifying taxpayers.

In the event that such evaluation produces the decision that tax incentives should be used in the East African Federation, it is recommended that the East African Federation consider making use of tax credit accounts¹⁰⁷ rather than the traditional tax holiday model. According to Tanzi and Zee, tax credit accounts would grant each qualifying investor a set amount of tax relief, such as US\$250 000 for example, against which such investor's actual tax liability would be set off.¹⁰⁸ For instance, in year one, after the investor files a tax return and its tax liability in that year amounts to US\$50 000, the investor's tax credit account would be reduced to US\$200 000 for the subsequent years.¹⁰⁹ This method would allow greater certainty for the taxpayer and the revenue service while also allowing for the tax incentive to be managed in an open and transparent manner.¹¹⁰ Moreover, this method would allow the East African Federation to have a better sense of the exact cost of the corporate tax revenues it is losing in order to attract foreign direct investment.

Uganda has been monitoring some of its tax incentives on a basis similar to the tax credit account. In terms of section 166(2) of the Income Tax Act in Uganda, companies benefitting from tax holiday periods are nonetheless required to submit their tax computations as though they were not exempt from tax.¹¹¹ The East African Federation would therefore be able to draw from the Ugandan experience in administering a tax credit account-like system.

In implementing this method, the East African Federation may wish to consider some of the guidelines issued on how developing countries should best design tax incentive schemes.¹¹² Zolt provides a synthesis of these guidelines as follows:¹¹³

- 1) The objectives of the tax incentives should be clearly set out¹¹⁴ – For the East African Federation, this would mean clearly identifying the purpose the tax incentives are meant to achieve in advance of the implementation of such

¹⁰⁷ V Tanzi and HH Zee, 'Tax Policy for Emerging Markets: Developing Countries' (2000) IMF Working Paper, WP/00/35, 26.

¹⁰⁸ Ibid.

¹⁰⁹ Ibid.

¹¹⁰ Ibid; Zolt (n95) 474.

¹¹¹ Income Tax Act (Uganda) section 166(2).

¹¹² RM Bird, 'Tax Incentives for Investment in Developing Countries' in G Perry, J Whalley and G McMahon (eds), *Fiscal Reform and Structural Change in Developing Countries* (Macmillan in association with the International Development Research Centre 2000) vol 1, 201-221; OECD, *Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries*, <<http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf>> accessed 19 July 2019.

¹¹³ Zolt (n95) 495.

¹¹⁴ Ibid.

- incentives. Possible objectives may include reducing unemployment in the region; increasing investment in a particular industry and improving the reputation of the East African Federation as a favourable investment destination and should be explicitly stated.
- 2) The type of tax incentive used should be fit to achieve the identified purpose¹¹⁵ – This would mean that the East African Federation should critically evaluate the types of tax incentives available – such as tax holidays, base-reducing incentives or zones – and their suitability in achieving the identified purpose. For instance, zones may be more effective in encouraging investment within a particular industry than a blanket tax holiday would in that zones may allow for more stringent entry requirements to be met before a taxpayer may access the tax benefits.
 - 3) A government should conduct a cost and benefits analysis of the proposed tax incentive¹¹⁶ – This would mean that the East African Federation should undertake a feasibility analysis of the proposed tax incentive and it should treat the proposed tax incentives as direct spending programmes¹¹⁷ when weighing it against the possible incoming investment. The tax credit account tax incentive would be an effective way of keeping track of the revenues foregone as a result of the implementation of the tax incentive.
 - 4) The design of the tax incentive programme should ensure accountability and transparency¹¹⁸ – It would be advisable for the East African Federation to table the proposed tax incentive programmes in Parliament and allow opportunities for debate and questioning. Moreover, once the tax incentive programme is in place, accountability should be ensured by requiring that any changes to the implemented programme should be submitted to the revenue authority via a publicly accessible platform, following which the Minister of Finance should annually report to Parliament on any amendments made to the implemented tax incentive programme.
 - 5) A termination clause should be built into the tax incentive programme to allow for the programme to come to an end should the objectives as specified not be achieved¹¹⁹ – The East African Federation should legislate a termination date for the tax incentive programme. Furthermore, the extension of this date should only be possible once a publicly accessible report on the performance of the tax incentive programme be made available which is to be followed by Parliamentary approval of the extension.

¹¹⁵ Ibid.

¹¹⁶ Ibid.

¹¹⁷ Ibid 467.

¹¹⁸ Ibid 495.

¹¹⁹ Ibid.

It is also recommended that the East African Federation focus on creating non-tax reasons for investors to invest in the region. One of these non-tax reasons should include creating a favourable investment environment for investors, as it has been noted that such an environment is directly related to ensuring the efficacy of any tax incentives offered.¹²⁰ Moreover, the budget of the East African Federation should focus on building infrastructure while the executive should focus on relaxing the bureaucracy around conducting business in the region. A further means of attracting foreign investment is through making the capital market more open and allowing for a greater mobility of capital.¹²¹ Through a careful devotion of resources to where it matters, the federation could easily create a good destination for foreign investment – all without surrendering its tax base.

3.2.3. CORPORATE INCOME TAX AND REDUCING THE INFORMAL SECTOR

3.2.3.1. The informal sector in the East African Region

The size of the informal sector or shadow economy is particularly problematic. A large informal sector has the effect of substantially narrowing the tax base to a small group of formal taxpayers.¹²² This, in turn, results in low income tax rates as the government fears that higher rates would force more taxpayers into the informal sector and out of the government's range.¹²³ A study conducted by Waseem indicates that informality remains one of the biggest barriers to emerging economies developing better fiscal capacity.¹²⁴ According to Buehn et al, these large informal sectors in developing countries are the product of high tax burdens.¹²⁵

Mitra argues that there are two ways to reduce the size of a large informal sector: improve tax enforcement and increase the formal sector's access to credit.¹²⁶ Once the enforcement and administrative capacity of revenue authorities are significantly improved, Mitra argues that this corresponds to a significantly increased risk of errant taxpayers being caught and penalized.¹²⁷ Similarly, once the formal sector has greater access to quality sources of finance, this acts as an incentive for businesses to

¹²⁰ Ibid 456.

¹²¹ Baker (n1) 414.

¹²² M Waseem, 'Taxes, Informality and Income-Shifting: Evidence from a Recent Pakistani Tax' (2018) *Journal of Public Economics* 41.

¹²³ Ibid.

¹²⁴ Ibid 57.

¹²⁵ A Buehn, R Dell'Anno and F Schneider, 'Exploring the Dark Side of Tax Policy: An Analysis of the Interactions between Fiscal Illusion and the Shadow Economy' (2018) *54 Empirical Economics* 1609, 1627.

¹²⁶ S Mitra, 'To Tax or Not to Tax? When Does It Matter for Informality?' (2017) *64 Economic Modelling* 117.

¹²⁷ Ibid 118.

migrate from the informal to the formal sector.¹²⁸ Mitra's study also produces the interesting result that once these factors are present in the economy, the link between the raising of taxes and the rise of the informal sector is broken.¹²⁹ These two factors therefore enable government to actually raise taxes without a consequent increase in the informal sector.¹³⁰

3.2.3.2. Recommendations for the East African Federation

In the light of the above discussion, the East African Federation would be well advised to devote resources towards the significant improvement of the administrative and enforcement capacity of its revenue authority. The East African Federation should also work towards improving the quality and capacity of the credit market and credit institutions. This could be done through making more government funding available for credit institutions and devoting more resources into developing the micro-lending market and suppliers within the East African region. In doing so, however, the East African Federation should not forget to also increase the regulation around the provision of credit so as to protect vulnerable debtors from unscrupulous debt-collection mechanisms. Should it devote the necessary resources in this targeted way, there is great potential for the federation to substantially increase its corporate income tax collections.

4. PROTECTING THE CORPORATE INCOME TAX BASE

In the wake of the global financial crisis of the 2000s, the G20 conceived of the Base Erosion and Profit Shifting project (BEPS) in 2013.¹³¹ The Organization for Economic Cooperation and Development (OECD) is tasked with implementing this project. The initial purpose of the BEPS project was to curb the aggressive tax planning methods employed by multinational companies which had the effect of eroding the corporate income tax base.¹³²

In order to fulfil its task of managing the anti-BEPS initiative, the OECD produced an array of fifteen actions over the course of two years. The actions cover a wide array of areas including a set of best practices relating to controlled foreign company rules; recommendations on hybrids, interest limitation and the analysis of BEPS data; changes to the provisions of the OECD Model Tax Convention in order to prevent treaty abuse, amending the language regarding permanent establishments, and

¹²⁸ Ibid.

¹²⁹ Ibid.

¹³⁰ Ibid.

¹³¹ See OECD, Press Release, *Closing Tax Gaps* (n4).

¹³² Ibid 11.

proposed options on how to address the challenges of the digital economy. Four actions are ‘minimum standards’ and represent actions which all participants to the BEPS Project politically agree to implement.¹³³ These are: provisions relating to transfer pricing documentation such as country-by-country reporting (action 13), rules against harmful tax practices (action 5), dispute resolution (action 14) and preventing the granting of treaty benefits in inappropriate circumstances (action 6). According to the OECD, these actions are built around three core principles: coherence, substance and transparency.¹³⁴

The BEPS project began with much hope as some speculated that the project would overhaul the international tax rules and so as to construct effective rules for a globalized world.¹³⁵ In reality, the BEPS project has fallen far short of this ideal.

Herzfeld argues that the BEPS project was never about fixing the antiquated and inappropriate underlying rules of the international tax system but was rather aimed at protecting the existing tax bases from rampant abuse.¹³⁶ She further notes that overall the BEPS project has produced poor outcomes because vague rules were generated and only served to further weaken the coherence of the international tax system.¹³⁷ This result is as a direct consequence of the failure to obtain the necessary consensus amongst States to make meaningful changes to the status quo.¹³⁸

De Wilde takes the same view.¹³⁹ He argues that the BEPS project merely treats the symptoms of a broken international tax system rather than the root underlying causes of its failure.¹⁴⁰ Despite the volumes of paperwork the BEPS project has produced, the flawed international corporate taxation framework remains in place.¹⁴¹

Despite its shortcomings, the BEPS project remains one of the most notable initiatives in international tax.¹⁴² In an EU

¹³³ OECD, *Executive Summaries 2015 Final Reports* OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2015).

¹³⁴ OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report* OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2015) 3.

¹³⁵ KA Parillo and others, ‘OECD BEPS Action Plan Draws Praise, Criticism’ (2013) 140 *Tax Notes* 437; S Picciotto, ‘Can the OECD Mend the International Tax System?’ (2013) 71 *Tax Notes International* 1105.

¹³⁶ M Herzfeld, ‘The Case Against BEPS: Lessons for Tax Coordination’ (2017) 21 *Florida Tax Review* 1.

¹³⁷ *Ibid* 59.

¹³⁸ *Ibid*.

¹³⁹ De Wilde (n24) 2.2.1.

¹⁴⁰ *Ibid*.

¹⁴¹ *Ibid*.

¹⁴² A Schnitger and I Zafirov, ‘Chapter 12: The Interest Limitation Rule’ in P Pistone and D Weber (eds), *The Implementation of Anti-BEPS Rules in the European Union: A Comprehensive Study* (IBFD 2018) 12.1.

context, the Commission set about co-ordinating the anti-tax avoidance response of the Member States – the product of which is the ATAD. The ATAD has been described as a major shift in the European response to anti-tax avoidance as the prevention of abusive tax practices has now become a European aim rather than just a goal within the purview of Member States.¹⁴³ Moreover, it has been commented that the ATAD is different from the other directives on direct taxation in that it has created rules of substantive law as it relates to corporate income tax while the other directives merely eliminate the tax effects which negatively affect the internal market.¹⁴⁴

The ATAD sets out five anti-tax avoidance measures which Member States are obliged to implement: control foreign company rules; an interest limitation rule; a general anti-abuse ('GAAR') rule; rules on hybrid mismatches; and exit taxation.

These measures to protect the corporate income tax bases of EU Member States may be of use to the East African Federation in designing measures to protect its own tax base. In considering the federation context, the author argues that the mechanisms most relevant for the East African Federation are: an interest deduction limitation rule, controlled foreign company rules and a GAAR. The application of an interest limitation rule and controlled foreign company rules will be discussed in the chapter, while the motivation for and development of a GAAR for the East African Federation is discussed in detail in chapter 4.

An interest deduction limitation rule is important for the East African Federation because it relates to the pre-BEPS issue of determining the point at which the deduction of interest is excessive. The deduction of interest expenses is a common element of tax systems in the world,¹⁴⁵ and it also features in the current corporate income tax systems of the EAC Partner States. Such commonality has resulted in the formation of the international norm to limit the deduction of interest in instances where the revenue authorities view the deduction as excessive in some way.¹⁴⁶

Controlled foreign company (CFC) rules are gaining increasing importance in the international tax sphere. It has been noted that the loss of corporate income tax for developing

¹⁴³ MC Barreiro Carril, 'Commentary on Chapter 16: Does the Anti-Tax Avoidance Directive Involve a Positive Step Towards the Completion of the Internal Market? Some Reflections in the light of Linking Rules Addressing Hybrid Mismatches' in P Pistone (ed), *European Tax Integration: Law, Policy and Politics* (IBFD 2018) section 4.

¹⁴⁴ D Gutmann and others, 'The Impact of the ATAD on Domestic Tax Systems: A Comparative Survey' (2017) 57 *European Taxation* 2.

¹⁴⁵ A Klemm, *Allowances for Corporate Equity in Practice* (2006) International Monetary Fund Working Paper, WP/06/259, 4.

¹⁴⁶ PA Barnes, 'Chapter 4: Limiting Interest Deductions' in A Trepelkov, H Tonino and D Halka (eds), *UN Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (UN 2015) 155, 172.

countries is mainly attributed to the erosion of rules regarding source taxation.¹⁴⁷ CFC rules are key in fighting such erosion because CFC rules remove the motivation for multinational enterprises and other taxpayers to actively circumvent source taxation.¹⁴⁸

A GAAR is necessary for the East African Federation because a study has highlighted the increasing need for the EAC Partner States to protect their tax bases, particularly its corporate income tax base.¹⁴⁹ Moreover, should the federation not implement a GAAR as its constituent Partner States have done, a reasonable inference to draw from this omission would be that the East African Federation is tolerant of tax abuse and lax about the protection of its tax bases. The federation cannot afford for such perceptions to take root. It would therefore be in the best interest of the East African Federation to design and implement a GAAR. GAARs are relatively quick to implement and there is a proliferation of GAARs across the world from which the East African Federation may draw in designing its own. The implementation of GAARs is also on the rise globally.¹⁵⁰ The federation cannot afford to wait for anti-tax avoidance doctrines to be developed through the courts. Chapter 4 of this study designs a GAAR for the East African Federation which draws from international best practices while at the same time considering the East African context in terms of which such legislation would be interpreted.

The author is of the view that the exit taxation measure under the ATAD is not appropriate for the East African Federation because its priority would be to make the federation an attractive destination for foreign investment. The spectre of exit taxation would not assist in meeting this objective as it would be far too easy for foreign investors to rather invest in other countries that do not have such restrictions on the movement of capital and assets.

The author is also of the view that the adoption of hybrid mismatch rules would not be appropriate for the East African Federation. It has been noted that these rules may impact the

¹⁴⁷ J Li, 'Chapter 8: Protecting the Tax Base in the Digital Economy' in A Trepelkov, H Tonino and D Halka (eds), *UN Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (UN 2015) 407, 411.

¹⁴⁸ C Turley, DG Chamberlain and M Petriccione, 'Chapter 8: Controlled Foreign Corporation Rules' in *A New Dawn for the International Tax System: Evolution from Past to Present and What Role Will China Play?* (IBFD 2017).

¹⁴⁹ B Peter, *Regional Integration and Tax Revenue: A Case Study of the East African Community (EAC)*, Master's Dissertation (Makerere University 2014).

¹⁵⁰ RE Krever, 'Chapter 1: General Report: GAARs' in M Lang and others (eds), *GAARs – A Key Element of Tax Systems in the Post-BEPS Tax World* (IBFD 2016).

efficacy of any tax incentives offered,¹⁵¹ and more generally may have a negative effect on economic growth as investors seek to avoid the application of these rules.¹⁵² Moreover, the effective implementation of hybrid mismatch rules requires strong exchange of information channels, good administrative support and ideally, a good co-operative relationship between the revenue authority and taxpayers.¹⁵³ It is recommended that the East African Federation consider hybrid mismatch rules only once these factors are already in place.

4.1. INTEREST DEDUCTION LIMITATION

The interest limitation rule is found in article 4 of the ATAD. The definition of borrowing costs is key to the application of article 4. 'Borrowing costs' is defined in article 2(1) as: 'interest expenses on all forms of debt, other costs equivalent to interest and expenses incurred in connection with the raising of finance as defined in national law'. This definition is expansive as it continues to list specific examples of contractual arrangements which would give rise to borrowing costs. The definition seems to be designed to cover the broadest meaning of interest, which may be described as 'all instances by which interest is designed to compensate the lender for [the lender's] inability to use the borrowed funds'.¹⁵⁴

In terms of article 4(1), the deduction of exceeding borrowing costs shall be limited to an amount up to 30% of the taxpayer's earnings before interest, tax, depreciation and amortisation ('EBITDA'). Such EBITDA is to be calculated in terms of article 4(2) which provides that the tax adjusted amounts for exceeding borrowing costs, for depreciation and for amortisation are to be added back to the income subject to corporate income tax at the exclusion of tax exempt income.

The ATAD allows for certain exclusions from the application of the interest limitation rule. These exclusions are for: 1) taxpayers with deductible exceeding borrowing costs up to EUR 3 million;¹⁵⁵ 2) taxpayers who are standalone entities; namely, taxpayers that are not part of a group, has no associated enterprises or permanent establishments;¹⁵⁶ 3) certain loans; namely, loans pre-dating the implementation of ATAD and loans related to public infrastructure payments;¹⁵⁷ 4) financial

¹⁵¹ B Kuzniacki and others, 'Preventing Tax Arbitrage via Hybrid Mismatches – BEPS Action 2 and Developing Countries' (2017) WU International Taxation Research Paper Series, No. 2017-03, 46.

¹⁵² Ibid.

¹⁵³ Ibid 45.

¹⁵⁴ A Titus, 'The Different Permutations of CSARS v Brummeria: Was It Something Other Than An 'Interest-Free' Loan?' (2012) 129 South African Law Journal 236, 244.

¹⁵⁵ Art 4(3) ATAD.

¹⁵⁶ Ibid.

¹⁵⁷ Art 4(4) ATAD.

undertakings¹⁵⁸ which includes banks, insurance and reinsurance undertakings and certain investment funds.¹⁵⁹

Any unused deductible exceeding borrowing costs may be carried forward for three years, five years or indefinitely depending on the period chosen by the Member State.¹⁶⁰ The ATAD also has provisions in place to address the treatment of groups in terms of the calculation of the 30% of EBITDA,¹⁶¹ and the treatment of individual companies belonging to the group who may be allowed to deduct its full borrowing costs if its equity to total assets ratio is up to two percentage points lower than the equivalent group's ratio.¹⁶² This chapter will not elaborate on the group company provisions of the ATAD because this would not be relevant to the East African Federation. Should the East African Federation implement the CCCTB, as recommended above under part 3.2.1.2, this would allow for the consolidated results of the group to be subject to a possible interest limitation rule.

The interest limitation rule has been described as one of the most difficult measures for the EU Member States to implement considering the complexity around group implementation and the choice of options afforded Member States.¹⁶³ Carmona Lobita argues that the ATAD's interest limitation rule fails to achieve the objective of standardizing the Member States' approach to placing a limit on the deductibility of interest because far too many options were given to Member States by which to adhere to the ATAD minimum standard.¹⁶⁴ He notes that the interest limitation rules in the ATAD could allow for 288 rules to be built, which is far too many to create any sense of legal certainty with respect to the ATAD's rules.¹⁶⁵

Moreover, Schnitger and Zafirov argue that the interest limitation rule may have an extremely negative effect on businesses generally, but especially those companies with low EBITDA results.¹⁶⁶ This is because the interest limitation rule does not allow Member States to consider the liquidity issues of taxpayers with low EBITDA results and the effect the limitation of interest deductibility may have on their economic situation.¹⁶⁷ This effect, however, is tempered by the fact that the non-

¹⁵⁸ Art 4(7) ATAD.

¹⁵⁹ Art 2(5) ATAD.

¹⁶⁰ Art 4(6) ATAD.

¹⁶¹ Art 4(1) ATAD.

¹⁶² Art 4(5) ATAD.

¹⁶³ Schnitger and Zafirov (n142) 12.1.

¹⁶⁴ J Carmona Lobita, 'The ATAD's Interest Limitation Rule – A Step Backwards?' (2019) 59 *European Taxation* 60.

¹⁶⁵ Schnitger and Zafirov (n142) 12.1.

¹⁶⁶ *Ibid* 12.3.2; D Fernley and M Moroney, 'EU Anti-Tax Avoidance Package: Impacts on Financial Instruments' (2016) 18 *Derivatives and Financial Instruments* 2.2.2.

¹⁶⁷ Schnitger and Zafirov (n142) 12.3.2.

deductibility is only temporary and may be carried forward.¹⁶⁸ Also, Popa argues that restrictive interest limitation rules may make EU Member States less competitive as investors seek out countries or Member States with more lenient rules or no restrictions on the deductibility of interest.¹⁶⁹

Heyvaert and Moonen, however, argue that the ATAD's interest limitation rule is a step in the right direction as the use of the EBITDA ratio is not as easily manipulatable; provides a direct connection between the taxpayer's taxable income and the interest deduction and also between the economic activity and the interest deduction.¹⁷⁰

4.1.1. RECOMMENDATIONS FOR THE EAST AFRICAN FEDERATION

It is recommended that the East African Federation consider implementing an interest limitation rule in its jurisdiction as it would be in keeping with the global movement towards the restriction on the deductibility of interest as a means to stop BEPS. While most EAC Partner States do have thin capitalization rules in place which typically limit the deduction of interest to a ratio of 3:1, an interest limitation rule may complement such thin capitalization rules.

An interest limitation rule may be easier to implement and administer in the East African Federation should a system similar to the CCCTB also be adopted in the federation. This would allow for consistency and certainty in the treatment of groups.

In designing the rule, however, the East African Federation should take care not to impose too strict an interest limitation rule as this may have a negative effect on the federation's competitiveness. The East African Federation should therefore allow for the indefinite carry forward of unused excessive borrowing costs, as is the option available to EU Member States under the ATAD. Also, the East African Federation should allow the excess borrowing costs not allowed under the thin capitalization rules to be carried forward under the interest limitation rule.

The East African Federation should adopt a similar definition to borrowing costs as defined in article 2(1) of the ATAD. The definition is extensive and covers a broad range of instances in which the lender may be compensated for the act of lending money. Moreover, in terms of calculating the amount of excess borrowing costs which will not be recognised for tax

¹⁶⁸ Ibid 12.4.1.

¹⁶⁹ O Popa, 'Romania – Implementation of the EU Anti-Tax Avoidance Directive (2016/1164)' (2018) 58 *European Taxation* 224.

¹⁷⁰ W Heyvaert and E Moonen, 'ATAD Implementation in Belgium: An Analysis of the New Interest Limitation Rule' (2019) 59 *European Taxation* 354.

purposes, the East African Federation may find the formula Bulgaria has included in its Corporate Income Tax Act useful in terms of ensuring greater clarity.¹⁷¹ The formula is as follows:

$$\begin{aligned} \text{UEBC}^{172} &= \text{EBC}^{173} - 0.30 \times \text{TFRITA}^{174} \\ \text{TFRITA} &= \text{TFR}^{175} + \text{ATA}^{176} - \text{ARI}^{177} + \text{EBC} \end{aligned}$$

The East African Federation should also be mindful of the industries that would likely be most affected by an interest limitation rule. It is recommended that the East African Federation exclude financial institutions such as banks and investment houses from the application of the interest limitation rule, as their inclusion may have negative effect on the economic growth prospects within the region. Also, it has been noted that capital-intensive industries typically have high EBITDA results given their high depreciation and amortisation figures.¹⁷⁸ As the East African region has a strong natural resources sector, an interest limitation rule may not affect these companies too greatly. Also, the East African Federation would likely continue the Partner States current practice of growing the energy sector – another capital-intensive sector with high EBITDA results which should remain robust against an interest limitation rule.

In the author's view, the implementation of an interest limitation rule in the East African Federation would be a useful tool in the fight to protect its corporate income tax base while also not bringing about too many adverse consequences in its wake.

4.2. CONTROLLED FOREIGN COMPANY RULES

CFC rules are described as essential to the international tax system in that they perform a three key functions: they protect the tax base, hinder tax deferral schemes and support capital export neutrality policies.¹⁷⁹ They do this by preventing taxpayers from shifting usually passive income offshore to taxpayer-controlled foreign companies through attributing such

¹⁷¹ Corporate Income Tax Act, National Legislation IBFD (Bulgaria).

¹⁷² 'UEBC' means unrecognised exceeding expenses of borrowing costs.

¹⁷³ 'EBC' means the excess borrowing costs before the application of the interest limitation rule.

¹⁷⁴ 'TFRITA' means the tax financial result before any interest, tax and annual tax amortization deduction.

¹⁷⁵ 'TFR' means tax financial result.

¹⁷⁶ 'ATA' means annual tax amortization.

¹⁷⁷ 'ARI' means annual recognised interest.

¹⁷⁸ Schnitger and Zafirov (n142) 12.3.2.

¹⁷⁹ D Cane, 'Controlled Foreign Corporations as Fiscally Transparent Entities: The Application of the Controlled Foreign Company Rules in Tax Treaties' (2017) 9 World Tax Journal 521.

income to the taxpayer.¹⁸⁰ As such, CFC rules support other anti-avoidance tools such as transfer pricing.¹⁸¹ CFC rules, however, typically exclude income that is generated by actual economic activity in the controlled-company's jurisdiction.¹⁸²

The CFC rules contained in the ATAD are largely based on the OECD's 'six building blocks' for the design of CFC rules.¹⁸³ First, the CFC is defined. Article 7(1) of the ATAD sets out the conditions that when met will classify an entity as a CFC. A CFC is an entity or permanent establishment – not subject to tax in the Member State of the taxpayer – that:

- 1) Has more than 50% of the participation in the voting rights within it or more than 50% of its capital directly or indirectly held by the taxpayer alone or together with enterprises associated with the taxpayer, or has more than 50% of its profits allocated to such taxpayer and/or associated enterprises;¹⁸⁴ and
- 2) Has an actual corporate income tax liability that is lower than the difference between the corporate income tax it would have paid had it been subject to the corporate tax system in the Member State of the taxpayer and the actual corporate income tax it paid on its profits.¹⁸⁵ In conducting such calculation, the permanent establishment of the CFC that is exempt or not subject to tax in the jurisdiction of the CFC shall be ignored.¹⁸⁶

Secondly, the ATAD defines the income that is to be the target of the CFC rules. Article 7(2) provides two methods by which the income may be identified. The entity or categorical approach¹⁸⁷ under article 7(2)(a) lists types of passive income that would be attributed to the taxpayer and include items such as interest, royalties and dividends. Article 7(2)(a) continues by excluding active income – income that is linked to 'substantial economic activity supported by staff, equipment, assets and premises' conducted by the CFC. The article further provides that Member States are not obliged to provide such exclusion to

¹⁸⁰ OECD, *Designing Effective Controlled Foreign Company Rules: Action 3 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (OECD Publishing 2015).

¹⁸¹ Turley, Chamberlain and Petriccione (n148) 8.1.1; Ibid 16.

¹⁸² OECD *Designing Effective CFC Rules* (n180) 18.

¹⁸³ Ibid 11.

¹⁸⁴ Art 7(1)(a) ATAD.

¹⁸⁵ Art 7(1)(b) ATAD.

¹⁸⁶ Ibid.

¹⁸⁷ CHJI Panayi, 'Chapter 16: The ATAD's Controlled Foreign Company Rule and its Impact on the Existing Regimes of EU Member States' in P Pistone and D Weber (eds), *The Implementation of Anti-BEPS Rules in the European Union: A Comprehensive Study* (IBFD 2018) 16.3.

CFCs resident or situated in countries that are not party to the EEA Agreement.¹⁸⁸

Article 7(2)(b) sets out the transactional approach¹⁸⁹ to identifying the income to be attributed to the taxpayer. In terms of this approach, income arising from ‘non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage’¹⁹⁰ shall be subject to tax in the taxpayer’s hands. The article continues by describing what is meant by the term ‘non-genuine’. A transaction is considered non-genuine where it is clear that the entity or permanent establishment owns assets or has undertaken risks which either partly or wholly generates its income, because it is controlled by the company where the ‘significant people functions’ key to the generation of that income take place.¹⁹¹

Thirdly, the ATAD’s CFC rules provides de minimus thresholds by which to exclude CFCs from the application of the CFC rules. Should the Member State have used the entity or categorical approach, a Member State may choose not to apply the CFC rules where at most one third of the entity or permanent establishment’s income falls within the listed categories of income.¹⁹² Moreover, Member States may exclude financial undertakings from the application of the CFC rules where at most one third of the entity’s income as listed in article 7(2)(a) results from transactions concluded with the taxpayer or its associated enterprises.¹⁹³

Should the transactional approach have been taken, Member States may exclude entities or permanent establishments with either less than EUR750 000 accounting profits or EUR 75 000 non-trading income, or accounting profits that amount to less than 10% of its operating costs for the tax period.¹⁹⁴ Article 7(4) further provides that the accounting profits relating to the operating costs calculation shall exclude payments made to associated enterprises and the cost of goods sold outside the resident country of the entity or permanent establishment.

Fourthly, the ATAD provides rules for the computation of the CFC’s income under article 8. In terms of the entity or categorical approach, the laws of the Member State in which the taxpayer is resident shall be used to calculate the income that is to be taxed in the taxpayer’s hands.¹⁹⁵ In conducting such calculations, losses of the entity or permanent establishment are to be carried forward but not included in the tax base of the taxpayer’s Member State.¹⁹⁶ In terms of the transactional

¹⁸⁸ Art 7(2)(a) ATAD.

¹⁸⁹ Panayi (n187) 16.3.

¹⁹⁰ Art 7(2)(b) ATAD.

¹⁹¹ Ibid.

¹⁹² Art 7(3) ATAD.

¹⁹³ Ibid.

¹⁹⁴ Art 7(4) ATAD.

¹⁹⁵ Art 8(1) ATAD.

¹⁹⁶ Ibid.

approach, the income shall be calculated according to the arm's length principle and shall be limited to 'amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company'.¹⁹⁷

Fifthly, the ATAD sets out how to determine the income to be attributed to the taxpayer. The income so calculated shall be included in the tax base of the taxpayer's Member State according to the taxpayer's participation in the CFC.¹⁹⁸ Moreover, in terms of the timing of the inclusion of such income, the inclusion shall take place in the taxpayer's tax period which corresponds to the entity's tax year end.¹⁹⁹

Sixthly, the ATAD sets out provisions designed to exclude the double taxation of the taxpayer. Articles 8(5), (6) and (7) provide for the elimination of double taxation in instances where profits have been distributed, participations have been disposed of and actual taxes paid by the CFC in its residence country or the country in which it is located.

The effect of the ATAD's CFC rules is to focus tax competition amongst Member States at the parent company level rather than at the subsidiary level.²⁰⁰ This may be a problem for Member States who have designed their tax policies to compete at the subsidiary level.²⁰¹ Moreover, Member States may temper the effect of CFC rules by changing their corporate income tax rate so as to manipulate when the effective tax rate requirement of the CFC definition applies.²⁰²

Some concerns have been raised regarding the CFC rules compliance with EU law. It is questioned whether 'non-genuine' test corresponds with the 'wholly artificial arrangement' test referred to in the Cadbury Schweppes case.²⁰³ Moreover, it is questioned whether not carrying on substantial economic activity is the same as artificiality as understood in terms of ECJ case law.²⁰⁴ Also, some have argued that ATAD's stance on allowing Member States to discriminate between operations conducted within the EU and outside the EU when deciding whether to exempt CFCs from the application of the CFC rules is not in keeping with EU law.²⁰⁵ This stance has also been

¹⁹⁷ Art 8(2) ATAD.

¹⁹⁸ Art 8(3) ATAD.

¹⁹⁹ Art 8(4) ATAD.

²⁰⁰ G van Hulle, 'Current Challenges for EU Controlled Foreign Company Rules' (2017) *Bulletin for International Taxation* 719, 724.

²⁰¹ *Ibid.*

²⁰² *Ibid.*

²⁰³ Panayi (n187) 16.3; RJ Dannon, 'Chapter 17: Some Observations on the Carve-Out Clause of Article 7(2)(a) of the ATAD with respect to Third Countries' in P Pistone and D Weber (eds), *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (IBFD 2018) 17.3.1.

²⁰⁴ *Ibid.*

²⁰⁵ *Ibid.*; Dannon (n203) 17.1.

criticised as working against the objectives of the OECD BEPS Action 3.²⁰⁶

The overall consensus, however, is that CFC rules are an effective measure to protect the corporate income tax base of the EU Member States.²⁰⁷

4.2.1. RECOMMENDATIONS FOR THE FEDERATION

It is recommended that the East African Federation implement CFC rules in order to protect its corporate income tax base. As the widespread global use of CFC rules has been hailed as supporting source country's taxation rights,²⁰⁸ it is important that the East African Federation adopt this policy which is becoming a global norm.

While most Partner States have transfer pricing rules, and the East African Federation would likely continue with this practice, CFC rules may be useful tool for the East African Federation to catch income in an administratively easier manner given that CFC rules would apply automatically. Transfer pricing adjustments, however, may only be made after the revenue authority's transfer pricing challenges are successfully made and defended.²⁰⁹

In terms of constructing the CFC rules in the East African Federation, it is recommended that the East African Federation adopt the definition of a CFC in terms of article 7(1) of the ATAD. The clear and comprehensive definition suitably captures the entities meant to fall within the CFC rules. Moreover, it is noted that second part of the CFC test in the CFC definition would be calculated with reference to the corporate income tax rate used in the East African Federation. In this regard, it is recommended that the East African Federation refrain from corporate income tax rate changes in order to manipulate the application of the CFC rules. Lowering the tax rate is not a panacea to falling corporate income tax revenues. Suarez Serrato and Zidar note that all reductions in tax rates do is garner media attention and public interest.²¹⁰ However, such reductions have a devastating effect on revenues and may even serve to reduce economic activity.²¹¹ Moreover, in terms of setting corporate income tax rates in the first place, Baker notes that there is no evidence that the governments in developing countries actually consider their own revenue needs when setting the corporate income tax rate.²¹² The East African Federation

²⁰⁶ Dannon (n203) 17.7.

²⁰⁷ Van Hulle (n200) 724.

²⁰⁸ Turley, Chamberlain and Petriccione (n148).

²⁰⁹ Ibid 8.1.1.

²¹⁰ JC Suarez Serrato and O Zidar, 'The Structure of State Corporation Taxation and its Impact on State Tax Revenues and Economic Activity' (2018) 167 *Journal of Public Economics* 158, 175.

²¹¹ Ibid.

²¹² Baker (n1) 415.

should break this trend. The extent of the budget deficits of the Partner States indicate that the East African region cannot actually afford to offer reduced corporate income tax rates to taxpayers over any period of time. The East African Federation should therefore remove all reduced corporate income tax rates currently operating in the region and should enforce the 30% corporate income tax rate. This rate has been proven to be the ideal rate at which to maximize corporate income tax collections.²¹³

Furthermore, it is recommended that the East African Federation adopt the transactional approach under article 7(2)(b) of the ATAD in identifying the income to fall within the CFC net. The East African Federation would likely follow a capital import neutrality objective as a net importer of capital, as most developing countries do.²¹⁴ As such, the author is of the view that the transactional approach would afford the East African Federation more flexibility and discretion to determine whether the CFC rules are perhaps having too great a deterrent effect on the inflows of foreign direct investment, and should thus be applied more sparingly.

It also recommended that the East African Federation apply the de minimus thresholds related to the transactional approach in terms of article 7(4) of the ATAD. It is further recommended that the East African Federation conduct an analysis of the appropriate thresholds to set for its markets. To do this, the East African Federation may collect data from the EAC Partner States on the average income levels of multinational enterprises and other companies operating within these Partner States. This would give the East African Federation an indication of which income levels would be too low to justify the administrative resources it would take to implement the CFC rules. Once this amount is determined, the East African Federation should represent this amount in its own prevailing currency.²¹⁵

In terms of the computation of the CFC income, it is recommended that the East African Federation adopt the method detailed in article 7(2) of the ATAD. This would entail the East African Federation applying the arm's length principle with a limitation for the amounts suitably linked to significant functions performed by the controlling company. This option would be suited for the East African Federation because this would allow

²¹³ Suarez Serrato and Zidar (n210) 159.

²¹⁴ ECCM Kemmeren, 'Legal and Economic Principles Support an Origin and Import Neutrality-Based over a Residence and Export Neutrality-Based Tax Treaty Policy' in M. Lang and others (eds), *Tax Treaties: Building Bridges between Law and Economics* (IBFD 2010) 4.7.

²¹⁵ This is on the assumption that at this stage, the East African Federation would have its own currency as a consequence of the creation of the federation, but also as a result of the successful implementation of the EAC Protocol on the Establishment of the East African Monetary Union (30 November 2013).

it to draw from the transfer pricing expertise the EAC Partner States may have built over time before the integration.

Finally, it is recommended that the East African Federation adopt the attribution of income rule as stated in article 7(3) of the ATAD. In doing so, it would be logical for the taxpayer's participation quotient be calculated with reference to the control levels calculated in the CFC definition of article 7(1) of the ATAD.²¹⁶ This would provide a suitable degree of consistency to the East African Federation's application of its CFC rules.

It is acknowledged that CFC rules are highly technical and complex.²¹⁷ The East African Federation should therefore invest in technical training to ensure that the revenue authority staff are adequately trained to identify and address CFC issues.

The author is of the view that CFC rules would be an effective mechanism by which the East African Federation may protect its corporate income tax base. More generally, however, the federation should pay close attention to the implementation progress of the ATAD by Member States in order to stay abreast of any further complications that may arise in future given that Member States have voiced the difficulty involved in comparing their domestic rules with that of the minimum standards of the ATAD.²¹⁸ This is of particular concern as it relates to the ability of the Member State to determine whether its domestic measures meet the minimum standards of the ATAD or not.²¹⁹

5. PRACTICAL ASPECTS OF IMPLEMENTING CORPORATE INCOME TAX AND THE MEASURES TO PROTECT IT

As a corporate income tax system will not operate within a vacuum within the East African Federation, it is important to consider the influence institutions within the East African Federation, such as the East African Court of Justice and the Council, may have on the implementation of corporate income tax. Also, as the East African Federation would be a developing country, the design of a corporate income tax system would not be complete without addressing the administrative challenges facing it.

The EU experience offers the East African Federation valuable insight into the influence institutions within a regional integration project may have on a corporate income tax system. This is even though EU Member States still retain sovereignty

²¹⁶ OECD *Designing Effective CFC Rules* (n180) 63.

²¹⁷ Turley, Chamberlain and Petriccione (n148).

²¹⁸ C Docclo, 'The European Union's Ambition to Harmonize Rules to Counter the Abuse of Member States' Disparate Tax Legislations' (2017) 71 *Bulletin for International Taxation* 367, 368.

²¹⁹ Gutmann and others (n144) 19.

over their direct taxes. The harmonization of direct taxes in the EU is a highly sensitive political issue.²²⁰

While substantive harmonization in direct taxes is scarce, some degree of harmonization is brought about in the EU through the TFEU principles (such as the prohibition of discrimination against or hindering goods, services, workers, undertakings and capital from other Member States, prohibition of any discrimination directly or indirectly based on the nationality of persons or on origin of goods, services and capital) constraining Member States in the making of tax laws and also, through tax competition amongst Member States causing ‘spontaneous harmonization’.²²¹

All this is occurring alongside the internal market ideal where businesses are meant to be in a position to source materials from anywhere within the market, produce at any location within the market and sell at any place within the market without being hindered by double taxation and tax discrimination issues.²²² The realization of this ideal is made difficult also by the design of the corporate income tax systems in EU Member States. The corporate income tax systems of the Member States are still modelled on a blueprint for the way of doing business in the 1920’s.²²³ The system works best when cross-border transactions are rare, there is a clear distinction between debt and equity, shareholders generally live in the same country as the companies in which they invest, and interest receipts are taxed in the hands of the credit providers.²²⁴ However, the globalized world has changed all of these economic markers and the failure of the Member States to adapt their corporate income tax systems to modernity has resulted in large gaps in the international tax system from which taxpayers have benefitted greatly and systematically.

In response to this, the EU Member States act as though their best offense would be a comprehensive and sustained defence of their tax sovereignty. This has resulted in a marked movement within the EU to test the limits of national sovereignty with respect to direct taxes rather than in working towards a supranational direct tax policy.²²⁵ At this point, the corporate income tax systems of the Member States have become decidedly protectionist of their local investment

²²⁰ PJ Wattel, ‘Chapter 1: Introduction’ in PJ Wattel, O Marres and H Vermeulen (eds), *Terra/Wattel – European Tax Law* (7th edn Wolters Kluwer 2019) 8.

²²¹ *Ibid* 6-7.

²²² Cnossen (n7) 809.

²²³ *Ibid* 810.

²²⁴ *Ibid* 811.

²²⁵ P Pistone, ‘European Tax Integration: The Need for a Traffic Light at the Crossroads of Law, Policy and Politics’ in P Pistone (ed), *European Tax Integration: Law, Policy and Politics* (IBFD 2018).

climate.²²⁶ It is so much so that Van Thiel questions whether this protectionist drive is in fact ‘constitutional’ in that questions may be raised as to whether institutions such as the ECJ and the Council are in fact carrying out their mandate as intended under the EU Treaties.²²⁷

In the light of this, this part shall set out the factors beyond the design of a corporate income tax system which the East African Federation should be aware of and take measures to address to ensure that an effective corporate income tax.

5.1. INFLUENCE OF INSTITUTIONS ON THE SHAPING OF CORPORATE INCOME TAX

5.1.1. THE ROLE OF THE COURT

It has been noted that the lack of secondary EU law on direct taxes has resulted in the ECJ having to address the clash between EU free movement rights, general principles of EU law and the Member States’ interest in protecting the tax bases.²²⁸ Moreover, it has been further commented that in fulfilling this role, the ECJ’s power with respect to direct taxes under the auspices of the TFEU is fundamentally destructive rather than constructive.²²⁹ The ECJ is only authorised to disqualify discriminatory national law and it cannot replace such law with more appropriate provisions.²³⁰ In this light, it is little wonder that the ECJ jurisprudence on direct tax issues has been described as chaotic.²³¹

More recently, the ECJ is said to be following a discrimination-based approach in assessing whether national tax provisions are compatible with the internal market.²³² In applying this approach, the court asks the following questions:

- 1) Prima facie, does the national tax provision make a distinction between the cross-border investment, establishment or work and its domestic counterpart?²³³
- 2) If yes, can the difference in tax treatment be explained as an objective difference between the cross-border and domestic

²²⁶ S van Thiel, ‘Commentary on Chapter 1: Trends in European Direct Taxation – Tax Harmonization, State Aid and Case Law’ in P Pistone (ed), *European Tax Integration: Law, Policy and Politics* (IBFD 2018) 5.

²²⁷ Ibid.

²²⁸ PJ Wattel, ‘Chapter 3: General EU Law Concepts and Tax Law’ in PJ Wattel, O Marres and H Vermeulen (eds), *Terra/Wattel – European Tax Law* (7th edn Wolters Kluwer 2019) 47.

²²⁹ Ibid 48.

²³⁰ Ibid.

²³¹ Ibid 47.

²³² PJ Wattel, ‘Chapter 14: Conceptual Background of the ECJ Case Law in Direct Tax Matters’ in PJ Wattel, O Marres and H Vermeulen (eds), *Terra/Wattel – European Tax Law* (7th edn Wolters Kluwer 2019) 626.

²³³ Case C-279/93 *Schumacker* [1994] ECR I-5535.

investment, establishment or work?²³⁴ In this regard, the ECJ case law indicates that the comparability analysis can only be conducted once the extent to which the income or person is subject to tax within that jurisdiction is determined.²³⁵ If the non-resident or income is not subject to tax within the jurisdiction, this would qualify as an objective difference such that there is no discrimination in the prima facie difference in tax treatment between the cross-border and domestic instances.²³⁶ Should there be no objective difference between the two instances, the court should then consider what the purpose and object of the relevant national tax provision are.²³⁷

- 3) Next, the court should examine whether discriminatory tax provisions may be justified by a legitimate aim.²³⁸
- 4) If such a justification exists, the court should next consider whether the discriminatory but justified tax provision is proportionate in that it does not restrict the freedom rights more than is necessary to achieve the legitimate aim.²³⁹

In applying this approach, it has been commented that the court has more recently been more consistent than its earlier cases.²⁴⁰ In terms of the compatibility test of the above approach, it is key that the court choose the correct comparator.²⁴¹ The court got this wrong in the *Marks & Spencer plc v Halsey*²⁴² case. In this case, UK law allowed the UK parent company to offset losses from its domestic subsidiary against its income. However, losses in the parent company's foreign subsidiaries could not be so offset. In labelling this exclusion discriminatory, Wattel notes that the court failed to take into account the fact that the foreign subsidiaries are not subject to tax in the UK while the domestic subsidiaries are.²⁴³ The court did, however, get the comparison right in the *Timac Argo* case.²⁴⁴ In this case, the court correctly recognised that foreign and domestic branches were not in comparable positions when only the domestic branch was subject to tax in Germany.

In terms of applying the justifiability leg of the approach, Wattel observes that the ECJ has only accepted one justification – the protection of the integrity of the Member State's tax

²³⁴ Ibid.

²³⁵ Case C-388/14 *Timac Agro Deutschland GmbH* EU:C:2015:829.

²³⁶ Ibid.

²³⁷ Case C-319/02 *Manninen* [2004] ECR I-7477.

²³⁸ Case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* [2006] ECR I-07995.

²³⁹ Case C-382/16 *Hornbach-Baumarkt AG v The Tax Office, Germany* EU:C:2018:366.

²⁴⁰ Wattel *Chapter 14* (n232) 634.

²⁴¹ Ibid 627.

²⁴² Case C-446/03 *Marks & Spencer plc v Halsey* [2006] BTC 318.

²⁴³ Wattel *Chapter 14* (n232) 628.

²⁴⁴ *Timac Agro Deutschland GmbH* (n235).

base.²⁴⁵ A leading case as an illustration of this is the *Cadbury Schweppes* case.²⁴⁶ The case concerned whether the controlled foreign company legislation in the UK was incompatible with the freedom of establishment. The court ruled that while the legislation did restrict the freedom of establishment, this could be justified where the national legislation served to prevent ‘wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned.’²⁴⁷

Finally, with respect to the application of the proportionality test, national legislation often fails this test.²⁴⁸ The ECJ recently considered the proportionality test in the *Hornbach Baumarkt* case.²⁴⁹ The case concerned whether transfer pricing provisions unjustifiably restrict the freedom of establishment in circumstances where the taxpayer is not allowed an opportunity to argue that valid commercial reasons exist for the deviation from the arm’s length standard. The German law involved did not allow the taxpayer the opportunity to make such arguments. While the ECJ failed to answer this question, the court did confirm its earlier judgment in *SGI*²⁵⁰ that although transfer pricing provisions do restrict the freedom of establishment such restriction is proportionate only in instances where the taxpayer can prove that commercial reasons exist for the contractual terms to deviate from the arm’s length standard as is typically applied within the OECD. The *Hornbach* court then went further by stating that such commercial reasons could relate to the status of the taxpayer being a shareholder of the related company.

Graetz and Warren argue that the ECJ’s approach to direct tax cases is incoherent.²⁵¹ This is because it is impossible to eradicate discrimination based on both the origin and destination of economic activity when the tax base and rate is not harmonized across the EU.²⁵²

Genschel and Jachtenfuchs echo this sentiment.²⁵³ They argue that very design of the direct tax regime means that it would not be compatible with the non-discrimination principle and the free movement rights.²⁵⁴ Direct tax regimes are protectionist in their design in that they operate domestically to

²⁴⁵ Wattel *Chapter 14* (n232) 631.

²⁴⁶ *Cadbury Schweppes* (n238).

²⁴⁷ *Ibid* para 51.

²⁴⁸ Wattel *Chapter 14* (n232) 633.

²⁴⁹ *Hornbach-Baumarkt AG* (n239).

²⁵⁰ Case C-311/08 *SGI v The Belgian State* ECR I-987.

²⁵¹ MJ Graetz and AC Warren, Jr, ‘Income Tax Discrimination and the Political and Economic Integration of Europe’ (2005-2006) 115 *Yale Law Journal* 1186.

²⁵² *Ibid*.

²⁵³ P Genschel and M Jachtenfuchs, ‘How the European Union Constrains the State: Multilevel Governance of Taxation’ (2011) *European Journal of Political Research* 293.

²⁵⁴ *Ibid* 302.

protect the domestic tax base from moving outside the border.²⁵⁵ Non-discrimination and the free movement rights, on the other hand, operate to ensure fairness across the borders of the Member States.²⁵⁶ It is difficult to see how such cross-purposes could be meaningfully resolved in the absence of harmonization in direct taxes.

Arguments have also been raised that the ECJ is in fact making tax policy decisions with its judgments. Graetz and Warren argue that with respect to the taxation of dividends, the ECJ has effectively worsened the debt-equity bias in taxation by making it more expensive to curb economic double taxation when the ECJ case law forces Member States to apply the same tax treatment to domestic and foreign dividends.²⁵⁷ The Manninen²⁵⁸ case provides an illustration how expensive it may be for a Member State to treat domestic and foreign dividends in the same way for tax purposes. Finland had granted resident shareholders imputation credits for the dividends they received from resident companies in an attempt to reduce the economic double taxation in respect of the dividends. Member States, like Finland, would be willing to grant such relief because the profits that are distributed to the shareholders in the form of dividends would have been subject to income tax in the hands of the company. However, when the ECJ ruled that Finland had to extend the imputation credits also to residents receiving dividends from foreign companies, this meant that Finland had to grant tax relief for the dividends received from a foreign company when Finland had not received the income tax which the distributing company had paid on the profits that constituted the dividend. Not every Member State would be willing to grant tax relief under these circumstances. Graetz and Warren further argue that this effect of ECJ judgments on shaping tax policy has been evident since the first ECJ cases on income tax, *Commission v French Republic (Avoir Fiscal)*.²⁵⁹

In this case, French law provided for shareholder credits to be provided under the French imputation system for dividends paid by domestic companies to domestic insurance companies or their domestic subsidiaries. The credits were not made available for dividends paid by domestic companies to the branches of foreign insurance companies situated in France. The ECJ decided that it was discriminatory to provide the credits only to domestic insurance companies and not also foreign insurance companies. The dividends paid to domestic or foreign companies are to be taxed in the same way within the Member State.

²⁵⁵ Ibid.

²⁵⁶ Ibid.

²⁵⁷ MJ Graetz and AC Warren, Jr, 'Dividend Taxation in Europe: When the ECJ Makes Tax Policy' (2007) 44 Common Market Law Review 1577, 1618.

²⁵⁸ *Manninen* (n237).

²⁵⁹ Case C-270/83 *Commission v French Republic (Avoir Fiscal)* [1986] ECR 273.

This case also serves to note the conflict between the internal market treatment of an income stream and the tax treatment of that stream – a conflict which the ECJ cannot possibly remedy. It has been noted that from a tax perspective, it matters greatly where the source of an income stream is and where it is going.²⁶⁰ However, from an internal market perspective, the entire purpose of an internal market is that it should not matter where a company is incorporated within the EU or to where its dividends are distributed within the EU.²⁶¹

Moreover, Graetz and Warren argue that the judgment in *Manninen*²⁶² that imputation credits are also to be provided to the receipt of foreign-sourced dividends would also greatly increase the administrative burden on revenue authorities within Member States.²⁶³ In the face of this administrative burden and the weight of the ECJ judgments, many Member States have made the policy decision to rather use dividend exclusions rather than imputation credits to address economic double taxation.²⁶⁴

A further recent and curious development in EU law illustrating the extent to which the ECJ may negate the tax policy decisions made by Member States is the spate of beneficial ownership cases. The judgments of *N Luxembourg I v Skatteministeriet*²⁶⁵ and joined cases²⁶⁶ along with *T Danmark*²⁶⁷ and another joined case,²⁶⁸ dealt with the interpretation of the beneficial ownership concept and the taxpayers' access to the withholding tax exemptions granted under the Parent Subsidiary Directive and the Interest and Royalty Directive. The ECJ ruled that despite the absence of national anti-abuse provisions, the Danish government was obligated to deny the taxpayers access to benefits under EU law in instances of abusive practices. In essence, the ECJ ruled that EU law obliged Member States to prevent abusive practices even in instances where Member States may have made policy decisions not to adopt national measures to this end in terms of EU directives which grant Member States such prerogative.

While this obligation seems largely moot given the ATAD's minimum standard that Member States adopt a GAAR by 1 January 2019, these judgments do raise institutional questions as to the actual extent of Member State's ability to

²⁶⁰ Wattel *Chapter 14* (n232) 614.

²⁶¹ *Ibid.*

²⁶² *Manninen* (n232).

²⁶³ Graetz and Warren *Dividend Taxation* (n257) 1618.

²⁶⁴ *Ibid.*

²⁶⁵ Case C-115/16 *N Luxembourg I v Skatteministeriet* EU:C:2019:134.

²⁶⁶ Joined Cases C-118/16 *X Denmark*, C-119/16 *C Danmark I* and C-299/16 *Z Denmark* EU:C:2019:134.

²⁶⁷ Case C-116/16 *T Danmark* EU:C:2019:135.

²⁶⁸ Joined Case C-117/16 *Y Denmark Aps* EU:C:2019:135.

make policy decisions under EU law and the broader question of the separation of powers under EU law.²⁶⁹

From an East African Federation perspective, it would be best for the federation to take note of the effects of a culture of rampant negative integration. Tax policy decisions should of course be made by those institutions constitutionally authorised to make such decisions. Such decisions should not be made indirectly through a process of negative integration. As difficult as it may be to design efficient tax policies, the East African Federation should ensure that legislation and directives are the primary sources of law for its corporate income tax system rather than the piecemeal decisions of its court, the East African Court of Justice.

Having said this, it is important to note the key role the ECJ has played in moving the integration project forward in Europe, particularly in instances where political stalemates made it difficult for decisions to be made.²⁷⁰ This was particularly the case historically in the period of the Luxembourg Accords and the political stagnation brought about by the veto powers afforded Member States.²⁷¹ At this time, it was the ECJ case law which kept the integration project on the agenda and laid the groundwork for the internal market as a concept to be taken forward.²⁷² It is therefore important also that the East African Federation not underestimate the important role the East African Court of Justice may play in furthering the integration ideal.

5.1.2. THE ROLE OF THE COUNCIL AND ITS DIRECTIVES

While the EU's harmonisation efforts in direct tax does not match the strides made in this regard in indirect taxes, a movement towards some form of harmonisation has occurred through the issue of Council Directives. This has been done under the auspices of Article 115 of the TFEU.

The EU Council has issued three directives that address the direct tax effects of conducting cross-border trade within the EU. These are: The Parent-Subsidiary Directive;²⁷³ the Merger

²⁶⁹ W Haslehner and GW Kofler, 'Three Observations on the Danish Beneficial Ownership Cases' (13 March 2019) Kluwer International Tax Blog <<http://kluwertaxblog.com/2019/03/13/three-observations-on-the-danish-beneficial-ownership-cases/>> accessed 20 July 2019.

²⁷⁰ A Cuyvers, 'The Road to European Integration' in E Ugirashebuja and others, *East African Community Law: Institutional, Substantive and Comparative EU Aspects* (Brill 2017) 29.

²⁷¹ Ibid.

²⁷² Ibid.

²⁷³ Council Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (30 November 2011). This directive is a recast of the earlier Council Directive 90/435/EEC (23 July 1990).

Directive;²⁷⁴ and the Interest-Royalty directive.²⁷⁵ These directives seek to ensure that cross-border profit distributions within a group, interest and royalty payments and cross-border mergers are only taxed once within the EU. Related to corporate income tax specifically, the EU has also issued the ATAD, which is discussed in Part 4 above.

Specifically, the Parent-Subsidiary directive allows for the cross-border payment of dividends between companies in a group to be made free of double taxation. This is done through abolishing any withholding tax being levied by the dividend source Member State, while the resident Member State of the recipient company is either to exempt the dividend received or grant a credit for the corporation tax already paid by the subsidiary. The application of the directive is wider than its name implies, as it requires a mere 10% shareholding to trigger the directive. The directive does, however, allow for certain instances where withholding taxes may well be levied.

The Parent-Subsidiary directive has, however, increased competition amongst the Member States to be the location of the holding company within the group.²⁷⁶ Moreover, it has been commented that the Parent-Subsidiary Directive does little more than subsidize the treasury of the State in which the parent company is resident, if it chooses to tax the received dividend.²⁷⁷

In terms of the Merger Directive, its purpose is to provide tax relief for the one-off tax consequences immediately arising from cross-border mergers, divisions and also share exchanges and asset transfers. The tax relief offered involves rolling over the deemed realisation of capital gains to the acquiring company in instances where no actual realisation has taken place. Moreover, any losses that would otherwise have been lost, depreciation recoupments and taxes arising from the shareholders' disposal of shares are deferred. It is required, however, that in the event of a merger a permanent establishment is to remain in the Member State in which the subsidiary had been.

It has been noted, however, that the Merger Directive does not apply to all the cross-border operations as it is expected

²⁷⁴ Council Directive 2009/133/EC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States (19 October 2009).

²⁷⁵ Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (3 June 2003).

²⁷⁶ O Marres, 'Chapter 6: The Parent-Subsidiary Directive' in PJ Wattel, O Marres and H Vermeulen (eds), *Terra/Wattel – European Tax Law* (7th edn Wolters Kluwer 2019) 277.

²⁷⁷ Ibid.

that it would cover.²⁷⁸ Also, the directive fails to deal with hybrid entities and only deals with the short-term tax issues arising from merger operations.²⁷⁹

In terms of the Interest and Royalties Directive, its purpose is to remove the cross-border effect from the interest and royalty payments made between associated companies within a group. The intention is to have such payments attract the same tax consequences as a purely domestic payment. Accordingly, withholding taxes are abolished and the residence country is entitled to tax the income.

This directive is not necessarily effective in achieving their stated purpose. While the Interest-Royalty directive effectively prohibits taxation at source of interest and royalties, it does not include a general subject-to-tax clause.²⁸⁰ The directive therefore does not actually ensure that such receipts are taxed in the EU.²⁸¹

While the ATAD, Parent-Subsidiary, Merger, Interest and Royalties directives are invaluable to the EU in minimizing the tax distortions created by businesses operating across Member States, these directives are of less significance to the East African context once the federation is formed and the Partner States become Constituent States of the East African Federation. However, it is important for the East African Federation to note the manner in which the ATAD has moved the EU closer towards establishing a European policy of preventing anti-tax avoidance practices. The effect of this has been the narrowing of the tax policy decisions which the Member States may make with respect to their corporate income tax systems.²⁸² This should emphasise for the East African Federation how important it is for important policy decisions to make at the supranational level in order to properly ensure a uniform and coordinated implementation of those policies.

5.2. ADMINISTRATIVE CAPACITY

It is envisaged that administrative capacity within the East African region should improve once the formation of the federation pools the government personnel. It is possible that some staff from one Partner State may be more expert in one area while others may be more expert in another. It would

²⁷⁸ F Boulogne, 'Chapter 7: The Tax Merger Directive' in PJ Wattel, O Marres and H Vermeulen (eds), *Terra/Wattel – European Tax Law* (7th edn Wolters Kluwer 2019) 328.

²⁷⁹ Ibid.

²⁸⁰ A Cordewener, 'Chapter 10: The Interest and Royalty Directive' in PJ Wattel, O Marres and H Vermeulen (eds), *Terra/Wattel – European Tax Law* (7th edn Wolters Kluwer 2019) 401.

²⁸¹ Ibid.

²⁸² MT Soler Roch, 'Commentary on Chapter 8: State Aid (R)evolution and Harmonization through the Back Door' in P Pistone (ed), *European Tax Integration: Law, Policy and Politics* (IBFD 2018).

therefore be possible for internal training measures to be adopted to bring all government officials to a certain minimum level of expertise. Beyond that level, perhaps the East African Federation should consider bringing in experts to train staff. The OECD is also making 'toolkits' available which may assist the East African Federation in developing its expertise in the relevant fields.

Moreover, it is suggested that a central database of taxpayers be formed so that each Constituent State authority may have all relevant information pertaining to a taxpayer operating within its province easily at hand. This database may include details of the taxpayer including: incorporation details, details of shareholders or owners and perhaps even stakeholders, location of operations, history of filed tax returns, history of audits conducted and the outcomes thereof, and financial records of the taxpayer if available. This central database may also be used to coordinate audits across local government authorities in respect of a taxpayer operating in more than one region.

In a similar fashion, the East African Federation should consider developing a protocol for the collection of taxes owed. This protocol should clearly set out the progression of tax collection methods in order to ensure that all taxpayers in the East African region are afforded the same treatment. Such progression may include notices of taxes due, the imposition of penalties and interest, the point at which judgment should be sought against a recalcitrant taxpayer; when garnishee orders should be sought, and when third parties (such as banks) may be enlisted to seize funds directly from taxpayer accounts. It is also suggested that such protocol be made publicly available so that taxpayers are aware of the collection mechanisms available to the East African Federation's tax authority.

It is further suggested that the East African Federation pass legislation specifically addressing the tax administration measures to be implemented within the region. This legislation should bear in mind that an appropriate balance should be sought between the rights of the taxpayer and that of the East African Federation's revenue authority.

The process of building administrative capacity cannot be completed overnight, and the creation of a strong administrative network should remain a longstanding item on the agenda of the East African Federation.

6. CONCLUSION

The East African Federation should choose to build on the existing corporate income tax systems currently operating within the Partner States rather than introduce a different system of taxing corporate profits, like the DBCFT. The current corporate income tax systems in the Partner States vary greatly with respect to tax base and rates – despite the past harmonization

effort that initially harmonized the corporate income tax rate at 30% in the region.

In proposing a design of the corporate income tax system in the East African Federation, this chapter has identified the key tax policy goal for the federation as the need to raise government revenues. Moreover, in suggesting the details of the design of the corporate income tax system for the East African Federation, this chapter has identified the lessons the East African Federation may learn from the EU experience and the design of its corporate income tax systems. In particular, it is suggested that the East African Federation implement a system similar to the CCCTB in the region. Also, the East African Federation should draw inspiration from the ATAD in designing mechanisms by which to protect its corporate income tax base.

It is suggested that the East African Federation build in an evaluation process by which to analyse the efficacy of the corporate income tax system in the East African Federation. In this respect, it is suggested that the East African Federation emulate the five-year report-back obligation placed on the European Commission under amendments to the CCCTB Proposal in terms of which the Commission is to report back to the Council on the implementation of the CCCTB five years after the implementation of the CCCTB regime. The federation could set up a sectoral committee to report to the executive on whether the policy goals of raising government revenues and reducing the size of the informal sector have been met. It is further suggested that this sectoral committee should be reconstituted to perform this function on an ongoing basis – perhaps every ten years.

From a regional integration perspective, the EAC and its proposed federation are poised to make great strides – provided that they heed the lessons that are readily available to them.

CHAPTER FOUR: DESIGNING A GENERAL ANTI-AVOIDANCE RULE FOR THE EAST AFRICAN FEDERATION

1. INTRODUCTION

A GAAR is a statutory provision invoked by the revenue authority to deny the tax advantages arising from tax planning arrangements that technically comply with tax legislation but are regarded as abusive.¹ GAARs are generally drafted broadly and are intended to counter avoidance arrangements which were not foreseen by the legislature.² In an ideal world where legislation is perfectly drafted based on sensible and clearly discernable principles, there would be no need for a GAAR.³ This would be because instances of abuse would be clearly identifiable as being contrary to the stated principles and underlying rationale of the tax legislation. A GAAR has been described as a weapon of last resort for the revenue authority to curb an abuse of tax legislation.⁴ Although it is difficult to define an abuse of tax legislation, generally it is understood that the GAAR is meant to stop only the tax planning that is artificial and simulated, and not all forms of tax planning per se.⁵

GAARs have become increasingly necessary in a modern age where tax schemes are highly sophisticated and always evolving. In fact, commentators have remarked that without a GAAR, the perception is created that the revenue authority has a tolerance for abusive tax avoidance.⁶ GAARs are not without their critics, and some argue that GAARs create uncertainty and allow revenue authorities too much discretion.⁷ Moreover, others

¹ BT Kujinga, 'Analysis of Misuse and Abuse in terms of the South African General Anti-Avoidance Rule: Lessons from Canada' (2012) 45 *Comparative and International Law Journal of Southern Africa* 429, 430.

² C Turley, DG Chamberlain and Petriccione, 'Chapter 10: General Anti-Avoidance Rules' in *A New Dawn for the International Tax System: Evolution from Past to Future and What Role Will China Play?* (IBFD 2017) sec. 10.1.1.

³ J Freedman, 'Designing a General Anti-Abuse Rule: Striking a Balance' (2014) 20 *Asia-Pacific Tax Bulletin* 167, 168.

⁴ Turley, Chamberlain and Petriccione (n2).

⁵ C Waerzeggers and C Hillier, 'Introducing a General Anti-Avoidance Rule (GAAR) – Ensuring that a GAAR Achieves its Purpose' (2016) *Tax Law IMF Technical Note* 1, 4.

⁶ RE Krever, 'Chapter 1: General Report: GAARs' in M Lang and others (eds), *GAARs – A Key Element of Tax Systems in the Post-BEPS Tax World* (IBFD 2016).

⁷ GS Cooper, 'Conflicts, Challenges and Choices - The Rule of Law and Anti-Avoidance Rules' in GS Cooper (ed), *Tax Avoidance and the Rule of Law* (IBFD 1997) 26; C Masters, 'Is There a Need for General Anti-Avoidance Legislation in the United Kingdom?' (1994) 6 *British Tax Review* 647;

have argued that some developing nations are too undeveloped to properly make use of a GAAR and that GAARs are essentially the tool of the developed world.⁸

As the EAC Partner States include some of the world's least developed nations, such comments are directly relevant. Freedman argues that even the most undeveloped nation may find a GAAR useful.⁹ Developing countries face the same tax abuses as developed nations, if not more so.¹⁰ Moreover, all that is needed for a developing nation to properly make use of its GAAR is to have a small group of highly skilled individuals within the revenue authority who are able to examine the suspected transactions.¹¹ The East African Federation would be in such a position to foster expertise in this area given that many of the EAC Partner States already have GAARs in place and the eventual formation of its federation would allow the East African Federation to pool its resources to develop the required expertise.

A GAAR is necessary for the East African Federation because a study has highlighted the increasing need for the EAC Partner States to protect their tax bases, particularly its corporate income tax base.¹² Moreover, should the East African Federation not implement a GAAR as its constituent Partner States have done, a reasonable inference to draw from this omission would be that the East African Federation is tolerant of tax abuse and lax about the protection of its tax bases. The East African Federation cannot afford for such perceptions to take root. It would therefore be in the best interest of the East African Federation to design and implement a GAAR. GAARs are relatively quick to implement and there is a proliferation of GAARs across the world from which the East African Federation may draw in designing its own. The implementation of GAARs is also on the rise globally.¹³ The East African Federation cannot afford to wait for anti-tax avoidance doctrines to be developed through the courts.

This chapter therefore aims to assist the East African Federation in designing a GAAR that is suited for the East African context. In conducting this study and in making recommendations, the author has adopted the comparative-

C Elliffe, 'International Tax Avoidance - the Tension between Protecting the Tax Base and Certainty of Law' (2011) 7 *Journal of Business Law* 647.

⁸ C Silvani, 'GAARs in Developing Countries' (2013) IFA Research Paper.

⁹ Freedman (n3).

¹⁰ P Rosenblatt, *GAARs for Major Developing Countries* (Wolter Kluwer 2015) 24.

¹¹ Freedman (n3) 173.

¹² B Peter, *Regional Integration and Tax Revenue: A Case Study of the East African Community (EAC)*, Master's Dissertation (Makerere University 2014).

¹³ Krever (n6).

functional approach.¹⁴ This approach has been adopted because the author is aware of the need to propose recommendations that would both address the legal aspects of designing a GAAR for the East African Federation and also the operational aspects which would consider the implementation of such a GAAR in the East African Federation. The EAC Partner States are all developing countries. This paper would therefore not be complete if the author did not specifically address how the East African Federation may tackle the significant capacity concerns and infrastructural drawbacks the region is currently facing.

The following structure is adopted in this chapter in order to meet the goal of designing a GAAR for the East African Federation: First, the rationale for the selection of the EU, Canadian and South African jurisdictions is set out in Part 2. This is followed by Part 3 which sets out and analyses the GAARs currently implemented in the EAC Partner States. This is followed by an analysis of the GAARs operating in the EU, Canada and South Africa in Part 4. Part 5 presents the author's recommendations to the East African Federation on how it may design its GAAR in the light of its existing legal context and while considering the international practices of the EU, Canada and South Africa. Finally, Part 6 of this chapter concludes.

2. WHY THE EUROPEAN UNION, CANADA AND SOUTH AFRICA?

The EU is a useful comparator for the East African Federation given that the founding treaties of the EU and EAC organizations are similar and therefore many of the issues arising in the EU may also be relevant to the East African regional integration project – both the East African Federation and its current organization, the EAC.

Both the EU and EAC are aimed at realising a deep and meaningful regional integration. This can be seen at article 3(3) of the TEU¹⁵ where the EU is tasked with promoting economic, social and territorial cohesion and solidarity among the Member States. This aim is echoed in article 5(1) of the EAC Treaty where the objective of the EAC is stated as developing policies and programmes aimed at widening and deepening co-operation among the Partner States in inter alia the political, economic, social and cultural fields.

A more specific aim that is common to both organizations lies in the establishment of a common or internal market. The EU is to

¹⁴ C Garbarino, 'Comparative Taxation and Legal Theory: The Tax Design Case of the Transplant of GAARs' (2010) 11 *Theoretical Inquiries in Law* 765; J van der Pas, 'Improving the Chinese Anti-Avoidance Rule: A Comparative and Functional Approach' (2016) 8 *World Tax Journal* 79.

¹⁵ Consolidated Version of the Treaty on European Union, OJEU C 326 13 (2012) [TEU].

establish an internal market in terms of article 3(3) of the TEU. This aim is further set out at article 26 of the TFEU.¹⁶ Article 26(2) defines the internal market as: “an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties.” Further provisions subsequently provide for measures to ensure the free movement of goods,¹⁷ persons, services and capital,¹⁸ known as the “four freedoms”. The EAC, in turn, is tasked with creating its common market under article 2(2) of the EAC Treaty. The common market is defined in article 1 as: “the Partner States’ markets, integrated into a single market in which there is free movement of capital, labour, goods and services”. As can be seen, both the European Union and the EAC use the same language in describing their internal markets. The presence of an internal market in both the EU and EAC is particularly relevant for this paper given the issues arising from the interplay between the maintenance of an internal market and the application of a supranational GAAR. The EU as a comparator is therefore particularly useful here.

The final point of similarity between the two organizations lies in the commonality of the institutional structures created under the EU Treaties and the EAC Treaty. Both organizations have created a legislative organ that is charged with producing legislation that is to apply across the region.¹⁹ The EU has the European Parliament and the EAC, the East African Legislative Assembly.²⁰ Both the EU and the EAC have an institution comprised of the Heads of States that is tasked with providing political direction and impetus to the development of the organization.²¹ The EU body is called the European Council while its EAC counterpart is called the Summit.²² The EU and the EAC have further both created a body consisting of Ministers of the various States that is tasked with policy-making and certain legislative and budgetary functions.²³ Both the EAC and EU body is called the Council.²⁴ Moreover, both organizations have created a court of justice that is to interpret and apply the provisions of their respective treaties.²⁵

A comparison between the East African Federation and Canada is useful here because Canada has had its GAAR in place

¹⁶ Consolidated Version of the Treaty on the Functioning of the European Union, OJEU C 326 47 (2012) [TFEU].

¹⁷ Title II, ‘Free Movement of Goods’, arts. 28 to 37 TFEU.

¹⁸ Title IV, ‘Free Movement of Persons, Services and Capital’, arts. 45 – 66 TFEU.

¹⁹ Art. 13 TEU and art. 9 EAC Treaty.

²⁰ Ibid.

²¹ Art. 15 TEU and arts 10 and 11 EAC Treaty.

²² Art. 13 TEU and art. 9 EAC Treaty.

²³ Art. 16 TEU and art. 13 and 14 EAC Treaty.

²⁴ Art. 13 TEU and art. 9 EAC Treaty.

²⁵ Art. 19 TEU and art. 23 EAC Treaty.

since 1988.²⁶ Canada therefore has a rich history of jurisprudential analysis of its GAAR, and how it would best serve the purpose for its enactment. The East African Federation would have much to gain from learning from the Canadian experience given that the relative youth of the EAC Partner States' jurisprudence in this regard. The legal cultures of Canada and that of the EAC Partner States are also similar in that both have elements of civil and common law traditions. Moreover, despite the developed nation-developing nation classifications, the economies in Canada and the EAC Partner States are dependent on natural resources. Such dependence shapes the making of policies and laws in the respective regions.

As the East African Federation would become a developing nation, it would be useful for the East African Federation to consider the lessons that may be learned from another developing nation in legislating a GAAR. South Africa would therefore serve as a useful comparator in this respect. South Africa has had its current GAAR since 2006,²⁷ while its first GAAR was introduced in 1941.²⁸ South Africa also has a deep jurisprudential bank of analysis of its GAARs, although its current GAAR has to date not yet been tested in court. Moreover, the legal systems in South Africa and the EAC Partner States contains a mixture of civil law and common law traditions. The economies of South Africa and the Partner States of the EAC are also dependent on natural resources. In the light of these similarities, the East African Federation may therefore learn from South Africa's experience as a developing nation as to how best to implement a GAAR.

The selection of the EU, Canada and South Africa therefore provides the East African Federation with a balanced account of the possible routes available to it in legislating a GAAR, and how best to do this.

3. CURRENT GAARS IN THE EAST AFRICAN COMMUNITY PARTNER STATES

This part serves to critically evaluate the GAAR legislation and applicable case law in the EAC Partner States. Bearing in mind the necessity of determining the legal culture of jurisdictions before borrowing from foreign GAARs,²⁹ this part will also serve to evaluate the prevailing jurisprudential culture in the EAC Partner States. To the extent that the GAARs in the various pieces of legislation refer to the avoidance or reduction of tax

²⁶ Income Tax Act, 1985, sec. 245 (Canada). This section became effective in Canada on 13 September 1988.

²⁷ Income Tax Act, 1962, sec. 80A-L (South Africa).

²⁸ Income Tax Act, 1941, sec. 90 (South Africa).

²⁹ Garbarino (n14).

liability, this paper shall refer to this as the obtaining of a “tax benefit”.

In evaluating the legal culture in the EAC, the author notes that legal culture is usually determined by reference to statutes, case law, administrative guidelines, and the positions of scholars.³⁰ The determination of such a legal culture in the EAC Partner States was a challenge given that the legal resources were not always easily accessible. For instance, South Sudan does not currently have a system by which judicial decisions are recorded and made available – not surprisingly, as the region is still racked by violent unrests. A similar lack of legal resources applies to Burundi given that it is a post-conflict State. Therefore, in making these summations the author has relied heavily on the available legal resources from Kenya, Rwanda, Tanzania and Uganda.

In terms of the institutional capacity of the courts in the EAC, the EAC Partner States exhibit a robust judiciary. Moreover, the East African Court of Justice is growing in stature and experience as it fulfills its mandate of ensuring adherence to EAC law.³¹ This court is also acting as an important check and balance to the national governments of the Partner States.³² While the East African Court of Justice adjudicates a wide range of cases spanning human rights law, environmental law and even the resolution of disputes between EAC employees,³³ the court does not address tax cases at present because the EAC Partner States still currently retain their tax sovereignty.

A GAAR cannot be proposed without understanding the approach taken to statutory interpretation in the region. The Uganda High Court in *Crane Bank v Uganda Revenue Authority*³⁴ enunciated its approach to the interpretation of statutes as follows:

The position of the law is that if any doubt arises from the words used in the statute, where the literal meaning yields more than one interpretation, the purposive approach may be used, to determine the intention of the law maker in enacting of the statute.³⁵

The Kenya High Court in *Law Society of Kenya v Kenya Revenue Authority*³⁶ echoed this approach to statutory interpretation. In this case, the court stated that the literal

³⁰ Garbarino (n14) 766.

³¹ A Possi, ‘An Appraisal of the Functioning and Effectiveness of the East African Court of Justice’ (2018) 21 Potchefstroom Electronic Law Journal <<http://dx.doi.org/10.17159/1727-3781/2018/v21i0a2311>> accessed 18 February 2019.

³² Ibid.

³³ Ibid.

³⁴ *Crane Bank v Uganda Revenue Authority* [2012] UGCOMM 42, HCT-00-CC-CA-18– 2010 (High Court, Uganda).

³⁵ Ibid 10.

³⁶ *Law Society of Kenya v Kenya Revenue Authority & another* (2017) eKLR, Petition No. 39 of 2017 (High Court, Kenya).

approach will only be departed from in the event of ambiguities.³⁷ In such event, a purposive interpretation is to be adopted by determining the object the legislature had in mind when using the words in question.³⁸ The Tanzanian court seems more inclined to adopt a more expansive, purposive approach to statutory interpretation and chooses not to confine itself to the literal interpretation of the legislation.³⁹ The approach to statutory interpretation in Rwanda was more difficult to determine given the multilingual system in which Rwanda's laws are legislated.⁴⁰ Typically, legislation is published in three different languages.⁴¹ There seems to be little clarity about the approach of the Rwandan courts towards the interpretation of legislation in such a context.⁴² Nonetheless, the author has noted a tendency on the part of the Rwandan courts to refer to the approach adopted by the courts in the other EAC Partner States.

A more general evaluation of the case law in the EAC Partner States indicates that the courts refer to cases from a wide range of foreign jurisdictions, including the EU, Canada and South Africa. It would therefore not be misplaced for these jurisdictions to be considered when developing a GAAR for the East African Federation.

Given the fact that the courts in the Partner States mainly follow a literal approach, it is important that any GAAR the East African Federation is to adopt must word the intention of the legislature as explicitly as possible.

Kenya, Tanzania, Uganda and Burundi each have their own GAAR currently in place. Whilst Rwanda may not have a formal GAAR in its statute books, the Rwandan Revenue Authority is nonetheless pursuing anti-abuse-like arguments in court – albeit unsuccessfully. South Sudan has a provision more akin to an anti-tax evasion provision than a GAAR in the true sense of the word.⁴³ The provision in South Sudan will therefore not be evaluated in this paper because the author is of the view that the applicable provision is not a GAAR.

³⁷ Ibid para 34.

³⁸ Ibid.

³⁹ *Commissioner General v. Airtel Tanzania Ltd* (2012) Appeal No. 14 of 2012 (Tax Revenues Appeal Tribunal, Tanzania).

⁴⁰ F Munyangabe, *Legal Meaning in the Interpretation of Multilingual Legislations: Comparative Analysis of Rwanda, Canada and Ireland*, Master's Dissertation (University of London 2010-2011); OB Kamugundu, *Statutory Interpretation in Multilingual Jurisdictions*, Master's Dissertation (University of London 2011-2012).

⁴¹ Kamugundu (n40) 6.

⁴² Ibid.

⁴³ Taxation Act, 2009, sec. 47(2) (South Sudan) – “If the Director General-Taxation believes that a taxpayer transferred assets to any beneficiary for the purpose of evading payment of a tax liability, after the accrual of such liability, he or she shall in coordination with the Ministry of Legal Affairs and Constitutional Development seek an order from the court to transfer the tax liability along with any resulting interest and penalty to the beneficiary of the taxpayer's assets.”

Burundi's GAAR may be found at article 50 of its Tax Procedural Code.⁴⁴ It reads as follows:

Tax administration may disregard acts that hide the true scope of an operation, whether these acts have a fictional character, or they have been inspired by no other reason than to avoid or mitigate the taxes that the person would normally have to pay in view of his situation or his real activities. In this case, the tax administration has the right to restore his true character to the operation concerned.

In order for the GAAR to apply in Burundi, the taxpayer must have deliberately attempted to conceal the true extent of a transaction from the tax authorities. The concealment may come about either through imposing a fiction on the transaction or through being motivated to obtain a tax benefit. The GAAR borrows somewhat from the GAAR in France,⁴⁵ as it requires that the taxpayer must have been "inspired by no other reason than to avoid or mitigate" tax.

The GAAR here focusses on the subjective intention of the taxpayer as supported by objective manifestations of that intention. This is problematic because subjective intent is very difficult to prove, even with the reference to objective indicators of that intention.⁴⁶ Furthermore, the intention that must be proven here is not just an intention to obtain some form of tax benefit as is the case with most GAARs. Instead it is necessary to prove *mala fides* on the part of the taxpayer. This is a heavy burden to prove. Presumably, this burden would fall to the revenue authority.

Burundi's GAAR is far too narrow as it hones in on the subjective intent⁴⁷ of only the taxpayer. Moreover, the burden to prove *mala fides* on the part of that taxpayer is far too onerous for the revenue authority to prove. It is therefore extremely unlikely that this GAAR is at all effective in curbing avoidance schemes. At the time of the writing of this paper, Burundi has no system by which judicial decisions are reported. The author is therefore unable to determine from case law whether the GAAR

⁴⁴ Tax Procedural Code, Law No. 11/18 of 6 September 2013, sec.50 (Burundi).

⁴⁵ French Code of Tax Procedure (LPF), art. L 64 (English translation) reads: "1. In order to restore the true character, the administration has the right to change, not to be invoked against the administration, the acts constituting an abuse of rights, whether those acts were of a fictional character, or, seeking to benefit from a literal application of the texts or decisions against the objectives pursued by their authors, if they have been inspired by no other motive than to avoid or mitigate the tax burden that the person, if the acts had not been passed or carried out, would normally have born in view of his situation or his real activities."

⁴⁶ Freedman (n3) 171.

⁴⁷ References to 'subjective intention' refers to the testimony of the taxpayer along with the consideration of objective facts which would serve to either support or contradict such testimony.

has been employed by the revenue authority, and also more generally, what the jurisprudential culture in Burundi is.

The GAAR in Kenya is in section 23(1) of its Income Tax Act.⁴⁸ It provides as follows:

Transactions designed to avoid liability to tax.

23.(1) Where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to tax for a year of income or that the main benefit which might have been expected to accrue from the transaction in the three years immediately following the completion thereof was the avoidance or reduction of liability to tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be effected by the transaction.

Kenya's GAAR makes a distinction between transactions effected in the same year in which the tax benefit was obtained, and transactions completed within a period of three years. In respect of the former, the GAAR requires the commissioner to form an opinion that the taxpayer's main purpose, or one of the main purposes, was to have the transaction effect the tax benefit. In respect of the latter, the commissioner must form the opinion that the main benefit which might have been expected to accrue from the transaction was the obtaining of a tax benefit.

In order for the GAAR to apply in Kenya therefore, the following elements must be proven:

- The commissioner must form the opinion that either:
- In a particular year of income, the transaction was effected with the main purpose, or with one of the main purposes, of avoiding or reducing the liability to tax; or
- Within a period of three years from the completion of the transaction, the main benefit which might have been expected to accrue from the transaction was the avoidance or reduction of liability to tax.

The GAAR would therefore seem to require a subjective intent on the part of the taxpayer as it applies to a transaction within a particular year of income (current transaction), while a more objective enquiry would seem necessary with respect to completed transactions. In theory, this would allow the court to adopt a more nuanced approach to determining purpose under the Kenyan GAAR in that the enquiry is not solely limited to determining the subjective state of mind of the taxpayer as

⁴⁸ Income Tax Act, 2004, Chapter 470, sec. 23(1) (Kenya) [Income Tax Act, Cap 470].

corroborated by the objective facts. In so far as the subjective intent of the taxpayer is required, the same concerns discussed under the GAAR in Burundi would apply here. However, this nuanced approach is only theoretical in Kenya because the GAAR can only apply to either current or completed transactions only if the commissioner has formed the opinion that the requirements of the GAAR have been met. The GAAR in Kenya is therefore entirely dependent on the discretion of the commissioner. Obbayi notes that the GAAR in Kenya is problematic because it does not provide any objective indicators by which to guide the commissioner in forming such an opinion.⁴⁹ This would therefore allow a great deal of discretion to fall into the hands of tax officials in Kenya. This problem is compounded by the fact that the GAAR further provides that even if the commissioner were to decide that the GAAR is to apply, it is again left to the discretion of the commissioner what adjustments should be made to counteract the avoidance.

The GAAR in Kenya allows the commissioner far too much discretion. No objective guidelines are provided in the legislation by which to test first whether the commissioner has in fact applied his/her mind to deciding if the GAAR is applicable, and secondly whether that decision was made rationally.⁵⁰ Moreover, the same concerns arise when considering the commissioner's discretion to decide on a means by which to counteract the tax avoidance should the GAAR be applicable.⁵¹ This creates concern because of the potential for corruption when such a concentration of power is in the hands of revenue authority officials.⁵² This coupled with a general lack of transparency allows the opportunity for the commissioner to make GAAR-related decisions behind closed doors. Not surprisingly, no GAAR cases have come before the courts in Kenya. Kenya does have specific anti-avoidance provisions in its Income Tax Act which are more widely used than its GAAR.⁵³ It is submitted that the scope and application of the GAAR in Kenya is uncertain in that it leaves too much discretion to the commissioner both in its application and its effect.

The GAAR in Tanzania is contained in section 35 of its Income Tax Act,⁵⁴ which reads as follows:

⁴⁹ GM Obbayi, *Tax Avoidance in Kenya: A Case for Adoption of General Anti-Avoidance Rules (GAAR)*, Master's Dissertation (University of Nairobi 2009/2010) 46.

⁵⁰ *Ibid.*

⁵¹ *Ibid.*

⁵² J Freedman, 'Responsive Regulation, Risk, and Rules: Applying the Theory to Tax Practice' (2012) 44 *University of British Columbia Law Review* 627, 637.

⁵³ For instance, see Income Tax Act, Cap 470, secs 18(3) and 16(2)(j) (Kenya).

⁵⁴ Income Tax Act, 2008, Chapter 332, sec. 35 (Tanzania) [Income Tax Act, Cap 332].

35. (1) Notwithstanding anything in this Act, where the Commissioner is of the opinion that an arrangement is a tax avoidance arrangement, he may by notice in writing make such adjustments as regards a person's or persons' liability to tax (or lack thereof) as the Commissioner thinks appropriate to counteract any avoidance or reduction of liability to tax that might result if the adjustments were not made.

(2) A notice issued under subsection (1) shall specify the arrangement and the adjustments.

(3) For the purposes of this section, "tax avoidance arrangement" means any arrangement –

(a) one of the main purposes of which is the avoidance or reduction of liability to tax of any person for any year of income;

(b) one of the main purposes of which is prevention or obstruction in collecting tax; or

(c) where the main benefit that might be expected to accrue from the arrangement in the three years following completion of the arrangement is –

(i) an avoidance or reduction of liability to tax of any person for any year of income; or

(ii) prevention or obstruction in collecting tax,

but excludes an arrangement where it may reasonably be considered that the arrangement would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

In order for the GAAR to apply in Tanzania therefore, the following elements must be met:

- the commissioner must form the opinion;
- that a tax avoidance arrangement is in place;
- but, excludes arrangements that would not result in a misuse or abuse of the provisions of the Income Tax Act.

Like the GAAR in Kenya, the GAAR in Tanzania makes a distinction between current and completed transactions. Current transactions require the subjective intent of the taxpayer to be determined, while completed transactions allow for a more objective enquiry to be undertaken. The GAAR in Tanzania is broader than the Kenyan GAAR in that the Tanzanian GAAR also considers a purpose directed at preventing or obstructing the collection of tax – not only the obtaining of a tax benefit. Moreover, the Tanzanian GAAR is different from the GAARs in the other EAC Partner States in that it allows an arrangement to escape the GAAR if reasonably considered it does not amount to a misuse or abuse of the provisions of the Income Tax Act – similar to the exclusion used in the Canadian GAAR before the amendments made to it in 2005.⁵⁵

⁵⁵ Discussed in more detail below at 4.2.

It is unfortunate that also like the GAAR in Kenya, the application of the Tanzanian GAAR is entirely dependent on the commissioner forming the opinion that the requirements of the GAAR have been met. The same concerns regarding the wide discretion afforded tax officials in Kenya along with the general lack of transparency and the potential for corruption applies equally to Tanzania. To date, there are no reported cases dealing with the application of the GAAR to a transaction. Tanzania does have specific anti-avoidance provisions in its Income Tax Act which are more widely used than its GAAR.⁵⁶

The GAAR in Uganda is found at section 91 of its Income Tax Act,⁵⁷ and states:

- 91(1) For the purposes of determining liability to tax under this Act, the Commissioner may—
- (a) recharacterise a transaction or an element of a transaction that was entered into as part of a tax avoidance scheme;
 - (b) disregard a transaction that does not have substantial economic effect; or
 - (c) recharacterise a transaction the form of which does not reflect the substance.
- (2) A “tax avoidance scheme” in subsection (1) includes any transaction one of the main purposes of which is the avoidance or reduction of liability to tax.

The GAAR in Uganda would therefore apply to one of the following transactions:

- a transaction which was entered into with the main purpose of avoiding or reducing liability to tax;
- a transaction which lacks substantial economic effect; or
- a transaction whose substance does not match its form.

Although the commissioner is mentioned in the GAAR, the commissioner’s discretion is not as wide as conferred under the GAARs in Kenya and Tanzania. The test to determine the existence of a tax avoidance scheme seems to be a subjective test grounded in the state of mind of the taxpayer as corroborated by objective facts. Also, the purpose test is also of intermediate scope in that it is not narrowly focused on determining a tax purpose as the only purpose, nor is it broadly framed so as to encompass any purpose.⁵⁸ The Ugandan GAAR is different from the GAAR in Kenya and Tanzania in that it explicitly provides that the GAAR may apply to individual steps of the transaction, and not only the entire transaction as a whole.

The concern with the Ugandan GAAR is that no objective indicators are provided to assist the commissioner in deciding

⁵⁶ For instance, see sections 12, 33 and 34 Income Tax Act, Cap 332 (Tanzania).

⁵⁷ Income Tax Act, 1997, Chapter 340, sec. 91 (Uganda).

⁵⁸ See Rosenblatt (n10) 54.

whether a transaction falls within paragraphs a), b) or c) of section 91(1). Moreover, it is not clear what the legislature intends the difference to be between the substance over form test under para c) and the “substantial economic effect” under para b). Presumably, the substance over form test under para c) would test that the commercial effect of the transaction matches its legal form while the test under para b) would entail checking that the transaction makes economic and commercial sense – aside from the tax benefit. The test under para b) arguably looks very similar to the “economic substance” doctrine such as the one in the United States. It is not entirely unreasonable to make this comparison given that the courts in Uganda do routinely refer to cases from a large swathe of foreign jurisdictions, including cases from the United States.⁵⁹

An interesting development in Uganda is that despite the fact that it has a GAAR in its Income Tax Act, the revenue authority does not rely on this section when mounting anti-avoidance arguments. For instance, in *Standard Bank (U) Ltd v Commissioner General Uganda Revenue Authority*⁶⁰ the revenue authority sought to apply a substance over form test to the issue of bonus shares. The revenue authority argued that the substance of the transaction was in effect a dividend while its legal form was that of the issue of bonus shares. This argument was motivated primarily by the fact that the effect of the transaction was to transfer profits from the company to the shareholders – all without attracting dividends withholding tax under section 83(1) of the Ugandan Income Tax Act. In support of its argument, the revenue authority relied on the decision of *Swan Brewery v Rex*.⁶¹ The court found that in the absence of clear legislation, bonus shares cannot be deemed to be dividends because the two differed fundamentally in their nature. A dividend was a distribution of profit while a bonus share allowed a shareholder a greater claim to the assets of the company. Although the revenue authority’s arguments were ultimately rejected by the court in this case, the Uganda Revenue Authority later amended the Income Tax Act to include the issue of bonus shares in the definition of a dividend.⁶²

Anti-avoidance language was used more directly in the *Uganda Revenue Authority v Total Uganda Limited*⁶³ case. Here the revenue authority argued that the taxpayer was “artificially recharacterizing its income to avoid taxes.”⁶⁴ The case dealt with whether the management fees received by the taxpayer should

⁵⁹ For instance, see *Crane Bank* (n34).

⁶⁰ *Standard Chartered Bank (U) Ltd. And Others v. The Commissioner General Uganda Revenue Authority* (2011) UGCOMMC 120, HCT-00-CC-CS-63- 2011 (High Court, Uganda).

⁶¹ *Swan Brewery v Rex* [1914] AC 231 (Privy Council, Australia).

⁶² Income Tax Amendment Act, 2013, sec. 2 (Uganda).

⁶³ *Uganda Revenue Authority v. Total Uganda Ltd* (2012) UGCOMMC 170, CAP 11/2012 (High Court, Uganda).

⁶⁴ *Ibid* 5.

be subject to VAT or not. The taxpayer argued that the taxpayer only made one actual supply – the supply of fuel – to the dealer stations, and that the provision of the management information system which allowed for the fuel to be paid for by card was a supply of services that was incidental to the supply of fuel. The VAT Act allowed for only the supply of goods or services to be subject to VAT while the supply of incidental services was not so subject.⁶⁵ The revenue authority, on the other hand, argued that the management fees paid to the taxpayer for the use of the management information system provided to dealer stations by the taxpayer was a separate and independent supply under the VAT Act. In support of its argument, the revenue authority relied on the United Kingdom case of *Barclays Mercantile v Mawson*.⁶⁶ The revenue authority argued that it made no commercial sense for the taxpayer to provide an information management system to the dealer stations in circumstances where an independent third party would have done the same at a charge – which would have been subject to VAT. Ultimately, however, the revenue authority was unsuccessful in its arguments. The court took the view that the facts gave rise to only one taxable supply – the provision of fuel – while the management fees paid were merely ancillary to the principle taxable supply.

It is perplexing that the Uganda revenue authority chose not to use its GAAR to dismantle the tax avoidance it clearly believed was afoot in the above cases. Perhaps this may be attributed to an expertise vacuum within the revenue authority, or perhaps there is a reluctance to use the GAAR given that the GAAR is often seen as the tool of last resort. Nonetheless, it is submitted that the arguments made by the Uganda revenue authority in the above cases should have been under the auspices of section 91. Had this been done, it would have added some much-needed clarity of purpose to the commissioner's arguments and also would have given the courts a clear sense of the parameters of the measures the commissioner sought to take. These cases were certainly lost opportunities by the Uganda revenue authority to make full use of all the tools available to it in its efforts to protect its tax bases.

At present, Rwanda does not have a GAAR in place. However, it would seem that the Rwanda Revenue Authority is attempting to have the courts develop jurisprudential anti-abuse doctrines. A spate of recent cases illustrate that the Rwanda Revenue Authority is more and more prepared to challenge transactions which it considers suspect.

⁶⁵ Value Added Tax Act, 1996, sec. 12(1) (Uganda).

⁶⁶ *Barclays Mercantile Business Finance Limited v. Mawson (Her Majesty's Inspector of Taxes*, [2005] STC 1 (House of Lords, United Kingdom).

The first of these is the *Rwanda Revenue Authority v Kamba General Merchandise Ltd.*⁶⁷ In this case, the taxpayer acted as some sort of intermediary in terms of which the taxpayer would receive cash deposits from buyers as a form of security which would later be reimbursed once the buyers received the purchased commodities. The cash deposits so received were not subject to income tax because the amounts were not income in the taxpayer's hands and were subsequently reimbursed. However, the revenue authority's suspicions were raised when a tax audit revealed accounting discrepancies in the recording of the cash deposits. Moreover, the revenue authority noticed that the cash deposits received were less than the amounts reimbursed by the taxpayer. The Rwanda Revenue Authority then sought to tax the difference as income in the taxpayer's hands under the Income Tax Act. The Rwanda Revenue Authority therefore attempted to recharacterize the receipt as income, all without relying on any authority by which it sought to do this. The court dismissed the revenue authority's arguments. The court accepted the taxpayer's arguments that the amounts received were in truth in the nature of a security and were therefore not in the nature of business profits which could be subject to income tax. The court further accepted that the discrepancies in the amounts received and the amounts released related to the availability of funds rather than a principled basis by which to earn remuneration.

The anti-avoidance arguments are more direct in *Rwanda Revenue Authority v Engen Rwanda Ltd.*⁶⁸ In this case, the revenue authority argued that the sale of all the shares in a company called Total Rwanda S.A.R.L. (which was exempt from VAT) was in reality a sale of the assets (which was subject to VAT). The revenue authority relied on its interpretation of the sale contract in making its argument.

First, it argued that the warranty in the contract by which the purchaser acknowledged the status of the assets and indemnified the seller from any defects which later may become apparent indicated that it was the assets that formed the real focus of the contract.

Secondly, the revenue authority noted that the company whose shares were sold was restricted under the contract from selling, leasing or otherwise alienating the immovable property it owned. The revenue authority argued that it made no commercial sense for the company to agree to accept such a hollowed-out version of ownership for no reason at all. In support of this argument, the revenue authority referred to the

⁶⁷ *Rwanda Revenue Authority v. Kamba General Merchandise Ltd* [2016] 3 Rwanda Law Reports 125, RCOMA0152/12/CS (Supreme Court, Rwanda).

⁶⁸ *Rwanda Revenue Authority v. Engen Rwanda Ltd* [2017] 2 Rwanda Law Reports 141, RCOMA0027/12/CS (Supreme Court, Rwanda).

United States case of *Frank Lyon Co v United States*.⁶⁹ In this case, the revenue authority argued, the United States Supreme Court had ruled that the ownership of assets is demonstrated by the right of the company to sell those assets. Therefore, if the intention was only to sell shares, why was Total Rwanda S.A.R.L. also deprived of the right to sell its own assets in favour of Engen International – the purchaser of the shares? The answer to this, according to the revenue authority, was because it was the assets which were in reality sold – not the shares. The taxpayer, however, was able to rationally explain the reasons for the identified provisions in the sale contract. First, the warranty was necessary in order for the purchaser to guarantee the capacity of the company selling the shares to carry on business. Second, the prohibition was necessary in order to ensure that the company's status did not change before the shares were transferred. The court rejected the revenue authority's arguments and accepted the taxpayer's rationale for the contract provisions. As the commissioner had no other evidence by which to challenge the conclusion that a sale took place, the court dismissed the commissioner's appeal.

It would seem that the Rwanda Revenue Authority was attempting to mount an economic substance argument. However, it is unfortunate that while the correct case to support such an argument – the *Frank Lyon* case – was cited, the ratio decidendi of this case was incorrectly identified and argued by the Rwanda Revenue Authority, which made it easy for the court to dismiss the revenue authority's entire anti-avoidance argument.

Upon an evaluation of the statutory GAARs across the EAC Partner States, it is firstly noted that Burundi's GAAR is an outlier from the other GAARs. The threshold for the application of its GAAR is quite high in that the commissioner must effectively prove mala fides on the part of the taxpayer before the GAAR may be applied. It is submitted that this bar is set too high for the GAAR to be of much use to the revenue authority.

The following common elements may be seen from an evaluation of the GAARs in the other EAC Partner States. There is some reliance on the subjective intention in all the GAARs with the GAAR in Burundi requiring mala fides and the GAARs in Kenya and Tanzania allowing for the relevance of a subjective intent to be limited to current transactions only. Furthermore, the Uganda GAAR and the jurisprudential GAAR-like arguments in Rwanda seem to refer to an economic substance element. A common aspect across all the GAARs is that no reference is made to when the relevant purpose or intent should be determined. While logically purpose should be determined at the time of entering into the transaction, it is recommended that this

⁶⁹ *Frank Lyon Co. v. United States* (1978) 435 U.S. 561 (Supreme Court, United States of America).

be made explicit in the legislation.⁷⁰ Kenya and Tanzania have introduced a prescription period of three years within which the revenue authority must apply the GAAR, presumably in order to ensure greater certainty. It is doubtful whether it is useful to close off transactions in this way given the capacity issues the revenue authorities in the two Partner States face.

The differences between the jurisdictions include that the Tanzanian GAAR includes the misuse and abuse provision which acts as an exclusion to the application of the GAAR. Moreover, Tanzania is also different in that it includes as a purpose the aim to prevent or obstruct the collection of tax – and not just the imposition of the tax liability. The GAAR in Uganda is also much broader than that of Kenya and Tanzania in that it includes elements of determining the economic substance of the transaction through the application of the GAAR.

In terms of the effectiveness of the various GAARs, it is noted that the GAARs in Kenya and Tanzania are the most problematic because of the wide discretion afforded the revenue authorities in whether to apply the GAAR or not. On paper, the GAAR in Uganda would be the most effective of the four because it allows the GAAR to be applied in circumstances unrelated to the subjective intent of the taxpayer. Moreover, the GAAR in Uganda is the only GAAR of the four that makes provision for the GAAR to be applied to individual steps of the avoidance scheme, while the other GAARs do not explicitly provide for this. However, as noted above, the Uganda Revenue Authority has chosen to litigate without relying on its own GAAR.

It is important for the East African Federation to build on these existing GAARs in the Partner States when legislating its own GAAR. The federation should bear the commonalities and drawbacks of all the Partner States' GAARs in mind when doing so. Now that the shortcomings of the existing GAARs in the Partner States have been identified, it is useful to consider the experiences of the EU, Canada and South Africa to determine what the East African Federation may learn from the GAARs in these jurisdictions.

⁷⁰ Rosenblatt (n10) 125.

4. GAAR IN THE EUROPEAN UNION, CANADA AND SOUTH AFRICA: LESSONS FOR THE EAST AFRICAN FEDERATION

4.1. EUROPEAN UNION

The Anti-Tax Avoidance Directive (2016/1164)⁷¹ (ATAD) was adopted on 12 July 2016 with an implementation date into national law set as 1 January 2019. A GAAR was introduced in Article 6. This GAAR is the most recent appearing in EU Directives, with other GAARs appearing in the Fiscal Merger Directive,⁷² the Parent Subsidiary Directive,⁷³ the Common Consolidated Corporate Tax Base Directive proposal⁷⁴ and the Common Corporate Tax Base Directive proposal.⁷⁵

The scope of the ATAD itself is much broader than previously adopted directives.⁷⁶ While initially the scope seems to be limited to only apply to taxpayers subjected to corporate tax in one or more Member States, neither the terms “taxpayer” or “corporate tax” are defined in the ATAD. It is therefore left to Member States to interpret these provisions according to their national laws.⁷⁷ The broad scope of the ATAD is also evidenced by the fact that it applies to situations with third countries.⁷⁸ De Wilde comments that the text of the ATAD does not limit itself to national law, and therefore it is possible that the ATAD may apply to any instance where a Member State subjects any entity to corporate tax.⁷⁹

In terms of the GAAR in the ATAD, the aim of this provision is not to harmonize the anti-avoidance measures across the Member States. Instead it is set as the minimum standard by

⁷¹ Council Directive 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L193/1 (2016) [ATAD]

⁷² Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States, OJ L310 (2009).

⁷³ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L345 (2011) [PSD].

⁷⁴ The 2011 version of Common Consolidated Corporate Tax Base Directive Proposal is published at <http://eur-lex.europa.eu/legalcontent/EN/TXT/?uri=celex:52011PC0121> – now withdrawn.

⁷⁵ Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM (2016) 683 final [CCCTB Proposal (2016/683)].

⁷⁶ A Rigaut, ‘Anti-Tax Avoidance Directive (2016/1164): New EU Policy Horizons’ (2016) 56 *European Taxation* 497, 502.

⁷⁷ *Ibid* 501.

⁷⁸ *Ibid* 502.

⁷⁹ MF de Wilde, ‘Chapter 14: Is the ATAD’s GAAR a Pandora’s Box?’ in P Pistone and D Weber (eds) *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (IBFD 2018) 14.2.1; A Garcia Prats and others, *EU Report*, in *Anti-avoidance Measures of General Nature and Scope - GAAR and Other Rules* (IFA Cahiers 2018) vol 103A 55, 66.

which all Member States are to comply.⁸⁰ Therefore, should Member States already have a GAAR which provides the same or better protection of the corporate tax base, it would not be necessary for such Member State to take any further action in complying with the ATAD.⁸¹ Moreover, the preamble to the ATAD states that as the GAAR is to operate within the EU, the focus of such application is on artificial arrangements.⁸² In so far as the GAAR is to apply to other situations, the aim of the ATAD is to ensure that the GAAR is applied consistently.⁸³ The GAAR is intended to be a catch all provision that is meant to cover the gaps that are not covered by specifically targeted legal provisions.⁸⁴

Article of 6 the ATAD (ATAD GAAR) provides as follows:

1. For the purposes of calculating the corporate tax liability, a Member State shall ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement may comprise more than one step or part.

2. For the purposes of paragraph 1, an arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

3. Where arrangements or a series thereof are ignored in accordance with paragraph 1, the tax liability shall be calculated in accordance with national law.

In terms of this provision, the revenue authority of a Member State may ignore a legal structure or arrangement if the following elements are present:

- An arrangement (or series of arrangements);
- Which was (or were) put in place for the main purpose, or one of the main purposes, of obtaining a tax advantage;
- Which has the effect of defeating the object or purpose of the applicable tax law; and
- Is (or are) not genuine having regard to all the relevant facts and circumstances. An arrangement shall be considered non-genuine to the extent that the

⁸⁰ Art 3 ATAD.

⁸¹ C Docclo, 'The EU's Ambition to Harmonize Rules to Counter the Abuse of Member States' Disparate Tax Legislations' (2017) 71 *Bulletin for International Taxation* 367, 368.

⁸² Preamble to ATAD, item 11.

⁸³ Preamble to ATAD, item 11.

⁸⁴ Preamble to ATAD, item 11.

arrangement has not been put in place for valid commercial reasons which reflect economic reality.⁸⁵

The wording of the ATAD GAAR borrows heavily from the GAAR found in the Parent-Subsidiary Directive.⁸⁶ It would therefore be of interest to see to what extent the European Court of Justice (ECJ) would transpose the interpretations of similar phrases under the Parent-Subsidiary Directive to the ATAD GAAR. The scope of the ATAD GAAR is, however, broader than the Parent-Subsidiary Directive and this may hinder such transposition. Moreno commented on the proposal form of the ATAD that the then-proposed GAAR contains several different elements of the various anti-abuse traditions across the Member States.⁸⁷ As the ATAD GAAR continues to include this array, this commentary continues to be relevant.

Further examination of the ATAD GAAR reveals that the provision refers to the concept of ‘purpose’ in three different connotations: purpose is referred to as a subjective state of mind (‘main purpose or one of the main purposes’); as a reference to artifice (‘non-genuine arrangement’); and as a reference to legislative intent (‘defeats the object or purpose or purpose of the applicable tax law’).⁸⁸ The political reason for such an array of anti-avoidance doctrines appears to be to make Member States feel more at ease with the directive.⁸⁹ In terms of applying these different intents, however, De Broe and Beckers comment that if the subjective and legislative intent tests were applied correctly, the genuine nature test serves to add little value.⁹⁰

Upon further analysis of the ATAD GAAR, Garcia Prats et al note that as a basic procedural point, it is not clear who is to bear the onus of proof under the provision.⁹¹ De Broe and Beckers speculate that in terms of determining whether a tax advantage defeats the purpose of the applicable law, this responsibility may fall on either the ECJ or a national court.⁹² The ECJ would have this authority when evaluating whether an arrangement defeats the object or purpose of a provision of EU law, while a national court would make this decision when it is

⁸⁵ L De Broe and D Beckers, ‘The General Anti-Abuse Rule of the Anti-Tax Avoidance Directive’ (2017) 26 EC Tax Review 133, 141.

⁸⁶ Art 1(2) PSD.

⁸⁷ AB Moreno, ‘A Pan-European GAAR? Some (Un)Expected Consequences of the Proposed EU Tax Avoidance Directive Combined with the Dzodzi Line of Cases’ (2016) 2 British Tax Review 143, 147.

⁸⁸ G Cooper, ‘The Role and Meaning of “Purpose” in Statutory GAARs’ in N Hashimzade and Y Epifantseva (eds), *The Routledge Companion to Tax Avoidance Research* (Routledge 2017) 140.

⁸⁹ Moreno (n87) 148.

⁹⁰ De Broe and Beckers (n85) 143.

⁹¹ Garcia Prats and others (n79) 71.

⁹² De Broe and Beckers (n85) 143.

the abuse of a domestic corporate tax rule that is called into question.⁹³

From an East African Federation perspective, the ATAD GAAR is of interest in the manner in which the different anti-avoidance doctrines have been blended together and codified. The ATAD GAAR therefore does not appear to rely too heavily on only the subjective purpose test. The East African Federation may also consider the relative brevity of the test itself attractive as some legislative GAARs can be quite lengthy and complex.

However, the East African Federation should bear in mind the concerns raised about the ATAD GAAR. Cédelle argues that the possible consequences which may arise from the implementation of the ATAD in the internal market has not been properly evaluated.⁹⁴ Moreover, in terms of the consequences arising from the application of the ATAD GAAR, concern has been raised that it is unclear as to what factual basis should replace the actual arrangement once the Member State is allowed to ignore the non-genuine arrangement in terms of article 6.⁹⁵ In this regard, De Broe and Beckers opine that in such instance, the Member State should calculate the tax liability in accordance with the purpose of the provision that was sought to be circumvented.⁹⁶ De Wilde, however, argues that taken to an extreme, the ATAD GAAR may allow Member States to take into account any facts they please in order to justify the imposition of any corporate tax burden they wish to impose – so long as the “spirit of the law” is broadly adhered.⁹⁷

Of further concern is that the ATAD GAAR has not yet been subject to interpretation by the ECJ. As a result, a great deal of uncertainty prevails regarding the course the ECJ is likely to take in interpreting the ATAD GAAR. The main concerns regarding the interpretation of the ATAD GAAR lies in its relation to the abuse of law doctrine developed under the ECJ in the context of interpreting the EU foundational treaties.⁹⁸

The EU foundational treaties do not contain a GAAR, and yet there is a need to prevent the exploitation of its rules in a manner that is contrary to the spirit and purpose of that law.⁹⁹ While GAARs typically function to prevent such exploitation,

⁹³ Ibid.

⁹⁴ A Cédelle, ‘The EU Anti-tax Avoidance Directive: A UK Perspective’ (2016) 4 British Tax Review 490, 495-496.

⁹⁵ De Wilde (n79) 14.2.2.1; P Rosenblatt and ME Tron, *General Report in Anti-avoidance Measures of General Nature and Scope - GAAR and Other Rules* (IFA Cahiers 2018) vol 103A 11, 28.

⁹⁶ De Broe and Beckers (n85) 144.

⁹⁷ De Wilde (n79) 14.2.2.1.

⁹⁸ See De Wilde (n79); Docclo (n81) 367; De Broe and Beckers (n85) 133; G Bizzioli, ‘Taking EU Fundamental Freedoms Seriously: Does the Anti-Tax Avoidance Directive take precedence over the Single Market?’ (2017) 26 EC Tax Review 167; Rosenblatt and Tron (n95) 20.

⁹⁹ I Mitroyanni, ‘Chapter 2: European Union’ in M. Lang and others (eds), *GAARs – A Key Element of Tax Systems in the Post-BEPS Tax World* (IBFD 2016) 2.6.2.2; Garcia Prats and others (n79) 71.

the ECJ developed the abuse of law doctrine to provide the necessary protection. At its heart, the abuse of law doctrine is premised on the principle that EU law cannot be used to support fraud or abuse.¹⁰⁰ This prohibition against abuse is very broad and covers all areas subject to the jurisdiction of the ECJ, not only taxation.¹⁰¹ Over the years, the ECJ has developed a deep pool of jurisprudence to prevent abusive practices including a number of cases in the area of taxation.

The first case in which the test for an abuse of law was set out was in the non-tax case of *Emsland-Stärke*.¹⁰² According to the court:

A finding of an abuse requires, first, a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purpose of those rules has not been achieved. It requires, second, a subjective element consisting in the intention to obtain an advantage from the Community rules by creating artificially the conditions laid down for obtaining it. The existence of that subjective element can be established, inter alia, by evidence of collusion between the Community exporter receiving the refunds and the importer of the goods in the non-member country.¹⁰³

This case therefore established that an abuse of law enquiry involves a two-step process. First, an objective enquiry to determine the purpose and rationale for the Community rule or law and whether such purpose has been circumvented despite the formal adherence to the law. This is to be followed by a subjective enquiry to determine whether there was the intention to benefit from the law through artificial means.

The manner in which the abuse of law doctrine applies to taxation matters, and particularly in an anti-abuse context, was set out in the *Halifax*,¹⁰⁴ *Cadbury*¹⁰⁵ and *Thin Cap GLO*¹⁰⁶ cases. It is in the context of these cases that it became established that a restriction of the four freedoms would be allowed in cases of an abuse of domestic law provisions only where the arrangement has been found to be ‘wholly artificial which does not reflect

¹⁰⁰ *Kefalas v. Elliniko Dimosio (Greek State), Organismos Ikonomikis Anasinkrotisis Epikhiriseon AE (OAE) and others* [1998] ECR I-02843, C-367/96 (European Court of Justice, Greece).

¹⁰¹ *Garcia Prats and others* (n79) 58.

¹⁰² *Emsland-Stärke GmbH v. Hauptzollamt Hamburg-Jonas* [2000] ECR I-11569, C-110/99 (European Court of Justice, Denmark).

¹⁰³ *Ibid* paras 52 and 53.

¹⁰⁴ *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v. Commissioners of Customs & Excise* [2006] ECR I-01609, C-255/02 (European Court of Justice, United Kingdom).

¹⁰⁵ *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* [2006] ECR I-07995, Case C-196/04 (European Court of Justice, United Kingdom).

¹⁰⁶ *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* [2007] ECR I-02107, Case C-524/04 (European Court of Justice, United Kingdom).

economic reality'¹⁰⁷ and where the arrangements try to avoid the application of the relevant domestic law provision and the consequent tax due.¹⁰⁸

The *Halifax* case was the first case in which the two-step test as set out in *Emsland-Stärke* was applied in a tax dispute. This case involved a series of transactions entered into with the aim of creating the impression of economic activity between three related companies. This structure allowed the parties to use provisions of the Sixth Directive¹⁰⁹ to claim input VAT in a manner that circumvented the exemption of financial services from VAT. The court found that the interspersing of two of the companies was artificial and unnecessary. Accordingly, Halifax was the only recipient of a true supply and was the only entity of the three to which the provisions of the Sixth Directive applied to allow the recovery of input VAT. In reaching this decision, the court applied the *Emsland-Stärke* test to tax cases as follows:

[A]n abusive practice can be found to exist only if, first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. As the Advocate General observed in point 89 of his Opinion, the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages.¹¹⁰

The court further commented that in applying the second leg of the test, the court may have regard to the 'purely artificial nature of those transactions and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden'.¹¹¹

The *Cadbury* case allowed the ECJ to further clarify how this second leg is to be applied in the context of EU law. In this case, the ECJ was asked to determine whether the United Kingdom's controlled foreign company ('CFC') laws unjustifiably restricted the freedom of establishment. The facts which gave rise to this enquiry involved the United Kingdom

¹⁰⁷ *Cadbury Schweppes* (n105) para 55.

¹⁰⁸ See *Imperial Chemical Industries PLC (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695, Case C-264/96 (European Court of Justice, United Kingdom); and *Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie* [2004] ECR I-2409, Case C-9/02 (European Court of Justice, France).

¹⁰⁹ Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax (Codified Version), OJ L347 (2006).

¹¹⁰ *Halifax* (n104) paras 74 to 75.

¹¹¹ *Ibid* para 81.

revenue authority using its CFC laws to attribute the income of a foreign company, incorporated in a low tax jurisdiction, to a United Kingdom resident company which indirectly owned that foreign company. The court ruled that the CFC laws were a restriction of the freedom of establishment. However, such restriction was justified where these laws operated to prevent ‘wholly artificial arrangements which do not reflect economic reality’¹¹² from escaping tax that would otherwise be due. Conversely, the court stated that the CFC laws “must not be applied where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that CFC is actually established in the host Member State and carries on genuine economic activities there.”¹¹³ This judgment therefore established that in the context of the abuse of law doctrine, an intention to use EU law to obtain a tax benefit did not in and of itself constitute an abuse of law. The court also ruled that the concept of ‘wholly artificial arrangements’ is to be determined on the basis of objective factors.

In *Thin Cap GLO*, the ECJ was given the opportunity to emphasize the continuing role of the principle of proportionality in applying the abuse of law doctrine. This case dealt with a company attempting to exploit the deductibility of interest in order to reduce its tax base. While reaffirming its earlier decided position that the freedoms guaranteed under the EU treaties may only be restricted in the cases of the most grievous abuse, the court found that proportionality must still be adhered to when determining the amount of interest which would be disallowed as a deduction.¹¹⁴

A recent development of the abuse of law doctrine is the spate of beneficial ownership cases. The judgments of *N Luxembourg I v Skatteministeriet*¹¹⁵ and joined cases¹¹⁶ along with *T Danmark*¹¹⁷ and another joined case,¹¹⁸ dealt with the interpretation of the beneficial ownership concept and the taxpayers’ access to the withholding tax exemptions granted under the Parent Subsidiary Directive and the Interest and Royalty Directive. These judgments raise issues regarding the interface between the beneficial ownership concept and the abuse of law doctrine. Haslehner and Kofler argue that the judgments should be read on the basis that taxpayer may be

¹¹² *Cadbury Schweppes* (n105) para 55.

¹¹³ *Ibid* para 75.

¹¹⁴ *Mitroyanni* (n99) 2.6.2.2.

¹¹⁵ *N Luxembourg I v Skatteministeriet* (2019) EU:C:2019:134, Case C-115/16 (European Court of Justice, Denmark).

¹¹⁶ *Joined Cases: X Denmark, C-118/16; C Danmark I, C-119/16 and Z Denmark, C-299/16* (2019) EU:C:2019:134 (European Court of Justice, Denmark).

¹¹⁷ *T Danmark* (2019) EU:C:2019:135, Case C-116/16 (European Court of Justice, Denmark).

¹¹⁸ *Joined Case: Y Denmark Aps* (2019) EU:C:2019:135, C-117/16 (European Court of Justice, Denmark).

denied the benefit of accessing tax benefits under EU directives as a result of the artificiality of the legal structure employed to access those benefits even though such taxpayer may actually be the beneficial owner of the relevant income.¹¹⁹ However, Haslehner and Kofler do question the ECJ's reliance on OECD materials to interpret provisions of the Interest and Royalty directive, also completely ignoring the difference in timing between the OECD Commentaries used and the adoption of the directive.¹²⁰ They also note that the judgments raises the question whether it is necessary for the recipient to be subject to tax in its country of residence in order to be the beneficial owner of the income.¹²¹ Haslehner and Kofler opine that this may well be the outcome of the judgments.¹²²

In this regard, Barba de Alba and Arribas note that the ECJ seems to conflate the beneficial ownership concept with that of the abuse of law concept.¹²³ This raises questions as to whether the beneficial ownership concept should be seen as a separate test by which to identify abuse cases.¹²⁴ Barba de Alba and Arribas comment that may not be odd as some beneficial ownership enquiries have in fact served to reveal cases of abuse.¹²⁵ However, they argue that ultimately the beneficial ownership concept should rather be seen as a relevant factor when identifying instances of abuse.¹²⁶

In the light of the important role the abuse of law doctrine plays in anti-avoidance, De Broe and Beckers echo the sentiment of expressed by Weber¹²⁷ and that of Debelva and Luts¹²⁸ in their commentary on the GAAR in the Parent-Subsidiary Directive, that it is odd that the ATAD GAAR refers to "non-genuine" arrangements and not 'wholly artificial' arrangements'.¹²⁹ Bizioli opines that this difference in wording should be reconciled in that both constructions are evident of a broad intent

¹¹⁹ W Haslehner and GW Kofler, 'Three Observations on the Danish Beneficial Ownership Cases' (13 March 2019) Kluwer International Tax Blog <<http://kluwertaxblog.com/2019/03/13/three-observations-on-the-danish-beneficial-ownership-cases/>> accessed 20 July 2019.

¹²⁰ *Ibid.*

¹²¹ *Ibid.*

¹²² *Ibid.*

¹²³ A Barba de Alba and D Arribas, 'The Interplay between Beneficial Ownership and Abuse in the Danish Cases on Dividends' (27 March 2019) Kluwer International Tax Blog <<http://kluwertaxblog.com/2019/03/27/the-interplay-between-beneficial-ownership-and-abuse-in-the-danish-cases-on-dividends/>> accessed 21 July 2019.

¹²⁴ *Ibid.*

¹²⁵ *Ibid.*

¹²⁶ *Ibid.*

¹²⁷ D Weber, 'The New Common Minimum Anti-Abuse Rule in the EU Parent-Subsidiary Directive: Background, Impact, Applicability, Purpose and Effect' (2016) 44 *Intertax* 98, 144.

¹²⁸ F Debelva and J Luts, 'The General Anti-Abuse Rule of the Parent-Subsidiary Directive' (2015) 55 *European Taxation* 223, 227.

¹²⁹ De Broe and Beckers (n85)143.

to target artificiality.¹³⁰ This sentiment echoes the views of Navarro, Parada and Schwarz in their comments on the proposal for an EU Anti-Tax Avoidance Directive.¹³¹

Moreover, in analyzing the term ‘main or one of the main purposes’, Weber comments that the possibility exists that an interpretation of this term would deviate from the current anti-abuse jurisprudence of the ECJ.¹³² Bizioli argues that such a deviation in interpretation would be jarring.¹³³ This is because while the purpose concept is a ‘recessive’ element under the ECJ anti-abuse doctrine with the ECJ being quick to legitimize the intent of minimizing the company tax burden since the tax competition between Member States is a manifestation of the Single Market, the purpose element in the ATAD GAAR is a central requirement to its application and therefore cannot be interpreted so dismissively.¹³⁴ It is therefore difficult to see how the anti-abuse jurisprudence on the purpose element may be reconciled with the interpretation of the “main or one of the main purposes” requirement of the ATAD GAAR.¹³⁵

How would the ECJ likely interpret the ‘main purpose of one of the main purposes’ provision then if not in keeping with the anti-abuse doctrine? De Wilde comments that this wording of the ATAD GAAR seems to suggest that a weighing of tax and non-tax purposes is to be conducted instead of determining whether the arrangement is wholly artificial.¹³⁶ Therefore, De Wilde argues, it is possible that considering the wider scope of words used in the ATAD GAAR an abuse of law may be found to be evident even in the presence of some form of economic substance.¹³⁷ This raises the question as to how much economic substance would be required to meet the ‘economic reality’ test under the ATAD GAAR.¹³⁸

Of principal concern to the East African Federation, however, and arising from the above discussion, is that it would seem that it is now largely left to the Member States to test to what extent the national measures to implement the ATAD GAAR is in fact compliant with EU law.¹³⁹ This is a less than ideal situation. And, a situation which entails a level of uncertainty which the East African Federation can scarcely afford to emulate.

¹³⁰ Bizioli (n98) 172.

¹³¹ A Navarro, L Parada and P Schwarz, ‘The Proposal for an EU Anti-avoidance Directive: Some Preliminary Thoughts’ (2016) 25 EC Tax Review 117, 124.

¹³² Weber (n127) 110.

¹³³ Bizioli (n98) 173.

¹³⁴ *Ibid.*

¹³⁵ *Ibid.*

¹³⁶ De Wilde (n79) 14.2.2.2.

¹³⁷ *Ibid.*

¹³⁸ *Ibid.*

¹³⁹ Docclo (n81) 368.

4.2. CANADA

Canada's GAAR may be found at section 245 of its Income Tax Act.¹⁴⁰ This GAAR was introduced in response to *Stubart Investments Ltd. v The Queen*.¹⁴¹ In this case, the court had endorsed the Duke of Westminster principle and in so doing, induced Parliament to provide the courts with a legislative means to fight tax avoidance.¹⁴²

The GAAR is encapsulated at section 245(2), which reads as follows:

(2) Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

Moreover, section 245(4) provides an additional requirement for the application of the GAAR. This section states:

(4) Subsection (2) applies to a transaction only if it may reasonably be considered that the transaction

(a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of

(i) this Act,

(ii) the Income Tax Regulations,

(iii) the Income Tax Application Rules,

(iv) a tax treaty, or

(v) any other enactment that is relevant in computing tax or any other amount payable by or refundable to a person under this Act or in determining any amount that is relevant for the purposes of that computation; or

(b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.

In order for the GAAR to apply, therefore, the following elements must be met:

- a 'tax benefit';¹⁴³
- an 'avoidance transaction',¹⁴⁴ and

¹⁴⁰ Income Tax Act, 1985, sec. 245 (Canada) [Canada ITA (1985)].

¹⁴¹ *Stubart Investments Ltd. v. The Queen* [1984] 1 SCR 536, 16623 (Supreme Court, Canada).

¹⁴² J Li and T Hwong, 'GAAR in Action: An Empirical Exploration of Tax Court of Canada Decisions (1997 – 2009) and Judicial Decision Making' (2013) 61 Canadian Tax Journal 321, 327.

¹⁴³ Sec. 245(1) Canada ITA (1985).

¹⁴⁴ Sec. 245(3) Canada ITA (1985).

- it would be reasonable to conclude that the transaction would, if not for the GAAR provision, result in a ‘misuse’ of the provisions of the Income Tax Act or other relevant laws such as tax treaties or an ‘abuse’ of the provisions of these provisions read as a whole.¹⁴⁵

A ‘tax benefit’ is defined in section 245(1) as:

[A] reduction, avoidance or deferral of tax or other amount payable under [the Income Tax Act], and includes a reduction, avoidance or deferral of tax or other amount that would be payable under [the Income Tax Act] but for a tax treaty or an increase in a refund of tax or other amount under [the Income Tax Act] as a result of a tax treaty.

Furthermore, an ‘avoidance transaction’ is defined in section 245(3) as any transaction, or part of a series of transactions, that would result, but for this section, in a tax benefit – either directly or indirectly – unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.¹⁴⁶

The Canadian GAAR was retroactively amended in 2005.¹⁴⁷ The effect of these amendments was to broaden the scope of the GAAR to apply to more than just the provisions of the Income Tax Act. Moreover, the amendments also stopped the “misuse and abuse” provision from operating as an exclusion and instead reinstated it as an additional requirement to the application of the GAAR.

The order of the above elements in applying GAAR was set out in *Canada Trustco Mortgage Co. v Canada*.¹⁴⁸ According to the court, it is first necessary to determine whether a tax benefit as defined has arisen from the transaction or series of transactions.¹⁴⁹ Next, there must be an avoidance transaction as defined.¹⁵⁰ Finally, it must be determined whether the avoidance transaction amounts to abusive tax avoidance in that the transaction or series of transactions does not align with the object, spirit and purpose of the legislative provisions employed by the taxpayer.¹⁵¹

Beswick and Nijhawan comment that once it has been determined that a tax benefit and an avoidance transaction is present, the taxpayer’s purpose becomes irrelevant for purposes

¹⁴⁵ Sec. 245(4) Canada ITA (1985).

¹⁴⁶ Sec. 245(3) Canada ITA (1985).

¹⁴⁷ CA: Budget Implementation Act, 2004, sec. 52.

¹⁴⁸ *Canada Trustco Mortgage Co. v Canada* 2005 SCC 54, 30290 (Supreme Court, Canada) para 66.

¹⁴⁹ *Ibid.*

¹⁵⁰ *Ibid.*

¹⁵¹ *Ibid.*

of the rest of the GAAR enquiry.¹⁵² The GAAR enquiry then determines the purpose of the provisions of the ITA or the tax treaty and whether the tax benefit obtained is consistent with that discerned purpose.¹⁵³ The Canadian GAAR therefore requires that a clear distinction be drawn between the purpose of the legal provision and the taxpayer's purpose.¹⁵⁴ Beswick and Nijhawan note that the Canadian GAAR is exceptional among other OECD States in the limited role the taxpayer's intention plays in the GAAR enquiry.¹⁵⁵

In terms of the onus of proof under the Canadian GAAR, *Canada Trustco* sets out which party is to bear the burden of proof in respect of which step. According to the court, the taxpayer bears the onus to refute the evidence of a tax benefit and an avoidance transaction,¹⁵⁶ while the onus is on the Canadian revenue authority to prove the existence of an abuse.¹⁵⁷ Moreover, the court in *Lipson*¹⁵⁸ has clarified that a transaction must be proven to result in a misuse or abuse on a balance of probabilities.

In the thirty years since the enactment of section 245, Canada has produced a deep jurisprudential pool of GAAR cases. In terms of determining the existence of a tax benefit, the Canadian courts conduct a comparative enquiry in terms of which the comparable transaction is one that "might reasonably have been carried out but for the existence of the tax benefit."¹⁵⁹

In terms of determining the existence of an avoidance transaction, Arnold notes that this test boils down to determining the existence or otherwise of a non-tax purpose.¹⁶⁰ Moreover, in order to avoid the GAAR such non-tax purpose must apply to every step in the series of transactions.¹⁶¹ A series of transactions is defined in the Canadian Income Tax Act. According to section 248(10): "For the purposes of this Act, where there is a reference to a series of transactions or events, the series shall be deemed to include any related transactions or events completed in contemplation of the series."¹⁶² In *Canada Trustco*, the court held that this definition expanded the common law meaning of series and that events occurring both before and after the first-

¹⁵² B Beswick and A Nijhawan, *Canada*, in *Anti-avoidance Measures of General Nature and Scope - GAAR and Other Rules* 222 (IFA Cahiers 2018) vol 103A 217.

¹⁵³ *Ibid.*

¹⁵⁴ *Ibid.*

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*

¹⁵⁷ *Ibid.*; *Lipson v Canada* 2009 SCC 1, 3204 (Supreme Court, Canada) para 21.

¹⁵⁸ *Ibid.*

¹⁵⁹ *Cophorne Holdings Ltd v Canada*, 2011 SCC 63, 33283 (Supreme Court, Canada) para 35.

¹⁶⁰ BJ Arnold, 'The Canadian General Anti-Avoidance Rule' (1995) 6 *British Tax Review* 541, 548.

¹⁶¹ *Canada v. MacKay*, 2008 FCA 105 (Federal Court of Appeal, Canada).

¹⁶² Sec. 248(10) Canada ITA (1985).

identified transaction may be included in the series.¹⁶³ Beswick and Nijhawan note, however, the exact scope of section 248(10) continues to be uncertain as it is not settled how the term “in contemplation of” is to be interpreted.¹⁶⁴

In many cases, taxpayers would concede to the existence of a tax benefit and an avoidance transaction, while the focus of the litigation would fall on whether the individual transactions (which may comprise a series) constitutes a misuse or abuse of the legal provisions.¹⁶⁵ In interpreting this provision, Duff and Alarie observe that the more recent judgments are more willing to have the GAAR fill unintended legislative gaps.¹⁶⁶ The courts now seem to be using the misuse and abuse provision to identify a broad policy that is abused by the transaction.¹⁶⁷

This approach can be seen in *Canada v Global Equity Fund Ltd*,¹⁶⁸ *Ontario Ltd v Canada*,¹⁶⁹ *Triad Gestco Ltd v Canada*,¹⁷⁰ and *Barrasso v The Queen*,¹⁷¹ where the ITA’s provisions regarding the recognition of a loss were used to offset capital gains in circumstances where the loss was merely paper-based. The taxpayers had manufactured a loss through the payment of a dividend that stripped the high cost-based share of its value before the share was sold at its lesser value. The loss was then used to absorb subsequent unrelated capital gains. The courts ruled that an abusive transaction existed because the ITA provisions the taxpayers had used required a decrease in ‘economic power’,¹⁷² which was found to be absent in the above cases.¹⁷³ Moreover, the court in *Global Equity Fund Ltd* found that there was ‘no air of economic or business reality’ in the series of transactions.¹⁷⁴ Beswick & Nijhawan opine that while the relevant ITA provisions did not explicitly contain an economic consequence, the courts likely read this into the provision spurred on by the objectionable nature of the transactions.¹⁷⁵

¹⁶³ *Canada Trustco* (n148) para 26.

¹⁶⁴ Beswick and Nijhawan (n152) 221.

¹⁶⁵ BJ Arnold, ‘The Long, Slow, Steady Demise of the General Anti-Avoidance Rule’ (2004) 52 *Canadian Tax Journal* 488; Beswick and Nijhawan (n152) 220.

¹⁶⁶ DG Duff and B Alarie, ‘Legislated Interpretation and Tax Avoidance in Canadian Income Tax Law’ in C Hunt, L Neudorf and M Rankin *Legislating Statutory Interpretation: Perspectives from the Common Law World* (Thomson Reuters 2018) 75.

¹⁶⁷ *Ibid.*

¹⁶⁸ *Canada v Global Equity Fund Ltd* 2012 FCA 272 (Federal Court of Appeal, Canada).

¹⁶⁹ *Ontario Ltd v Canada*, 2012 FCA 259 (Federal Court of Appeal, Canada).

¹⁷⁰ *Triad Gestco Ltd v Canada* 2012 FCA 258 (Federal Court of Appeal, Canada).

¹⁷¹ *Barrasso v The Queen* 2014 TCC 156 (Federal Court of Appeal, Canada).

¹⁷² *Triad Gestco Ltd* (n170) para 42.

¹⁷³ Beswick & Nijhawan (n152) 223.

¹⁷⁴ *Global Equity Fund Ltd* (168) para 68.

¹⁷⁵ Beswick & Nijhawan (n152) 223.

In evaluating Canada's GAAR, the author argues that this GAAR is attractive for the East African Federation in its relative simplicity. The test basically involves three steps – 1) determining the existence of a tax benefit; and 2) an avoidance arrangement before 3) considering whether a misuse or abuse of the ITA or other laws, such as tax treaties, is present. The GAAR may also be attractive to the federation in its comprehensive definition of a 'tax benefit'. The GAARs in the EAC Partner States do not use the term 'tax benefit'. The East African Federation may therefore find it instructive how the Canadian definition is comprehensive enough to capture many of the ways in which a tax benefit may arise.¹⁷⁶ It may also learn from the capability of the Canadian GAAR to apply to every step in a series of transactions and not only the whole series.¹⁷⁷

However, the Canadian GAAR is not without concerns. It has been commented that the misuse and abuse provision is too broad and undefined to be effective.¹⁷⁸ Very little guidance is provided to determine whether any misuse or abuse is present.¹⁷⁹ Moreover, the East African Federation should also note that it is uncertain to what extent the Canadian GAAR should consider the element of 'artificiality' and 'economic substance'.¹⁸⁰ This issue is compounded by the fact that while the explanatory notes to the GAAR state that section 245(4) are intended to apply to transactions with 'real economic substance',¹⁸¹ the actual GAAR does not make reference to this term. Moreover, the Supreme Court of Canada has adopted a restrictive approach towards the incorporation of the term in the GAAR analysis.¹⁸²

Li argues that determining the economic substance of a transaction is relevant to the GAAR enquiry.¹⁸³ She further argues that in conducting the enquiry under section 245(4), the court should find that the transaction is abusive if the transaction

¹⁷⁶ J Cassidy, "'To GAAR or not to GAAR – That is The Question": Canadian and Australian Attempts to Combat Tax Avoidance' (2005) 36 *Ottawa Law Review* 259, 312.

¹⁷⁷ *Ibid.*

¹⁷⁸ Arnold *The Long, Slow, Steady Demise* (n165); Cassidy (n176) 259; DG Duff, 'The Supreme Court of Canada and the General Anti-Avoidance Rule: Canada Trustco and Mathew' (2006) 60 *Bulletin for International Taxation* 54; and J Freedman, 'Converging Tracks? Recent Developments in Canadian and UK Approaches to Tax Avoidance' (2005) 53 *Canadian Tax Journal* 1038.

¹⁷⁹ P Samtani and J Kutyan, 'GAAR Revisited: From Instinctive Reaction to Intellectual Rigour' (2014) 62 *Canadian Tax Journal* 427; Arnold (n160) 401, 549.

¹⁸⁰ Beswick and Nijhawan (n152) 223.

¹⁸¹ Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax*, clause 186 (Ottawa: Department of Finance, 1988).

¹⁸² Beswick and Nijhawan (n152) 223; J Li, "'Economic Substance": Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance' (2006) 54 *Canadian Tax Journal* 23, 26.

¹⁸³ Li (n182) 23.

lacks economic substance.¹⁸⁴ Moreover, ‘economic substance’ in this context should be understood as meaning that the taxpayer was exposed to a level of economic risk or was offered the prospect of making a profit commensurate to the tax benefit obtained.¹⁸⁵ In this way, Li argues, it is possible to draw a relatively clear distinction between legitimate tax planning and abusive tax avoidance.¹⁸⁶

Should the East African Federation choose to include a ‘misuse and abuse’ provision in its GAAR, it should do well to consider Li’s argument. It would be advisable for the East African Federation to perhaps legislate that the ‘misuse and abuse’ provision should be interpreted in light of the economic substance of the transaction, and it would also perhaps be useful to also define what is meant by the term ‘economic substance’ in the East African Federation’s GAAR.

From an administration perspective, the East African Federation should also note that the promulgation of section 245 was accompanied by the Canadian Revenue Authority issuing a document which provided taxpayers with a guide as to the application of the Canadian GAAR.¹⁸⁷ Such a step would be useful to the East African Federation so as to provide taxpayers and investors to the East African Federation with a sense of its revenue authority’s approach to the GAAR. A guidance document by the East African Federation’s revenue authority would assist in providing certainty to the interpretation and application of a GAAR. Moreover, the East African Federation may also be interested in the GAAR Committee operating in Canada. The committee consists of representatives from the Canadian Revenue Authority, the Department of Finance and the Department of Justice.¹⁸⁸ The GAAR Committee is tasked with ensuring that the GAAR is applied consistently and uniformly across Canada. Should the East African Federation form such a committee, within its revenue authority perhaps while also including representatives from other government organizations; legal practitioners and academics, this would allow greater certainty to be created around the application of a GAAR.

4.3. SOUTH AFRICA

South Africa has had several GAARs. The first GAAR was introduced in 1941 in section 90 of the Income Tax Act, 1941¹⁸⁹

¹⁸⁴ Ibid 53.

¹⁸⁵ Ibid 45.

¹⁸⁶ Ibid 56.

¹⁸⁷ Canadian Revenue Authority, *Information Circular 88-2 General Anti-Avoidance Rule – section 245 of the Income Tax Act* < <http://www.cra-arc.gc.ca/E/pub/tp/ic88-2/ic88-2-e.html> > accessed 23 July 2019.

¹⁸⁸ W Adams, *The General Anti-Avoidance Rule (GAAR) Committee in Report of Proceedings of the Forty-Seventh Tax Conference, 1995 Conference Report, 54:1-2* (Canadian Tax Foundation 1996).

¹⁸⁹ Income Tax Act No. 31 of 1941, sec. 90 (South Africa) [SA ITA (1962)].

and was later replaced by section 103(1) in the Income Act, 1962.¹⁹⁰ Section 103(1) was amended before being replaced by the current GAAR found in sections 80A-L, introduced in 2006.¹⁹¹ The earlier GAARs were replaced as both were widely considered to be ineffective.¹⁹²

South Africa's current GAAR looks markedly different from the old section 103(1) and is similar to the Canadian GAAR. The operative section of South Africa's GAAR is found at section 80A, and reads as follows:

80A. Impermissible tax avoidance arrangements.

An avoidance arrangement is an impermissible avoidance arrangement if its sole or main purpose was to obtain a tax benefit and –

a) in the context of business –

i) it was entered into or carried out by means or in a manner which would not normally be employed for bona fide business purposes, other than obtaining a tax benefit; or

(ii) it lacks commercial substance, in whole or in part, taking into account the provisions of section 80C;

(b) in a context other than business, it was entered into or carried out by means or in a manner which would not normally be employed for a bona fide purpose, other than obtaining a tax benefit; or

(c) in any context –

i) it has created rights or obligations that would not normally be created between persons dealing at arm's length; or

(ii) it would result directly or indirectly in the misuse or abuse of the provisions of this Act (including the provisions of this Part).

In order for the current GAAR to apply in South Africa, the following elements must be present:

- An arrangement;
- That results in a tax benefit and there is therefore an avoidance arrangement;
- The sole or main purpose of which is to obtain a tax benefit; and
- One of the following tainted elements is present: 1) abnormality with respect to the means, manner, rights or obligations under the arrangement concluded in a

¹⁹⁰ Sec. 103 SA ITA (1962).

¹⁹¹ Sec. 80A-L SA ITA (1962).

¹⁹² R Tooma, *Legislating Against Tax Avoidance* (IBFD 2008); E Mazansky, *The Duke of Westminster Still Lives in South Africa (But is Very Careful When He Crosses the Road)* (2005) 59 *Bulletin for International Fiscal Documentation* 116; SARS, *Discussion Paper on Tax Avoidance and Section 103 of the Income Tax Act, 1962* (2005) < <https://www.sars.gov.za/AllDocs/LegalDoclib/DiscPapers/LAPD-LPrep-DP-2005-01%20-%20Discussion%20Paper%20Tax%20Avoidance%20Section%20103%20of%20Income%20Tax%20Act%201962.pdf> > accessed 23 July 2019.

business context; 2) an absence of commercial substance (either in whole or in part); 3) the creation of rights and obligations in any context that would not normally be created between parties transacting at arm's length; or 4) a misuse or abuse of the provisions of the ITA.¹⁹³

The current GAAR is fairly lengthy as it goes on to discuss the 'tainted elements' in some detail. With respect to determining purpose, section 80G is noteworthy in that it provides that once a tax benefit is identified, it is rebuttably presumed that the sole or main purpose of the arrangement is to obtain a tax benefit.¹⁹⁴ Purpose continues to play a pivot role in the application of the current South African GAAR because if the taxpayer is successful in rebutting this presumption, the GAAR cannot be applied – even if the other elements are met.¹⁹⁵ Similarly, the abnormality requirement continues to play an important role in the current GAAR – just as it did in the old GAAR under section 103(1) – given that an arrangement would escape the application of the current GAAR if it were classified as 'normal'.¹⁹⁶

Given the continued importance of the abnormality requirement in the current GAAR, it is concerning the number and gravity of the issues raised regarding the application of the two new elements of the abnormality requirement under the South African GAAR – the 'commercial substance' element and the 'misuse and abuse' provision.

The 'commercial substance' provision under section 80C(1) provides that an arrangement will lack commercial substance if the arrangement results in a significant tax benefit for one party while having no significant effect on either the net cash flows or business risks of the other party.¹⁹⁷ Mazansky notes that this section introduces very broad and vague concepts to the South African GAAR.¹⁹⁸ Kujinga observes that while section 80C does go on to provide a list of indicators of a lack of commercial substance, uncertainty still exists as to how to conduct the comparison required under section 80C(1).¹⁹⁹ He argues that South African courts should draw from the economic substance doctrine in the United States for guidance on how to identify cases which lack commercial substance.²⁰⁰ In this way,

¹⁹³ Sec. 80A SA ITA (1962).

¹⁹⁴ Sec. 80G SA ITA (1962).

¹⁹⁵ D Kruger and others (eds), *Broomberg on Tax Strategy* (5th ed, LexisNexis 2012) 263.

¹⁹⁶ A Marais, *South Africa*, in *Anti-avoidance Measures of General Nature and Scope - GAAR and Other Rules* (IFA Cahiers 2018) vol 103A 683, 686.

¹⁹⁷ Section 80C(1) of the SA ITA (1962).

¹⁹⁸ E Mazansky, 'South Africa's New General Anti-Avoidance Rule – the Final GAAR' (2007) 61 *Bulletin for International Taxation* 159, 162.

¹⁹⁹ B Kujinga, 'The Economic Substance Doctrine Against Abusive Tax Shelters in the United States: Lessons for South Africa' (2015) 27 *South African Mercantile Law Journal* 218, 221.

²⁰⁰ *Ibid.*

Kujinga argues South African courts may find that arrangements that are consistent with an identified statutory purpose would not lack commercial substance while arrangements that a reasonable business person would not enter into if not for the tax benefits would often lack the necessary commercial substance.²⁰¹ Moreover, Kujinga pragmatically suggests that the courts adopt a mechanical approach to the comparison required under section 80C(1) in that the courts should be swayed by the numerical imbalance produced by the comparison.²⁰² It is also unclear what the link is between the general test for commercial substance under section 80C(1) and the list of indicators of a lack of commercial substance under section 80C(2).²⁰³

The current GAAR has also introduced the ‘misuse and abuse’ element, inspired by a similar provision in the Canadian ITA.²⁰⁴ Broomberg raises a concern in the way that the ‘misuse and abuse’ element in the South African GAAR is used as a catch all provision.²⁰⁵ As a result of this provision, he argues, the South African GAAR has no limitation.²⁰⁶ This would likely mean that the courts will interpret the GAAR restrictively in order to impose the necessary limitation to the GAAR’s application in South Africa.²⁰⁷ A further implication of the “misuse and abuse” provision is that it introduces an untenable degree of uncertainty to the application of the GAAR. Clegg argues that the term ‘abuse’ is subjective and that what may constitute an abuse to one may not be classified as such by another.²⁰⁸

The current South African GAAR has also raised other concerns. Cassidy observes that it is difficult to understand conceptually how a ‘transaction’ can have a purpose as an inanimate construct.²⁰⁹ However, Cooper argues that this is not uncommon in common law jurisprudence.²¹⁰ Cooper notes that as early as 1958 Lord Denning in *Newton v. Federal Commissioner of Taxation*²¹¹ explained that when determining the purpose of an arrangement, the acts by which the arrangement was implemented must lead one to assert that the arrangement was implemented in that particular way in order to

²⁰¹ Ibid 244.

²⁰² Ibid.

²⁰³ EB Broomberg, *Then and Now – V* (2008) 22 Tax Planning 3.

²⁰⁴ *Explanatory Memorandum to the Revenue Laws Amendment Bill, 2006* 63 (South Africa).

²⁰⁵ Ibid.

²⁰⁶ Ibid.

²⁰⁷ Ibid.

²⁰⁸ D Clegg, ‘Use it or Abuse it’ (2007) 21 Tax Planning 2; L van Schalkwyk and B Geldenhuys, ‘Section 80A(c)(ii) of the Income Tax Act and the Interpretation of Tax Statutes in South Africa’ (2009) 17 *Meditari Accountancy Research* 167.

²⁰⁹ J Cassidy, ‘The Holy Grail: The Search for the Optimal GAAR’ (2009) 126 *South African Law Journal* 740, 766.

²¹⁰ Cooper (n88) 140.

²¹¹ *Newton v. Federal Commissioner of Taxation*, [1958] UKPCHCA 1 (Privy Council, Australia).

avoid tax.²¹² Moreover, the test of determining the purpose of an arrangement has been aptly described as determining ‘the mechanics of implementation’, a test which is removed from determining the motives of the persons involved with the transaction.²¹³ Cooper argues that when the ‘purpose of an arrangement or transaction’ test is used, it is in fact a poorly drafted reference to artifice.²¹⁴ Therefore, an arrangement or transaction would have the requisite purpose where it was fashioned in such a way so as to obtain the tax advantage.²¹⁵

The current South African GAAR does not make an overt reference to artifice because South Africa has a fairly well-developed jurisprudence on substance over form, the doctrine within which the determining of artifice is usually housed. There is therefore no need to include the substance over form test in the GAAR legislation. In South Africa, a court will first apply the substance over form test before applying the GAAR.²¹⁶ In other words, a court must first determine that the transaction before it is genuine and properly labelled for what it actually is before the court will consider the GAAR provisions and whether the transaction meets its requirements. Should the court find that the form of the transaction is not genuine or that its label does not match its true substance, the court will give effect to the true agreement between the parties and in so doing apply the tax consequences to the actual agreement. This step will have the effect of removing the tax advantage and therefore making it unnecessary to apply the GAAR.

This was the case in *Erf 3183/1 Ladysmith (Pty) Ltd v Commissioner for Inland Revenue*,²¹⁷ for example. In this case, the parties inserted a tax-exempt party (a pension fund) between the main lease and the sub-lease so as to prevent the accrual of income in the hands of the taxpayer as the main landlord, while still allowing for a deduction to be claimed on leasehold improvements made by the sub-tenant. The court noted that the agreements had a ‘distinct air of unreality’ about them in that all the agreements were signed simultaneously, and it was clear that they were interdependent.²¹⁸ Such interdependence resulted in some obligations in one contract being cancelled in another contract. Viewed in this way, it was clear that it was never the

²¹² Ibid para 15.

²¹³ J Prebble and H McIntosh, ‘Predication: The test of tax avoidance in New Zealand from Newton to Ben Nevis’ (2015) 46 Victoria University of Wellington Law Review 1011, 1017.

²¹⁴ Cooper (n88) 143.

²¹⁵ Ibid.

²¹⁶ P Surtees and S Millard, ‘Substance, Form and Tax Avoidance’ (2004) Nov./Dec. Accountancy SA 14; T Legwaila, ‘Modernising the Substance over Form Doctrine: Commissioner for the South African Revenue Service v NWK’ (2012) 24 South African Mercantile Law Journal 115.

²¹⁷ *Erf 3183/1 Ladysmith (Pty) Ltd v. Commissioner for Inland Revenue*, 1996 (3) SA 942 (SCA), 527/94IH (Supreme Court of Appeal, South Africa).

²¹⁸ Ibid 241.

intention of the parties that the pension fund conduct the improvements. Accordingly, the court disregarded the pension fund. This resulted in the income accruing to the taxpayer in terms of the legislative provision which then became applicable once the court gave effect to the true intention of the parties.

On the other hand, however, should the court be satisfied that the agreement properly reflects its substance then the court will continue to test the agreement against the GAAR. This process was followed in *Commissioner for Inland Revenue v Conhage (Pty) Ltd.*²¹⁹ In this case, the parties entered into a sale-and-leaseback agreement. The commissioner argued that the actual agreement between the parties was that the taxpayer would 'borrow' the purchase price of the assets sold, and accordingly the taxpayer was not entitled to claim a deduction of the rental paid under the sale-and-leaseback agreement. The court dismissed the commissioner's arguments. The court held that the sale-and-leaseback agreement correctly reflected the true intention of the parties, and that there was no evidence of any form of deception or subterfuge on the part of the parties to the contract. The court then considered whether the GAAR of the time should be applied to the facts. The court held that not all of the requirements of the then GAAR were met. The taxpayer was accordingly allowed to claim the deduction.

The benefit of the above jurisprudential approach is that there is a relatively clear line of cases dealing with subterfuge and artificiality and another line of cases dealing with GAAR in what may be called 'true' GAAR cases. Having said that, the current GAAR has not yet been tested in a South African court. Several questions therefore remain unanswered with respect to the interpretation and application of the South African GAAR. Questions such as: How will a South African court determine the intention of a transaction?²²⁰ How would such a court interpret the term 'commercial substance'?²²¹ Will the South African courts follow the Canadian courts in the interpretation of the 'misuse and abuse' test?²²² How is the GAAR to apply if an arrangement has a mixed business and non-business purposes?²²³ Who is to bear the onus under the GAAR provisions?²²⁴

A possible reason for the lack of current GAAR cases may be attributable to the procedural and administrative measures put in place in South Africa. The Advance Tax Rulings system allows the South African revenue authority to provide binding advice in the form of rulings on the interpretation of the

²¹⁹ *Commissioner for Inland Revenue v. Conhage (Pty) Ltd.*, 1999 (4) SA 1149 (SCA), 606/97 (Supreme Court of Appeal, South Africa).

²²⁰ Cassidy *The Holy Grail* (n209) 766.

²²¹ Marais (n196) 695.

²²² *Ibid.*

²²³ Cassidy *The Holy Grail* (n209) 769.

²²⁴ Marais (n196) 683.

GAAR before the transaction is implemented.²²⁵ Moreover, the notice procedures under the current GAAR allows for the taxpayer to persuade the South African revenue authority against applying the GAAR. Section 80J requires the South African revenue authority to issue a written notice to the taxpayer of its intention to apply the GAAR.²²⁶ This notice should set out the reasons for the intended application of the GAAR.²²⁷ The taxpayer is then given an opportunity to file reasons as to why the GAAR should not be applied.²²⁸ Following this, the South African revenue authority is then required to respond by requesting further information from the taxpayer; withdrawing the GAAR notice altogether; or determining the taxpayer's liability by applying the GAAR.²²⁹ The purpose of the GAAR notice is to provide taxpayers with early warning of the South African revenue authority's intent to apply the GAAR and to address these concerns before the undertaking of a comprehensive GAAR audit.²³⁰ However, in practice this notice has not been used as intended.²³¹ The practice of the South African revenue authority has been to only issue the GAAR notice towards the end of its GAAR audit, making the notice itself rather ineffectual.²³² In theory, however, the notice procedures under section 80J²³³ may be of interest to the East African Federation.

Moreover, the East African Federation may consider the South African GAAR attractive for the following reasons. First, the East African may find the way in which the South African GAAR has moved away from a subjective purpose, as corroborated by objective facts, to an objective purpose instructive. In particular, it should note the negative impact the subjective enquiry into determining purpose had on the old South African GAAR, which led to South Africa's current adoption of a GAAR devoid of subjective intent. This discussion is apt considering that Kenya, Tanzania and Uganda's GAARs require the commissioner to be satisfied that the main or one of the main purposes of the transaction was to obtain a tax benefit before the GAARs may be applied. The East African Federation can ill afford a similar experience to that in South Africa under South Africa's old GAAR.

²²⁵ Tax Administration Act No. 28 of 2011, chapter 7 (South Africa).

²²⁶ Sec. 80J(1) SA ITA (1962).

²²⁷ *Ibid.*

²²⁸ Sec. 80J(2) SA ITA (1962).

²²⁹ Sec. 80J(3) SA ITA (1962).

²³⁰ E Liptak, 'The New GAAR 10 Years On – Part II: Mistakes and Missed Opportunities' Dec. Tax Talk, (2016), <<https://sait.site-ym.com/news/326188/The-New-GAAR-10-Years-On--Part-II-Mistakes-and-Missed-Opportunities-.htm>> accessed 23 July 2019.

²³¹ *Ibid.*

²³² *Ibid.*

²³³ Sec. 80J SA ITA (1962).

With respect to proving purpose, the East African Federation should note the South African rebuttable presumption of intention under section 80G²³⁴ of the current GAAR. A similar provision in a GAAR for the East African Federation may address some of the capacity concerns it may face regarding the application of a GAAR. Its capacity issues may be further addressed by adopting similar administrative measures to South Africa in emulating its advance tax rulings system and notice procedures. Second, the East African Federation may also consider emulating the manner in which the South African GAAR makes use of objective elements – such as round trip financing and accommodating or tax-indifferent parties – to determine whether an avoidance arrangement is an impermissible avoidance arrangement. Should the East African Federation emulate this practice, however, it should bear in mind the uncertainties created under section 80C in the South African ITA. In particular, the East African Federation should perhaps consider legislating the link which is to exist under the general test for commercial substance under section 80C(1) and the objective factors listed under section 80C(2).

Moreover, the East African Federation should carefully consider whether to include the ‘misuse and abuse’ element in its own GAAR. It may be tempted to include the provision given that it is an international best practice to include such an element and that Tanzania already includes the ‘misuse and abuse’ element in its GAAR – although the provision is used as an exclusion in Tanzania. Should the East African Federation decide to use the provision as it is used in South Africa and currently in Canada, it should pay close attention to the serious issues commentators have raised regarding its application. Not least of all, the East African Federation should be concerned that the provision fails to provide a necessary limit to the application of the GAAR. Moreover, the East African Federation should be wary of the likely effect this would have on its courts when interpreting the GAAR. The East African Federation should also carefully consider the implications this provision may have on its courts’ approach to statutory interpretation. Particularly, it should evaluate whether the purposive approach required by the provision may work with the current literal approach to statutory interpretation followed by courts in the EAC Partner States.²³⁵

The East African Federation may also be somewhat concerned that the South African revenue authority has not used its own GAAR in court in over ten years since the GAAR was introduced. This may either indicate that the GAAR has been successful in deterring the worst of the objectionable avoidance arrangements, or it may indicate that the South African revenue authority has a lack of confidence in its own GAAR and how

²³⁴ Sec. 80G SA ITA (1962).

²³⁵ See further discussion of the legal culture in the EAC Partner States at 5 below.

effective it is in targeting objectionable avoidance arrangements. This concern, however, may be tempered by the fact that it took almost ten years for the first Canadian GAAR case to reach a court,²³⁶ and seventeen years before the first appeals regarding section 245 to reach the Canadian Supreme Court.²³⁷ The South African circumstance is, however, compounded by the widespread perception that the South African revenue authority has no confidence in its own GAAR, a perception which the South African revenue authority does little to prove wrong.²³⁸ Some, however, do not share this view and see the ever present threat of GAAR litigation as unnerving and worrying.²³⁹ The East African Federation should carefully follow South African litigation in this respect to see how the GAAR is applied in practice, whenever such litigation may materialize.

5. RECOMMENDATIONS FOR THE EAST AFRICAN FEDERATION

This chapter recommends first, that the East African Federation should include a substance over form test as the initial step in applying the proposed GAAR. Secondly, the proposed GAAR should include the following three essential elements of a GAAR - a definition of a 'scheme'; a definition of a 'tax benefit'; and an objective purpose to use the scheme to obtain a tax benefit. Thirdly, the proposed GAAR should also include the 'misuse and abuse' provision currently in the Tanzanian GAAR. It is further recommended that the 'misuse and abuse' provision be used as an exclusion to the application of the GAAR as it is used in Tanzania. Moreover, it is argued that 'misuse and abuse' should be understood with reference to the term 'economic substance'.²⁴⁰ This would mean that an arrangement would be abusive if it were to lack economic substance.²⁴¹ Finally, it is recommended that the economic substance enquiry be bolstered with a list of objective indicators. Each of these recommendations will be discussed in turn below.

It is submitted that no recommendations can credibly be made without addressing the critical capacity concerns the revenue authorities in the Partner States currently face and which the East African Federation is likely to face. This chapter therefore also includes operational recommendations that may assist the East African Federation in equipping its revenue authority with the means to undertake GAAR enquiries.

²³⁶ Tooma (n192) 5.2.2.

²³⁷ The first cases were: *Canada Trustco* (n148) and *Mathew v. Canada*, 2005 SCC 55, 30067 (Supreme Court, Canada).

²³⁸ Liptak (n230); Marais (n196) 683.

²³⁹ Marais (n196) 683.

²⁴⁰ Li (n182) 53.

²⁴¹ Ibid.

5.1. SUBSTANCE OVER FORM TEST

It was noted above that in South Africa, the substance over form test is applied by the courts before the GAAR is considered. Should the courts find that the substance of the transaction does not match its legal form, the courts disregard the legal form and only have regard the true transaction intended by the parties.²⁴² In this enquiry, legal substance and not economic substance is envisaged here. Legal substance involves an enquiry whether the taxpayer's behaviour or actions in implementing the arrangement is consistent with the rights and obligations documented in the contracts detailing the arrangement.²⁴³ This is different from an economic substance enquiry which would entail comparing the economic position of the taxpayer before and after the arrangement.²⁴⁴ While an economic substance enquiry has merit, this paper argues that for the East African Federation such an enquiry would be best placed to occur at a later stage of the GAAR enquiry – as detailed further below under Part 5.3.

As a result of the application of the substance of the form test as a legal substance test, the South African courts apply tax consequences to the true transaction. In such case, there is no need to further consider the GAAR because the tax benefit has already been removed.²⁴⁵ In theory, the South Africa GAAR would then only apply to genuine transactions.

It is recommended that the East African Federation follow this route. Moreover, it should explicitly state this line of reasoning in the proposed GAAR. Such a recommendation is apt for the East African context given that the Uganda GAAR already includes the substance over form test. It is further recommended that the East African Federation adopt similar wording as to that used in the ATAD GAAR in determining whether the arrangement is genuine or not, suitably adapted to make it clear that test here is focused on legal substance as opposed to economic substance. Accordingly, the proposed GAAR could include a provision along the following lines:

As an initial step to the application of the GAAR, it is necessary to determine if the arrangement is genuine. An arrangement shall be regarded as non-genuine to the extent that the behaviour or actions of the taxpayer or any other party to the arrangement does not correspond to the rights and obligations reflected in the legal form of the arrangement itself.

²⁴² See *Erf 3183/1 Ladysmith (Pty) Ltd* (n217).

²⁴³ *Li* (n182) 43.

²⁴⁴ *Ibid* 44.

²⁴⁵ See *Conhage* (n219) and *Erf 3183/1 Ladysmith (Pty) Ltd* (n217). Although these cases were decided under the old SA GAAR (s103(1)), the same process would nonetheless continue to apply to GAAR cases decided under s80A-L of the SA ITA (1962).

This recommendation would have the benefit of allowing a distinction to be made between sham or simulated transactions as non-genuine arrangements – which arguably could be adjudicated fairly quickly based mostly on the evidence before the court – and, more complex GAAR cases (in the true sense of the word) which would involve a consideration of all the elements of the GAAR.

5.2. ESSENTIAL ELEMENTS OF GAAR – SCHEME, TAX BENEFIT AND PURPOSE

It is suggested that the East African Federation consider following most modern GAARs in including the following three elements of the GAAR: identification of a ‘scheme’ or ‘arrangement’ as defined; identification of a ‘tax benefit’ as defined; and identification of a purpose. Most of the GAARs in the Partner States already include at least the latter two elements.

5.2.1. SCHEME OR ARRANGEMENT

It is recommended that the East African Federation move away from the ‘transaction’ used in the Kenyan and Ugandan GAARs along with the ‘operation’ used in the GAAR in Burundi. These have the tendency to be read as singular. Therefore, its effect is to limit the GAAR to only applying to the whole transaction or otherwise to just one, singular transaction while ignoring others. Instead, it is recommended that the East African Federation include a definition of an ‘arrangement’ which would make it clear that the GAAR may be applied to a single transaction or the whole series of transactions. It is further suggested that it use the word ‘arrangement’ rather than ‘scheme’ given that the Tanzanian GAAR already makes reference to an ‘arrangement’. The author finds the following recommended clause proposed by the European Commission in 2012²⁴⁶ as useful here:

An arrangement means any transaction, scheme, action, operation, agreement, grant, understanding, promise, undertaking or event. An arrangement may comprise more than one step or part.²⁴⁷

5.2.2. TAX BENEFIT

None of the EAC Partner States have included a definition of a ‘tax benefit’ in their GAARs. It is recommended that the East African Federation include this in its proposed GAAR because it is important to determine what tax event would trigger the application of the GAAR.

²⁴⁶ European Commission, *Commission Recommendation of 6.12.2012 on Aggressive Tax Planning* (Brussels, 2012).

²⁴⁷ Ibid 4-5.

Although ‘tax benefit’ as such is not defined in the Partner States’ GAARs, reference is consistently made to the ‘avoidance or reduction of liability to tax’. This does look very similar to the triad that often appears in the definition of a tax benefit – ‘reduction in, avoidance of or deferral of tax otherwise payable’.²⁴⁸ This fairly broad definition, however, does serve to include the main tax events that would typically trigger the application of a GAAR in most foreign jurisdictions.²⁴⁹ Rosenblatt suggests that developing countries include such a broad definition coupled with a non-exhaustive list of specific tax benefits that would trigger the GAAR.²⁵⁰ However, the drawbacks of adopting such an approach includes the fact that the list must be updated regularly in order to stay current and also, the list tends to impair the effectiveness of the general definition.²⁵¹

Given the capacity issues of the revenue authorities in the EAC Partner States, the author recommends that the proposed GAAR only include the broad definition – similar to the phrase already used in the current GAARs of the EAC Partner States. It is recommended that for now the East African Federation should not include a list of tax benefits. Such a list would demand that the East African Federation devote some resources towards ensuring that the codified list is continually kept up to date. It is submitted that such resources would be better devoted elsewhere in the GAAR enquiry.

It is therefore recommended that the proposed GAAR word the definition of a tax benefit as follows: ‘A tax benefit means the avoidance of, reduction in or deferral of liability to tax.’

5.2.3. PURPOSE

At the moment, the main manner in which purpose is used by the EAC Partner States is in a subjective sense. The usefulness of such a provision is apparent in so far as it acknowledges that tax avoidance is a purpose-driven concept.²⁵²

However, the inclusion of a subjective purpose in a GAAR enquiry may be problematic. Freedman notes that a subject intent, especially in the complex field of tax, is difficult to prove.²⁵³ Moreover, Waerzeggers and Hillier note that a subjective purpose test may serve to inhibit ordinary commercial

²⁴⁸ Rosenblatt (n10) 42.

²⁴⁹ Ibid.

²⁵⁰ Ibid 46-47.

²⁵¹ Cassidy *The Holy Grail* (n209) 755.

²⁵² GS Cooper, ‘International Experience with General Anti-Avoidance Rules’ (2001) 54 *Southern Methodist University Law Review* 83, 99; VR Almendral, ‘Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?’ (2005) 33 *Intertax* 560, 563.

²⁵³ Freedman (n3) 171.

decisions.²⁵⁴ From a developing State perspective, South Africa has experienced its subjective purpose test as counterproductive as Williams noted that taxpayers could use the subjective enquiry to escape the application of the then GAAR altogether.²⁵⁵

Some have argued that a subjective purpose may be discerned by examining that of a fictitious or 'reasonable person'.²⁵⁶ This is while others have argued against the use of a subjective test altogether.²⁵⁷ Banoun argues that '[w]hether or not a transaction is taxable should depend on the characteristics particular to the transaction and not be tied to the subjective attitudes of each taxpayer'.²⁵⁸

The author is not convinced that a subjective purpose test would be suited to the East African Federation context. The current GAARs in many of the EAC Partner States already encompasses a subjective purpose test. Since no GAAR cases have reached the courts in the EAC Partner States, it is difficult to determine the efficacy of this test and even how this test would be interpreted by the courts. However, it is not a good sign that some Partner States are litigating anti-avoidance cases without using the legislated GAAR.²⁵⁹

It is recommended that the East African Federation should perhaps take heed of the South African experience with its old GAAR under section 103(1) and move away from this subjective intent test while stating this explicitly in the proposed GAAR. It is proposed that the East African Federation state that it is irrelevant whether the taxpayer or any third party involved in the arrangement had the subjective intent or not to obtain a tax benefit from the arrangement, as Rosenblatt advises developing States to do.²⁶⁰ In legislating this objective approach to purpose, it is recommended that the East African Federation follow South Africa's approach and state that it is the purpose of the arrangement that is to be ascertained. Furthermore, the East African Federation should also follow South Africa's approach in legislating a rebuttable presumption in the proposed GAAR regarding purpose. It is suggested that the proposed GAAR state that, as soon as a tax benefit has been determined, it will be presumed that one of the main purposes for entering into the arrangement was to obtain a tax benefit. The onus would then be

²⁵⁴ Waerzeggers and Hillier (n5) 4.

²⁵⁵ RC Williams, 'The 1996 Amendments to the General Anti-Tax-Avoidance Section of the Income Tax Act' (1997) 114 South African Law Journal 675.

²⁵⁶ Cooper (n88) 142.

²⁵⁷ N Orow, *General Anti-avoidance Rules: A Comparative International Analysis* (Jordans 2000) 111-112; M Lang, 'The General Anti-Abuse Rule of Article 80 of the Draft Proposal for a Council Directive on a Common Consolidated Corporate Tax Base' (2011) 51 European Taxation 223, 225.

²⁵⁸ B Banoun, 'Tax Avoidance Rules in Scandinavian and Anglo-American Law' (2002) 56 Bulletin for International Fiscal Documentation 485, 488.

²⁵⁹ See above discussion in Part 5.

²⁶⁰ Rosenblatt (n10) 54.

on the taxpayer to dislodge this presumption. Such a rebuttable presumption would greatly assist the East African Federation in relieving the revenue authority of some of the evidentiary burden of mounting a GAAR argument while the East African Federation builds its expertise and capacity in this area. Finally, it is recommended that the proposed GAAR explicitly state that the purpose of the arrangement is to be determined at the time that the arrangement was entered into, and not at any subsequent time.

From a legislation drafting perspective, it is recommended that the East African Federation follow the wording used in the South African GAAR in so far as it uses the term ‘avoidance arrangement’ to indicate that this is an arrangement with a tax benefit purpose. It has been argued that developing countries should avoid adding on terms such ‘impermissible’, ‘unacceptable’ or ‘irresponsible’ because these are often subjectively determined and would leave too much discretion to the revenue authorities.²⁶¹ The advice would be well placed for the East African Federation.

It is therefore recommended that the East African Federation word the purpose element of its proposed GAAR as follows:

An avoidance arrangement is an arrangement where one of the main purposes of the arrangement, as determined at the time of entering into of the arrangement, was to obtain a tax benefit. When determining such purpose, it is irrelevant whether the taxpayer or any third party connected to the arrangement subjectively had the purpose to obtain a tax benefit from the arrangement.

An avoidance arrangement is presumed to have been entered into or carried out for one of the main purposes of obtaining a tax benefit once the tax benefit has been determined, unless and until the party obtaining a tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not one of the main purposes of the avoidance arrangement. The purpose of a step in or part of an avoidance arrangement may be different from a purpose attributable to the avoidance arrangement as a whole.

5.3. ABUSE AND MISUSE OF THE PROVISIONS OF THE INCOME TAX ACT

The GAAR in Tanzania already includes a reference to the ‘misuse and abuse’ provision, and it is employed as an exclusion in the same manner as the original GAAR in Canada. The provision operates to prohibit the application of the GAAR unless it is proven that the arrangement constitutes an abuse or misuse of the provisions of the Income Tax Act. This is as opposed to the manner in which the misuse and abuse provision

²⁶¹ Ibid 55; Rosenblatt and Tron (n95) 47.

is used in South Africa and currently in Canada – as one of the elements that would bring about the application of the GAAR.

It is recommended that the East African Federation retain this element of the GAAR in the way that it is currently used in Tanzania – as an exclusion to the application of the GAAR. In so doing, this provision could apply as a limitation to the application of the GAAR. The author is of the view that it would be best for the East African Federation to avoid the uncertainty and serious concerns raised regarding the use of the ‘misuse and abuse’ provision as it appears in the South African GAAR and the current Canadian GAAR. For the sake of clarity, it is recommended that the East African Federation legislate that the ‘misuse and abuse’ provision is meant to exclude arrangements with actual economic substance. Thus, as Li argues, an arrangement would constitute an abuse or misuse of the provisions of the Income Tax Act if the arrangement lacks economic substance.²⁶² It also recommended that a definition of economic substance be provided to further guide the interpretation of the ‘misuse and abuse’ provision. Li’s definition is useful here, and provides that economic substance means that a taxpayer was exposed to a level of economic risk or was offered the prospect of making a profit commensurate to the tax benefit obtained.²⁶³ A reference to the economic substance would be apt for the East African Federation given that the Rwandan Revenue Authority is in essence currently making economic substance arguments in its anti-avoidance efforts, and also that the Ugandan GAAR refers to transactions that lack substantial economic effect.

It is further recommended that the proposed GAAR legislate a list of objective factors that would indicate that the arrangement may lack economic substance. These factors could borrow from the South African ‘tainted elements’ in its GAAR and include the following:

- The presence of round trip financing (which would be defined in the proposed GAAR and largely borrowing from the South African definition in section 80D of the South African Income Tax Act);
- The presence of an accommodating or tax indifferent third party (which would be defined in the proposed GAAR and largely borrowing from the South African definition in section 80E of the South African Income Tax Act);
- The presence of elements that have the effect of offsetting or cancelling each other; and
- Lack of ‘commercial effect’ - an arrangement lacks commercial effect if it would result in a significant tax

²⁶² Li (n182) 53.

²⁶³ Ibid 45.

benefit for a party but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained.

The last factor above borrows the test for commercial substance as used in the South African GAAR but replaces the term 'commercial substance' with the term 'commercial effect'. The author is of the view that the term 'commercial substance' should be avoided because it would raise unnecessary normative questions about its relation to economic and legal substance. It is proposed that the term 'commercial effect' be used instead as it more clearly indicates that it is the effect of the arrangement as it corresponds to commercial realities that should be determined.

In this regard, it is important for the East African Federation to clearly legislate the link between the general test for economic substance and the list of objective factors. In so doing, the East African Federation would learn from the South African experience regarding South Africa's section 80C.

Accordingly, the author recommends that the proposed GAAR should include an 'abuse and misuse' provision that may be worded as follows:

An arrangement will be excluded from the application of the GAAR where it may reasonably be considered that the arrangement would not result directly or indirectly in a misuse or abuse of the Income Tax Act as a whole or any of its provisions. An arrangement will be considered abusive if it lacks economic substance.

In this context, "economic substance" means that a taxpayer is exposed to economic risk or is offered the prospect of making a profit which is commensurate to the tax benefit obtained.²⁶⁴

As a means of determining the existence of economic substance as defined, a court may have regard to the following list of factors which may indicate the lack of economic substance:

- The presence of round trip financing as defined;
- The presence of an accommodating or tax indifferent third party as defined;
- The presence of elements that have the effect of offsetting or cancelling each other; or
- Lack of commercial effect - an arrangement lacks commercial effect if it would result in a significant tax benefit for a party but does not have a significant effect upon either the business risks or net cash flows of that party apart from any effect attributable to the tax benefit that would be obtained.

²⁶⁴ Ibid.

5.4. ADMINISTRATIVE CAPACITY RECOMMENDATIONS

The recommendations made here encompass both measures which may be undertaken immediately to ameliorate the effects of the critical lack of capacity at the revenue authorities within the East African region, and also measures which over the long term will make the implementation of the GAAR easier and more certain.

5.4.1. IMMEDIATE CAPACITY RECOMMENDATIONS

Some of the recommendations as made under Part 5.1 to 5.3 above would have relevance here. For instance, the rebuttable presumption regarding purpose would serve to alleviate the burden on the revenue authority to submit evidence in this regard. Also, the recommendations made for the proposed GAAR to retain as many elements of the existing GAARs of the EAC Partner States would also serve to build on any expertise already present in the revenue authorities in applying the existing the GAARs.

Further recommendations include that the East African Federation should provide a GAAR policy document that should accompany the promulgation of the proposed GAAR; it should form a centralized GAAR Panel within the East African Federation's revenue authority; and it should adopt measures similar to the reportable transactions procedures implemented by Canada regarding the identification of potential GAAR arrangements.

It is recommended that once the East African Federation is ready to promulgate its GAAR, it should do so while also making available a policy document which would detail the legislature's intent and policy considerations that went into shaping the GAAR provisions as they appear in the legislation. This would immediately serve to add some level of certainty to the GAAR. This would accordingly have a positive effect on investors as they would be able to make commercial decisions with more information than they otherwise would have had without the policy document at their disposal.

It is also recommended that the East African Federation form a centralized GAAR Panel that would be the only body within the federation authorized to make GAAR-related decisions. The East African Federation should explicitly state that the GAAR will not be applied to any arrangement within the federation unless such action is undertaken by the GAAR Panel. In creating this panel, the East African Federation would be following the example of other jurisdictions such as Canada and the United Kingdom. The GAAR Panel could perhaps consist of a small group of tax practitioners, academics and revenue authority officials. It is further suggested that the taxpayer should not be allowed to argue its case formally before the

GAAR Panel as this would have the effect of transforming the panel into a quasi-court-like forum. Instead, taxpayers would be invited to make submissions on paper why they (or it) is of the view that the GAAR should not apply to their arrangement. It should then be left to the GAAR Panel to deliberate whether it would be in the interest of the revenue authority to pursue the GAAR enquiry. This decision should not be subject to appeal, and instead should continue straight to court should the decision be made to continue the GAAR enquiry.

This, of course, raises questions as to how such potential GAAR enquiries would be identified. It is recommended that this could be done in the same manner it is currently done in Canada. Section 237.3 of the Income Tax Act in Canada requires that ‘reportable transactions’ are to be disclosed to the revenue authority on an annual basis.²⁶⁵ ‘Reportable transactions’ meet the following two requirements:

- The transaction is an avoidance transaction as determined under section 245(3);²⁶⁶ and
- Two of the following three elements are present in respect of that transaction:²⁶⁷
 - o A ‘fee’ is paid to the tax advisor which is based, at least in part, on the tax benefit that would result from the avoidance transaction, or the fee is contingent on the obtaining of the tax benefit under the avoidance transaction;
 - o The tax advisor obtains confidential protection in respect of the avoidance transaction;²⁶⁸ or
 - o The tax advisor obtains contractual protection in respect of the avoidance arrangement.²⁶⁹

The rationale for the meeting of these requirements is that these criteria would likely indicate the potential for an abuse of the Income Tax Act.²⁷⁰

The obligation to report such transactions is placed on every party involved in the reportable transaction so as to ensure that the most accurate information may be obtained about the transaction.²⁷¹ Accordingly, this obligation is imposed upon: the person obtaining the tax benefit under the reportable transaction;

²⁶⁵ Sec. 237.3 Canada ITA (1985).

²⁶⁶ Sec. 237.3(1) Canada ITA (1985).

²⁶⁷ Ibid.

²⁶⁸ Sec. 237.3(1) Canada ITA (1985): Confidential protection entails a prohibition of the disclosure of the details of the transaction to any person.

²⁶⁹ Sec. 237.3(1) Canada ITA (1985): Contractual protection means any form of insurance against the failure of the transaction to obtain the planned tax benefit and any form of undertaking from the tax advisor to assist with any dispute regarding the tax benefit of the transaction.

²⁷⁰ Cooper (n88) 174.

²⁷¹ Sec. 237.2 Canada ITA (1985).

any person who enters into the transaction on behalf of such person obtaining the tax benefit; the tax advisor involved in the reportable transaction and who is entitled to a fee; and any person who is not dealing at arm's length with the tax advisor of the reportable transaction and who is entitled to a fee.²⁷² However, the full and accurate disclosure of the details of the transaction may absolve the other parties from their obligation to also file such information with the revenue authority.²⁷³

A failure to meet the reporting obligations under the Income Tax Act may result in strict penalties.²⁷⁴ Should the reportable transaction not be reported, section 237.3(6) of the Income Tax Act allows the revenue authority to deny the tax benefit altogether. This would allow the revenue authority to completely ignore the misuse and abuse provisions of section 245(4) under the Canadian GAAR.²⁷⁵ Moreover, a penalty equal to the fees received under the reportable transaction is imposed for which all parties to the transaction are jointly and severally liable.²⁷⁶ Any party to the transaction may raise a defense to the imposition of the penalty based on the fact that such person had exercised the degree of care, diligence and skill expected of a reasonably prudent person in comparable circumstances when seeking to prevent the failure to file.²⁷⁷

It is submitted that the implementation of a similar reportable transaction system in the East African Federation would assist greatly in its ability to identify potential GAAR cases, but also to almost immediately reduce tax leakages arising from tax abuse cases. Should the East African Federation place the obligation on the parties to the reportable transaction to report the details of the transaction to the GAAR Panel of the East African Federation's revenue authority, subject to the specter of a denial of tax benefits and the imposition of a substantial penalty in the event of non-disclosure, the capacity concerns within the East African Federation should no longer be of such concern as all the relevant information would be forwarded to the East African Federation's revenue authority on a fairly automatic basis. Moreover, should the East African Federation follow the Canadian example by avoiding the misuse and abuse provision of the GAAR when denying the tax benefit, it would allow some level of certainty and timeliness to permeate the tax administration process as all reportable transactions would be tested against fairly objective criteria that could be determined in a fairly short timeframe. In the light of the above, it is recommended that the East African Federation follow the

²⁷² Ibid.

²⁷³ Sec. 237.3(4) Canada ITA (1985).

²⁷⁴ Cooper (n88) 175.

²⁷⁵ Ibid.

²⁷⁶ Sec. 237.3(8) and (9) Canada ITA (1985).

²⁷⁷ Sec. 237.3(11) Canada ITA (1985).

Canadian example by introducing a reportable transactions system of reporting when implementing its GAAR.

Once the East African Federation's revenue authority is aware of potential GAAR case identified through the reportable transactions system, the East African Federation may do well to consider implementing an advance tax ruling system similar to South Africa. After the reporting stage, the East African Federation may invite the parties to the transaction to apply for an advance tax ruling in which the East African Federation may provide its advice on the interpretation of its GAAR. The provision of such an option may assist in creating certainty in the interpretation and application of the GAAR. Whether the parties choose to use the advance tax ruling system or not, the East African Federation may also wish to consider legislating similar notice procedures in its GAAR similar to that undertaken in South Africa. The East African Federation may therefore legislate that the its revenue authority is to provide taxpayers with written notice of its intent to apply the GAAR along with its reasons for invoking the GAAR. The taxpayer may then be allowed an opportunity to submit reasons for the GAAR not to apply. Following this, the legislation may provide that the East African Federation's revenue authority is to communicate its decision whether to apply the GAAR or not to the taxpayer within a stipulated period. It is submitted that the adopting of these administrative measures would greatly assist in creating certainty in the interpretation and application of the GAAR in the East African Federation.

In order to ensure certainty also across the adjudication of GAAR cases, it is recommended that all GAAR cases be heard and decided upon by the East African Court of Justice only. In this way, it is ensured that all GAAR cases would be considered consistently and thereby allowing GAAR jurisprudence to be developed and applied uniformly across the East African Federation. It is acknowledged that if such route were followed it would deprive the East African Court of Justice of the considered reasoning of the other courts before the case were to be appealed to the East African Court of Justice. However, it is argued that allowing the East African Court of Justice to be an appeal court only for GAAR cases would allow a considerable degree of uncertainty to prevail within the East African Federation while the outcome of the appeal is awaited from the East African Court of Justice. It is submitted that it would be in the federation's interest to avoid as much uncertainty in respect of its GAAR as possible.

5.4.2. LONG TERM RECOMMENDATIONS

Over the long term, it is recommended that the East African Federation's legislature and revenue authority be explicit about the underlying policies and rationale behind the imposition of

tax legislation. It is recommended that future tax legislative provisions should be enacted with explicit detailing of the underlying principles and policies that are applicable to the particular provisions.²⁷⁸ In this way, all parties to a potential GAAR case – the taxpayer, tax advisors, revenue authority, and the courts – would have a clear sense of the rationale for the imposition of the particular tax legislative provision, particularly as the parties grapple with the misuse and abuse element of the proposed GAAR for the East African Federation.

It is argued that should the East African Federation implement the above recommendations, it would be in a position to not only overcome many of the capacity-related concerns some may have regarding the ability of the East African Federation to properly implement a GAAR, but it would also place the East African Federation in a position to limit any uncertainties that may arise in the application and adjudication of GAAR cases in the East African Federation.

6. CONCLUSION

It is important for the East African Federation to take appropriate measures to protect its tax bases, particularly its corporate tax base as it represents one of the largest sources of revenue for African States.²⁷⁹ This chapter argues that the East African Federation needs a GAAR whose effectiveness would be drawn from its design. Furthermore, this chapter proposes the design of a GAAR which focusses both on the existing legal context within the EAC Partner States and international best practices. The GAAR proposed in this chapter is not merely imported wholesale from foreign jurisdictions but is tailored to accommodate the exigencies of the East African context.

The East African context includes a consideration of the GAARs already existing in the EAC Partner States. It has also been noted that the legal culture in the EAC Partner States tends to lean towards a literal approach to statutory interpretation. This chapter argues that the GAARs of the EAC Partner States are problematic in that they rely too heavily on determining the subjective intent as confirmed by objective manifestations of that purpose and also afford the revenue authorities too much discretion as to the application of their GAARs. The concentration of power in the hands of the revenue authority officials and a culture of non-transparency creates a breeding ground for corruption.

In the light of the East African context, and while considering the best practices adopted in the EU, Canada and

²⁷⁸ J Freedman, 'Interpreting Tax Statutes: Tax Avoidance and the Intention of Parliament' (2007) 123 *Law Quarterly Review* 74.

²⁷⁹ AW Oguttu, 'Tax Base Erosion and Profit Shifting in Africa – Part 1: What Should Africa's Response be to the OECD BEPS Action Plan?' (2015) 48 *The Comparative and International Law Journal of Southern Africa* 516, 526.

South Africa, this chapter recommends that the East African Federation move away from a subjective intent in designing its GAAR and build on the existing elements in the GAARs of the EAC Partner States. This chapter also recommends that the East African Federation address its institutional capacity concerns through the establishment of a GAAR Panel and the introduction of a reportable transaction system, similar to that in Canada. It is also recommended that the East African Federation should perhaps consider centralizing the adjudication of GAAR disputes through the East African Court of Justice.

CHAPTER FIVE: TAX TREATIES AND THE EAST AFRICAN FEDERATION

1. INTRODUCTION

As global trade has increased, the problem of double taxation has become increasingly important. Despite the fact that double taxation agreements ('DTAs') are not strictly necessary to relieve the effects of double taxation,¹ the conclusion of DTAs has become the norm in international tax. There are currently over 3000 DTAs currently in force globally.² DTAs are therefore a reality in international tax. A further reality is that the current DTA framework – modelled as it is on the OECD Model Tax Convention on Income and Capital³ ('OECD MC') – is constructed in favour of countries of residence and this at the expense of source countries.⁴

Even though source countries are theoretically in a stronger position than residence countries in that the income subject to tax in both countries actually arose in the source country,⁵ source countries are nonetheless entering into DTAs which typically strip them of their right to tax such income.⁶ Baistrochhi comments that this comes about because of the 'prisoner dilemma' developing countries (and who are also typically source countries) face.⁷ Developing countries are faced with the choice of declining the invitation to enter into a DTA and potentially watching foreign direct investment move to a competing developing country that was willing to conclude the DTA, or entering into the DTA and thereby agreeing to a loss of revenue as a result of the concessions made in the DTA.⁸ Moreover, Avery Jones has noted that once a country enters into

¹ T Dagan, 'The Tax Treaty Myth' (2000) 32 *New York University Journal of International Law and Policy* 939.

² K Brooks and R Krever, 'Chapter 6 – The Troubling Role of Tax Treaties' in M Geerten, M Michielse and V Thuronyi (eds), *Tax Design Issues Worldwide* (Series on International Taxation, Kluwer Law International 2015), vol 51, 159, 160.

³ OECD, *Model Tax Convention on Income and Capital: Condensed Version 2017* (OECD Publishing 2017) [OECD MC].

⁴ Brooks and Krever (n2) 160; A Easson, 'Do We Still Need Tax Treaties?' (2000) 54 *Bulletin for International Taxation* 619, 624.

⁵ CR Irish, 'International Double Taxation Agreements and Income Taxation at Source' (1974) 23 *The International and Comparative Law Quarterly* 292, 313.

⁶ P. Pistone, 'Geographical boundaries of Tax Jurisdiction, Exclusive Allocation of Taxing Powers in Tax Treaties and Good Tax Governance in Relations with Developing Countries' in Y Brauner and M Stewart (eds), *Tax, Law and Development* (Edward Elgar Publishing Limited 2013) 267, 276.

⁷ E Baistrocchi, 'The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications' (2008) 4 *British Tax Review* 352.

⁸ *Ibid* 355.

a DTA a ‘lock-in’ effect occurs as the developing country finds it very difficult to change existing DTAs while also suffering the inhibiting effect that DTAs have on making domestic law changes for fear of breaching its international obligations.⁹

In the light of the above, this chapter considers two questions: Should the East African Federation enter into a DTA at all? And, if yes, what provisions should such a DTA include?

In answering these questions, this chapter sets out the existing framework within which DTAs are currently concluded. The OECD MC and the United Nations Model Double Taxation Convention between Developed and Developing Countries¹⁰ (‘UN MC’) are the model tax conventions most often referred to when countries seek to conclude DTAs. The OECD MC has a strong residence-bias,¹¹ while the UN MC has a more source-based bias.¹² The OECD MC is by far the most preferred model tax convention.¹³ Other alternative model tax conventions, however, do exist although they are not as often used. This chapter also considers the provisions of the Andean Model Tax Convention¹⁴ (‘Andean MC’) and the African Tax Administration Forum Model Tax Convention¹⁵ (‘ATAF MC’).

Following this, chapter analyses the provisions of the DTAs concluded by the EAC Partner States. In doing so, the most recent Kenyan High Court judgment¹⁶ regarding the Kenya-Mauritius DTA is analyzed as it grapples with issues of inter-nation equity and the procedural requirements at play when a country enters into a DTA. This analyses of the DTAs concluded by the EAC Partner States seeks to determine how successful or otherwise the Partner States have been in incorporating the provisions of the UN MC in their concluded DTAs.

After considering the position of the EAC Partner States, this chapter addresses the question whether it would be in the best interest of the East African Federation to follow the example set

⁹ JF Avery Jones, ‘The David Tillinghast Lecture – Are Tax Treaties Necessary?’ (1999) 53 *Tax Law Review* 1, 4.

¹⁰ United Nations, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (United Nations Publications 1980) [UN MC].

¹¹ EA Baistrocchi, ‘The Structure of the Asymmetric Tax Treaty Network: Theory and Implications’ (1991) *Bepress Legal Series Working Paper* 1, 26 fn 112 < <https://law.bepress.com/expresso/eps/1991/> > accessed 23 July 2019.

¹² DR Whittaker, ‘An Examination of the OECD and UN Model Tax Treaties: History, Provisions and Application to US Foreign Policy’ (1982) 8 *North Carolina Journal of International Law and Commercial Regulation* 39, 46.

¹³ Brooks and Krever (n2) 164.

¹⁴ Andean Community, *Income and Capital Model Tax Treaty* (1971) [Andean MC].

¹⁵ African Tax Administration Forum, *Income Model Convention and Commentary* (2016) [ATAF MC].

¹⁶ *The Tax Justice Network – Africa v The Cabinet Secretary for National Treasury, The Kenya Revenue Authority and the Attorney-General* (2019) eKLR, Petition 494 of 2014 (High Court, Kenya).

by the EAC Partner States to conclude DTAs. This discussion is followed by a list of recommendations as to how the East African Federation may form its tax policy as it relates to the entering into of DTAs, before the chapter concludes.

2. THE PARAMETERS OF THE CURRENT DOUBLE TAXATION AGREEMENT FRAMEWORK

There are over 3000 bilateral DTAs currently in force between countries.¹⁷ Most of these adhere to the format and content of the OECD MC.¹⁸ The UN MC has seen much less adoption of its provisions in the existing DTA network as some have commented that its importance has decreased over the years.¹⁹ The Andean and ATAF models are even more seldom incorporated into concluded DTAs. Over time, the OECD MC has emerged as the ‘worldwide standard of accepted tax treaty practice’²⁰ although some have labelled this development as a new form of colonialism or imperialism.²¹

2.1. OECD MODEL CONVENTION

The OECD MC has its origins in the work of the League of Nations conducted between the First and Second World Wars.²² Initially, the OECD MC was intended only to apply to DTAs concluded between two developed countries.²³ According to the preamble of the OECD MC, the aim of the convention is to eliminate double taxation and non-taxation while also preventing tax evasion and avoidance.²⁴ Brooks and Krever, however, note that only a fraction of the OECD MC actually address these aims.²⁵ The elimination of double taxation is facilitated through articles 23A and 23B which provide for the countries of residence to either exempt foreign-sourced income or grant a tax credit for taxes paid in the source country. Double non-taxation is prevented through article 23A (4) which allows the residence country to tax foreign-sourced income that has not been taxed in

¹⁷ Brooks and Krever (n2) 160.

¹⁸ Ibid.

¹⁹ Pistone (n6) 270.

²⁰ Ibid 268.

²¹ Ibid 276; SA Rocha, ‘International Fiscal Imperialism and the “Principle” of the Permanent Establishment’ (2014) 68 *Bulletin for International Taxation* 83.

²² CJ Taylor, ‘Twilight of the Neanderthals, or Are Bilateral Double Taxation Treaty Networks Sustainable?’ (2010) 34 *Melbourne University Law Review* 268, 270. For further discussion on the origins of the OECD model, see S Jogarajan, *Double Taxation and the League of Nations* (Cambridge University Press 2018).

²³ OECD (n3) 10 para 6; V Daurer and R Krever, ‘Choosing Between the UN and OECD Tax Policy Models: An African Case Study’ (2014) 22 *African Journal of International and Comparative Law* 1, 6.

²⁴ Ibid 27.

²⁵ Brooks and Krever (n2) 165.

the source country. The objective of curbing tax evasion is met through the exchange of tax information between the contracting countries' revenue authorities as detailed in article 26. Finally, the prevention of tax avoidance is facilitated through article 29 which provides for a general anti-avoidance rule in article 29(9) along with specific anti-avoidance rules in sub-paragraphs (1) to (8) of the OECD MC. Most of the provisions of the OECD MC, however, concerns the allocation of taxing rights between the contracting countries – a result that does not directly further any of the identified aims of the OECD MC.²⁶

The OECD MC allocates taxing rights to the contracting countries according to the different types of income identified in the model convention. The residence country is allocated the exclusive right to tax a key income stream – business profits that are generated within the source country – unless such profits are generated by a permanent establishment in the source country as per article 7. In such event, only the income attributable to that permanent establishment may be taxed in the source country.²⁷ Moreover, while the source country is allocated the right to tax the passive income streams arising from dividends and interest, such rights are capped under articles 10 and 11 respectively. Also, the residence country is exclusively allocated the right to tax royalties arising from the use of intellectual property under article 12. Finally, article 21 allows the residence country the right to tax all other income not specifically identified in the model convention.

It has been noted with concern that the OECD MC has a clearly apparent residence-bias in that the OECD MC allocates the country of residence taxing rights in respect of the most important streams of income at the expense of developing countries.²⁸ Developing countries are more likely to be the country of source. The initial rationale for the residence-bias of the OECD MC was made apparent in the League of Nations discussions around the drafting of the Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion published by the League in 1927,²⁹ which formed part of the precursor discussions around the formation of the draft

²⁶ Ibid 166.

²⁷ Art 7(2) OECD MC.

²⁸ Brooks and Krever (n2); K Brooks, 'Tax Treaty Treatment of Royalty Payments from Low-Income Countries: A Comparison of Canada and Australia's Policies' (2007) 5 *eJournal of Tax Research* 168; T Dagan, *International Tax Policy: Between Competition and Cooperation* (Cambridge University Press 2017) 168; Easson (n4) 624; L Sheppard, 'How Can Vulnerable Countries Cope with Tax Avoidance?' (2013) *Tax Notes International* 410; E van der Bruggen, 'A Preliminary Look at the New UN Model Tax Convention' (2002) 2 *British Tax Review* 119.

²⁹ League of Nations, *Double Taxation and Tax Evasion: Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion* (Publications of the League of Nations 1927) <https://biblio-archiv.unog.ch/Dateien/CouncilMSD/C-216-M-85-1927-II_EN.pdf> accessed 23 July 2019.

model conventions produced in 1928 – one of which became the basis of the OECD MC.³⁰ In these discussions, it became apparent that many of the developed countries were of the view that the state of being a capital-importing country only was a temporary condition and that the ‘normal’ position of being both a capital-importing and capital-exporting country should be the standard against which the draft model convention should be considered.³¹ Brooks notes that this thinking is rooted in the orthodox economic theory.³² Such theory is the idea that capital will eventually move to developing countries where the return on investment is high because of the shortage of capital and that this will be triggered by a capital flight from developed countries because of the abundance of capital and consequent low rate of returns.³³ Brooks, however, argues that this theory has been proven to be incorrect in the wake of the African economic crisis and the sluggish growth in Latin America and some parts of Asia.³⁴ Moreover, notwithstanding its falsity, the incorporation of such thinking in the application of the OECD MC would necessarily limit the accommodations which could be made for the issues concerning developing countries as these concerns would be relegated to the realm of ‘temporary’ issues that should resolve themselves.

The OECD MC has been the subject of much criticism. Commentators have described the OECD MC as irrelevant,³⁵ inflexible,³⁶ and inefficient.³⁷ Particularly, concerns have been raised around the ability of the OECD MC to address issues arising from the digitization of the global economy.³⁸ For instance, Goel and Goel argue that the permanent establishment concept as it is currently understood is irrelevant and should be developed to allow for virtual businesses to constitute a permanent establishment.³⁹ They further argue that this could be done by amending the definition of ‘permanent establishment’ to include ‘digital establishments’ or by including a provision after article 5(8) which would deem business activities conducted by electronic means to be a permanent

³⁰ Jogarajan (n22) 182 and 243.

³¹ Ibid 112.

³² Brooks (n28) 169.

³³ Ibid.

³⁴ Ibid.

³⁵ R Vann, ‘A Model Tax Treaty for the Asian-Pacific Region?’ (1991) 45 *Bulletin for International Fiscal Documentation* 99.

³⁶ Ibid.

³⁷ L Sheppard, ‘Twilight of the International Consensus: How Multinationals Squandered their Tax Privileges’ (2014) 44 *Washington University Journal of Law and Policy* 61, 75.

³⁸ OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* OECD /G20 Base Erosion and Profit Shifting Project (OECD Publishing, 2015) 16.

³⁹ A Goel and S Goel, ‘Has the Permanent Establishment Rule Outlived Its Utility in a Digitized World?’ (2018) 11 *National University of Juridical Sciences Law Review* 25.

establishment.⁴⁰ The work in this area is ongoing as the OECD is continues to consider how the international tax framework could be developed to meet the challenges of the digital economy as part of its Base Erosion and Profit Shifting Project.⁴¹

In the light of the flaws of the OECD MC, its inability to properly cater for the concerns of developing countries and its struggle to stay relevant in a digitized economy, it is incumbent on developing countries to create their own fora to address the issues which concern them in the international tax arena. It also critical that developing countries critically evaluate the ‘globally accepted standard’ of international tax treaty practice to determine whether it would be in their best interest to conclude a DTA which closely adheres to the OECD MC. In undertaking such a critical evaluation, the UN MC should continue to have relevance to developing countries and the evidence suggests that it still does in practice.⁴²

2.2. UN MODEL CONVENTION

The UN MC was published in 1980 and provides an alternative model convention which developing and developed countries may use during their negotiations of a DTA.⁴³ Its aim is to provide an equitable allocation of taxing rights between developed and developing countries.⁴⁴ However, commentators have bemoaned the fact that the UN MC has failed in this objective and that it is too closely aligned to the OECD MC.⁴⁵ The UN MC has been updated three times, most recently in 2017.

The structure of the UN MC follows closely that of the OECD MC and both conventions are based on the concept of residence.⁴⁶ Moreover, the UN MC incorporates the OECD MC’s concept of a permanent establishment and the consequent restriction of the source country’s right to tax the business income generated within its borders unless those profits are attributable to a permanent establishment.⁴⁷ Notwithstanding

⁴⁰ Ibid.

⁴¹ OECD, *Addressing the Tax Challenges of the Digitisation of the Economy – Public Consultation Document* (OECD Publishing 2019) 7.

⁴² Peru, for instance, is a developing country which strongly relies on the UN MC when negotiating its DTAs – see K Luyo Acosta, ‘The Role of the UN Model in Peru’s Tax Treaties’ (2015) 69 *Bulletin for International Taxation* 149.

⁴³ UN MC (n10).

⁴⁴ UN MC (n 10) iii.

⁴⁵ Rocha (n21) 83; Baistrocchi (n11); Brooks and Krever (n2) 165.

⁴⁶ A Becker, ‘The Principle of Territoriality and Corporate Income Taxation – Part 2’ (2016) 70 *Bulletin for International Taxation* 246, 250.

⁴⁷ Art 5(3)(b) UN MC; Rocha (n21) 84.

this adherence to the OECD MC, the UN MC does allocate more taxing rights to the source country than the OECD MC.⁴⁸

This is done in the following respects:

- i) The UN MC created the concept of the ‘service permanent establishment’ which allows a permanent establishment to be established in the source country on the basis of the rendering of services and the presence of employees.⁴⁹ This concept has been labelled a ‘delicate’ issue as the OECD MC does not recognize this concept and developing countries may accordingly face some resistance in having it included in the DTAs they conclude.⁵⁰
- ii) The UN MC has also broadened the definition of a ‘permanent establishment’ by allowing for construction sites and supervisory activities related thereto to constitute a permanent establishment if the site or activities is in place for more than six months.⁵¹ Moreover, the UN MC has removed some of the activities from the list of exclusions from the permanent establishment definition. The activities excluded are the use of facilities solely for the purpose of delivery of goods belonging to the enterprise and the maintenance of a stock of goods belonging to the enterprise solely for the purpose of delivery.⁵²
- iii) The UN MC definition of ‘royalties’ is broader than its counterpart in the OECD MC. Article 12 of the UN MC includes the use of or right to use industrial, commercial or scientific equipment.
- iv) Also related to royalties, article 12 of the UN MC allows for the source country to impose a withholding tax on royalty payments, although the model convention does not suggest a rate at which such withholding tax should be set.
- v) The UN MC introduced a withholding tax on fees for technical services under article 12A.⁵³ In terms of article 12(3), ‘fees for technical services’ means payment made by resident taxpayers for the rendering of managerial, technical or consultancy services by non-residents unless such payments are made to the payer’s employee, the

⁴⁸ S Surrey, *United Nations Model Convention for Tax Treaties between Developed and Developing Countries: A Description and Analysis* (IBFD 1980); Brooks (n28) 174.

⁴⁹ Rocha (n21) 84.

⁵⁰ J Braun and D Feuntes, ‘The Effects of Double Taxation Treaties for Developing Countries: A Case Study for Austria’s Double Taxation Treaty Network’ (2016) 4 *Public Finance and Management* 383, 391.

⁵¹ Art 3(a) UN MC.

⁵² Art 5(4)(a) and (b) UN MC.

⁵³ This was introduced with the most recent changes made to the UN Model in 2017.

payment relates to educational teaching, or the payment is made by an individual for that person's use of personal services. Article 12A is wide-reaching in that it does not actually require that the services be rendered in the source country by the non-resident service provider in order for the source country to impose the withholding tax.⁵⁴ Again, while the UN MC allows for the source country to levy a withholding tax on fees paid for technical services, the convention fails to suggest a rate at which such withholding tax should be set. The Commentary does, however, suggest that this withholding tax rate correspond to the withholding tax rate on royalties as some contracts may provide for both the provision of services and the right to use property.⁵⁵ Moreover, in order to protect the integrity of the source country's withholding tax under article 12A, articles 23A and 23B oblige the residence country to provide a deduction or a tax credit for this withholding tax paid in the source country.

- vi) Finally, the UN MC makes provision at article 21 for the source country to also lay a claim to the taxation of income not specified in the UN MC.

The introduction of article 12A has generated some comment and speculation. Arnold notes that the new article 12A has introduced a significant change in the allocation of taxing rights between developed and developing countries as it affects technical service fees.⁵⁶ Moreover, the new article 12A on fees for technical services has been earmarked as being particularly significant in the desire to tax the income arising from the digital economy.⁵⁷ Michel notes that this article may be effective in bringing within its scope the business activities that are essential to the world's big digital companies.⁵⁸ As an example, he argues that the designing of a digital marketing campaign and the client discussions that would form part of that process could conceivably fall within the scope of article 12A as consultancy services rendered.⁵⁹ However, the argument may also be made that these payments could conceivably qualify as the payment of royalties.⁶⁰ This overlap could not have escaped the attention of the United Nations Committee of Experts, and thus it would seem that article 12A may be a tool afforded developing

⁵⁴ BJ Arnold, 'The UN Committee of Experts and the UN Model: Recent Developments' (2017) 71 Bulletin for International Taxation 131, 132.

⁵⁵ Commentary on article 12A UN MC, para 5.

⁵⁶ Arnold (n54) 132.

⁵⁷ B Michel, 'Release of the UN Model (2017) Update' (2018) 46 Intertax 686.

⁵⁸ Ibid 688.

⁵⁹ Ibid.

⁶⁰ Ibid.

countries to avoid the rhetoric of why royalties should be taxed at residence.

Moreover, there is evidence that article 12A is beginning to find traction as a viable source of revenue for the source country as Brazil has successfully concluded treaties with Switzerland and Singapore in which article 12A of the UN MC has been incorporated.⁶¹ This development ties in with the calls made for greater source taxation in international tax and is a heartening move in the direction of greater taxing rights for developing countries.⁶² Although one would hope that this movement towards greater source taxation stems from developed countries' concern that treaty provisions contribute to revenues lost in developing countries, Zolt cautions that this is probably not the reason for the movement.⁶³ He reasons that the drive for greater source taxation more likely relates to correcting the discrepancy between the profits earned in the source country and the taxes collected there – an aim which happens to be in the interest of both the developed and developing world.⁶⁴

2.3. OTHER ALTERNATIVE MODEL TREATIES

The movement towards allocating more taxing rights to source countries has placed some attention on other model tax conventions which may work as alternatives to the OECD MC and the UN MC. Of interest is the Andean MC and the ATAF MC. These conventions are of interest because they represent efforts from two significant regional groupings – one in South America and the other in Africa – towards the development of a tax treaty standard that is more suited to a developing country context.

⁶¹ See Art. 13 of the Convention between the Swiss Confederation and the Federative Republic of Brazil for the elimination of double taxation with respect to taxes on income and the prevention of tax evasion and avoidance, signed on 3 May 2018 (not yet effective); and Art. 13 of the Agreement between the Republic of Singapore and the Federative Republic of Brazil for the elimination of double taxation with respect to taxes on income and the prevention of tax evasion and avoidance, signed on 7 May 2018 (not yet effective); Michel (n57) 688.

⁶² For more on the calls for greater source taxation, see RS Avi-Yonah, 'Globalisation, Tax Competition and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard Law Review* 1573; R.S. Avi-Yonah, 'Chapter 3: A Perspective of Supra-Nationality in Tax Law' in Y Brauner and P Pistone (eds), *BRICS and the Emergence of International Tax Co-ordination* (IBFD 2015); Becker (n46); L Sheppard, 'Revenge of the Source Countries, Part 4: Who Gets the Bill?' (2005) *Tax Notes International* 411.

⁶³ EM Zolt, 'Tax Treaties and Developing Countries' (2018) Oxford University Centre for Business Taxation Working Paper Series WP 18/05, 41.

⁶⁴ *Ibid.*

2.3.1. ANDEAN MC

The Andean MC came about in 1971 after five South American countries (Bolivia, Chile, Colombia, Peru, and Venezuela) established a common market through the Cartagena Agreement of 1969.⁶⁵ The convention has a source-bias as it is aimed at protecting the interests of the five South American countries when negotiating DTAs with developed countries.⁶⁶

The Andean MC does not follow the OECD MC structure and language. It allocates greater tax rights to the source country in the following respects:

- i) All residual income streams not specifically mentioned in the convention are to be taxed exclusively by the source country according to where the source of production of such income is located.⁶⁷
- ii) The earnings arising from the exploitation of natural resources, or the income arising from the leasing, subleasing or transfer of the right to exploit or use natural resources shall only be taxable in the country where the exploitation is being carried out.
- iii) Business earnings are to be taxed in the county where such earnings are obtained. Although the Andean MC does not mention the ‘permanent establishment’ concept, it does mention certain indicators which would result in an enterprise conducting activities within the source country and thus creating business earnings in that country. The list of indicators looks similar to the list of activities which would qualify as a permanent establishment under article 5 of the OECD MC. The indicators include: an office or business management site, a construction site, an agent or representative, a warehouse or storehouse and a factory, plant or industrial or assembly workshop.⁶⁸
- iv) Royalties from the use of intellectual property is to be taxed only in the country in which such intellectual property is used.⁶⁹
- v) Interest is only taxed in the country in which the loan funds are used.⁷⁰
- vi) Dividends and equity distributions are taxed in the company’s country of residence.

⁶⁵ Andean MC (n14); Baistrocchi (n11) 23.

⁶⁶ Baistrocchi (n11) 23.

⁶⁷ Art 4 Andean MC.

⁶⁸ Art 7 Andean MC.

⁶⁹ Art 9 Andean MC.

⁷⁰ Art 10 Andean MC.

- vii) Income arising from the provision of professional services and technical assistance are taxable in the country in which the services are rendered.⁷¹

Baistrochhi notes that despite the Andean MC being in operation since 1971, it has not been used as a basis for a DTA concluded between a developing and a developed country.⁷² Baistrocchi further contends that the Andean MC is irrelevant from an international tax perspective because it is so seldom used.⁷³ However, the Andean MC may yet gain some importance in the current climate of increasing the taxing rights of source countries, and should perhaps be referred to as an ideal outcome for developing countries.

2.3.2. ATAF MC

The African Tax Administration Forum approved a model tax convention in 2016. The ATAF MC follows the structure of the 2011 version of the UN MC.⁷⁴ The ATAF MC does make provision for the greater allocation of taxing rights to the source country than in the UN MC.

These are in respect of the following provisions:

- i) A structure used for the exploitation of natural resources may constitute a permanent establishment if the structure has been in place for a set time as negotiated by the contracting countries.⁷⁵
- ii) Article 14(5) allows for the country of the company's residence to tax the income arising from the sale of ordinary shares if the alienator had a certain stake in the company, the exact quantity of which is to be determined by the contracting countries.⁷⁶

The rest of the ATAF MC largely follows that of the UN MC. The ATAF MC is currently being modified and the new version should be released in the near future. It is too early to gauge the impact of the current ATAF MC on the DTAs concluded between developing and developed countries.

In the light of the above model tax convention framework, it would be of interest to evaluate which model the EAC Partner States have implemented in their own DTA networks. The following section will consider this.

⁷¹ Art 14 Andean MC.

⁷² Baistrochhi (n11) 24.

⁷³ Ibid.

⁷⁴ J Hattingh, 'The Impact of the BEPS Multilateral Instrument on International Tax Policies' (2018) 72 *Bulletin for International Taxation* 234, 241.

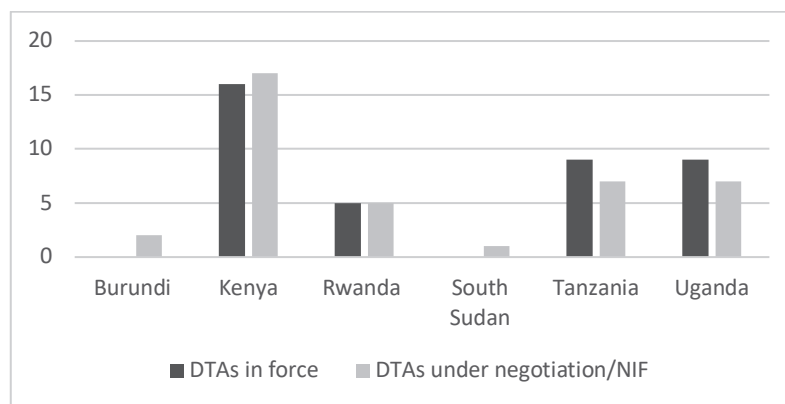
⁷⁵ Art 5(3)(d) ATAF MC.

⁷⁶ Art 14(5) ATAF MC.

3. CURRENT DOUBLE TAXATION AGREEMENTS ENTERED INTO BY THE EAST AFRICAN COMMUNITY PARTNER STATES

The EAC Partner States have 39 double taxation treaties (DTAs) in force amongst them.⁷⁷ Kenya has the most DTAs in force with 16,⁷⁸ Tanzania and Uganda each have 9,⁷⁹ and Rwanda currently has 5 in force.⁸⁰ While Burundi and South Sudan currently do not have any DTAs in force, both have DTAs which have been signed but not yet ratified.⁸¹ Moreover, all of the Partner States also have a number of DTAs that are either under negotiation⁸² or have been signed, but not yet ratified.⁸³ The number of DTAs currently in force in the EAC along with the number of DTAs either under negotiation or soon to be ratified, is represented in the graph below.

*Graph 1 – The number of DTAs currently in force in the EAC, and the number either under negotiation or signed but not yet ratified. **



* Source: IBFD Database of double taxation agreements.

⁷⁷ This is according to the IBFD database of double taxation agreements as at 31 March 2019.

⁷⁸ Kenya has DTAs with the following countries: Canada (1983); Denmark (1972); France (2007); Germany (1977); India (2016); Iran (2012); The Republic of Korea (2014); Norway (1972); Qatar (2014); Seychelles (2014); South Africa (2010); Sweden (1973); Switzerland (1963); United Arab Emirates (2011); United Kingdom (1973); and Zambia (1968).

⁷⁹ Tanzania has DTAs with Canada (1995); Denmark (1976); Finland (1976); India (2011); Italy (1973); Norway (1976); South Africa (2005); Sweden (1976); and Zambia (1968). Uganda has DTAs with Denmark (2000); India (2004); Italy (2000); Mauritius (2003); the Netherlands (2004); Norway (1999); the United Kingdom (1992); and Zambia (1968).

⁸⁰ Rwanda has DTAs with the following countries: Belgium (2007); Jersey (2015); Mauritius (2013); Singapore (2014); and South Africa (2002).

⁸¹ Burundi has a DTA with Turkey and another with the United Arab Emirates which has been signed but not yet ratified. Similarly, South Sudan has a DTA with Morocco which has been signed but not yet ratified.

⁸² DTAs that are currently under negotiation: Kenya has 7; Tanzania has 7; Uganda has 4 and Rwanda has 1.

⁸³ DTAs that have been signed but not yet ratified: Kenya has 10; Rwanda has 4; Uganda has 3; Burundi has 2 and South Sudan has 1.

Furthermore, the table below indicates with whom the EAC Partner States have concluded DTAs and with which countries they have done so in common.

*Table 1 – The number of DTAs in force in the EAC and their treaty partners**

	Burundi	Kenya	Rwanda	South Sudan	Tanzania	Uganda
Treaties in Force						
Belgium			✓			
Canada		✓			✓	
Denmark		✓			✓	✓
Finland					✓	
France		✓				
Germany		✓				
India		✓			✓	✓
Iran		✓				
Italy					✓	✓
Jersey			✓			
Korea		✓				
Mauritius		NIF - CRT void	✓		U/N	✓
Netherlands						✓
Norway		✓			✓	✓
Qatar		✓				
Seychelles		✓				
Singapore			✓			
South Africa		✓	✓		✓	✓
Sweden		✓			✓	
Switzerland		✓				
UAE		✓				
UK		✓				✓
Zambia		✓			✓	✓

*Source: IBFD Database of double taxation agreements.

The table above indicates that South Africa has concluded DTAs with the greatest number of Partner States (4), while Norway; Denmark and India each have a DTA with 3 of the EAC Partner States. While others have commented on the DTAs concluded by African countries either as a sample of several East African

countries⁸⁴ or individually,⁸⁵ this chapter will analyze the common features of the DTAs the EAC Partner States have concluded with a common treaty partner. Accordingly, this chapter will consider the DTAs Kenya, Rwanda, Tanzania and Uganda have concluded with South Africa (as an example of a developing country treaty partner); and the DTAs Kenya, Tanzania and Uganda have concluded with Denmark (as an example of a developed country treaty partner).

Also, of particular interest, are the DTAs Kenya, Rwanda and Uganda (the text of the DTA under negotiation with Tanzania is not yet publicly accessible) have concluded with Mauritius. This is of interest because of the Kenya High Court decision in March 2019 to void the DTA between Kenya and Mauritius.⁸⁶ The reasons for this decision along with an analysis of the DTAs concluded by Rwanda and Uganda with Mauritius will be analyzed further below.

In conducting this analysis, the most contentious provisions of the DTA are considered. These are: the details of article 5 addressing permanent establishments – the length of time to establish a construction permanent establishment, and whether a service permanent establishment may be created; the withholding tax rates for dividends (article 10); interest (article 11); royalties (article 12); management or technical fees (article 12A); capital gains (article 13); and the taxation of other income (article 21).

3.1. COMMON FEATURES OF THE DTAs WITH A COMMON TREATY PARTNER

3.1.1. SOUTH AFRICA

South Africa concluded a DTA with Kenya in 2010, Rwanda in 2002, Tanzania in 2005 and Uganda in 1997. All of the DTAs largely follow the UN Model. Table 2 indicates the positions taken by the EAC Partner States with respect to the particular treaty provisions identified.

⁸⁴ Daurer and Krever (n23); M Hearson, 'Tax Treaties in Sub-Saharan Africa: A Critical Review' Working Paper, LSE Research Online < <http://eprints.lse.ac.uk/67903/>> accessed 23 July 2019.

⁸⁵ M Hearson and J Kangave, 'A Review of Uganda's Tax Treaties And Recommendations For Action' (2016) Working Paper 50, International Centre for Tax and Development < <http://eprints.lse.ac.uk/67868/>> accessed 1 April 2019.

⁸⁶ *Tax Justice Network – Africa* (n16).

Table 2 – EAC Partner States and South Africa as treaty partners⁸⁷

South Africa DTA	Kenya – 2010	Rwanda – 2002	Uganda – 1997	Tanzania – 2005
Construction PE	6 months	6 months	6 months	6 months
Supervisory activities included	Yes	Yes	Yes	Yes
Services PE	6 months	6 months	No*	6 months
Dividend WHT	10%	10% or 20%	10% or 15%	10% or 20%
Interest WHT	10%	10%	10%	10%
Royalties WHT	10%	10%	10%	10%
Management Fees/Technical service fees WHT	No	No	10%	No
Capital gains: property-rich entity provision	Yes	Yes	No*	Yes
Capital Gains: sale of ordinary shares	No	No	No	No
Source taxation of other income	Yes	Yes	Yes	Yes

*The asterisk indicates where Uganda is in a worse position than the other EAC Partner States.

Although Uganda was the only EAC Partner State to have successfully negotiated the inclusion of the withholding tax on technical service fees, overall Uganda seems to be in a worse position than the other EAC Partner States in contracting with South Africa. It is the only EAC Partner State to not make provision for a service permanent establishment in its DTA with South Africa, and also its DTA has no provision addressing the capital gain arising from the sale of an interest in a property-rich company, trust or partnership. Tanzania and Rwanda seem to have fared the best as they were able to introduce a 20% dividend withholding tax rate in the event of direct investments. Generally, the EAC Partner States have done well to negotiate the 6-month construction permanent establishment provision; the inclusion of the service permanent establishment threshold; the capital gain provision regarding the sale of an interest in a property-rich entity; and the source taxation of other income. Also, the negotiated withholding tax rates are reasonable.

⁸⁷ The layout of this table follows that used by Hearson (n84) 27.

3.1.2. DENMARK

Denmark has concluded DTAs with Kenya in 1972, Tanzania in 1976 and Uganda in 2000. Despite the 24 to 28-year disparity in signature dates, the DTAs with Denmark are remarkably similar, as represented in the table below (Table 3). The DTAs between Denmark and the EAC Partner States largely follow the UN Model treaty.

Table 3 – EAC Partner States and Denmark as treaty partners

Denmark DTA	Kenya – 1972	Tanzania – 1976	Uganda – 2000
Construction PE	6 months	6 months	6 months
Supervisory activities included	Yes	No*	Yes
Services PE	No	No	No
Dividend WHT	20% or 30%	15%	10% or 15%
Interest WHT	20%	12,50%	10%*
Royalties WHT	20%	20%	10%*
Management Fees/Technical service fees WHT	20%	20%	10%*
Capital gains: property-rich entity provision	No	No	No
Capital Gains: sale of ordinary shares	No	No	No
Source taxation of other income	No	No	Yes

* The asterisk represents where the EAC Partner State is in a worse position than the other EAC Partner States.

The EAC Partner States have not fared as well in their negotiations with the OECD-member country, Denmark. None of the EAC Partner States were able to negotiate the inclusion of the services-permanent establishment provision. Also, the EAC Partner States were unsuccessful in including the capital gains provisions regarding the sale of interests in property-rich entities or the sale of shares generally. However, Kenya and Tanzania were successful in negotiating higher than normal withholding tax rates on dividends, interest and royalties. All three EAC Partner States were also successful in negotiating a withholding tax on technical service fees or management fees. Kenya's DTA with Denmark has the most favourable terms for an EAC Partner State, while Tanzania and Uganda's DTAs have produced mixed results. Tanzania's DTA with Denmark does not include supervisory activities which may create a permanent

establishment, but it does include higher than normal withholding tax rates across the board. Uganda's DTA with Denmark, on the other hand, includes withholding tax rates at the normal 10% rate, but it does allow for supervisory activities to include a permanent establishment and for other income to be taxed at source.

3.1.3. THE EAC PARTNER STATES AND MAURITIUS

Mauritius is often labelled a tax haven.⁸⁸ In 1998, the OECD defined tax havens in terms of the following characteristics: 1) the jurisdiction has no or nominal taxes; 2) it facilitates, or is perceived to facilitate, tax evasion; 3) the jurisdiction exhibits a lack of transparency with regard to financial transactions and a general secrecy in respect of taxpayer information; and 4) it allows for a minimal, non-substantive business presence.⁸⁹ The fact that the EAC Partner States have DTAs with Mauritius is of interest because of the warnings that countries should not enter into DTAs with tax havens.⁹⁰ However, Brooks and Krever argue that developing countries should conclude DTAs with tax havens because most investment flows are routed through tax havens.⁹¹ It would therefore make sense for developing countries to have DTAs with tax havens because it would be tax havens that would effectively be the investment partners of developing countries.⁹²

Mauritius signed a DTA with Kenya in 2012, Rwanda in 2013 (the earlier DTA signed in 2001 was terminated in 2012 and replaced with the 2013 DTA), and Uganda in 2003. The table below (Table 4) indicates how the EAC Partner States have fared in negotiating their DTAs with Mauritius. In this regard, it is important to note that Kenya's High Court in Nairobi in March 2019 declared the Kenya-Mauritius DTA void. This judgment will be discussed below.

⁸⁸ 'Mauritius Named Amongst "World's Worst" Corporate Tax Havens' *BusinessTech* (12 December 2016) <<https://businesstech.co.za/news/banking/147279/mauritius-named-among-worlds-worst-corporate-tax-havens/>> accessed 2 April 2019; Investopedia, 'Tax Havens' <<http://www.investopedia.com/terms/t/taxhaven.asp>> accessed 2 April 2019.

⁸⁹ OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris 1998), 22 <<http://www.oecd.org/tax/transparency/about-the-global-forum/publications/harmful-tax-competition-emerging-global-issue.pdf>> accessed 2 April 2019.

⁹⁰ Sheppard (n28) 411.

⁹¹ Brooks and Krever (n2) 173.

⁹² *Ibid.*

Table 4 – EAC Partner States and Mauritius as treaty partners

Mauritius DTA	Kenya - 2012 (void)	Rwanda - 2001	Rwanda 2013	Uganda - 2003
Construction PE	12 months	12 months	6 months	6 months
Supervisory activities included	Yes	Yes	Yes	Yes
Services PE	6 months	12 months	6 months	4 months
Dividend WHT	5% or 10%	Exempt	10%	10%
Interest WHT	10%	Exempt	10%	10%
Royalties WHT	10%	Exempt	10%	10%
Management Fees/Technical service fees WHT	No	Exempt	12%	10%
Capital gains: property-rich entity provision	No	No	No	No
Capital Gains: sale of ordinary shares	No	No	No	No
Source taxation of other income	No	No	Yes	No

In 2012, Rwanda strategically terminated its DTA with Mauritius.⁹³ A year later, the two parties signed a new DTA on terms much more favourable for Rwanda. Rwanda managed to renegotiate from its 2001 DTA position of not imposing withholding taxes to a 10% withholding tax on dividends, interest and royalties and also a 12% withholding tax on technical service fees. Rwanda also successfully negotiated that other income is to be taxed at source.

The Kenya-Mauritius DTA of 2012 is not favourable to Kenya with a 12-month construction permanent establishment provision; no withholding tax on technical service fees; no capital gain provisions addressing the sale of interests in a property-rich entity or on the sale of shares generally; and no provision made for the taxation at source of other income. It is in these circumstances that the Tax Justice Network – Africa (TJN-A) took the National Treasury, the Kenya Revenue

⁹³ Hearson (n84) 26.

Authority and the Attorney General to court to challenge the validity of the Kenya-Mauritius DTA.⁹⁴

In *Tax Justice Africa Network – Africa v Cabinet Secretary for National Treasury and others (Tax Justice-Africa)*,⁹⁵ the TJN-A argued that the Kenya-Mauritius DTA violated Article 10, 20 and 201 of the Kenyan Constitution.⁹⁶ Article 10, as is applicable here, provides that the State is bound by the national values and principles of governance when enacting, interpreting or applying any law, or making or implementing any policy decision.⁹⁷ The applicable national values and principles of governance are: good governance; integrity; transparency; accountability; and sustainable development. The TJN-A argued that the relevant Kenyan authorities failed to adhere to the national values and principles of good governance when they failed to have the DTA ratified in terms of the Treaty Making and Ratification Act.⁹⁸ Moreover, article 20 of the Kenyan Constitution provides for the application of the Bill of Rights in so far as every person enjoys the rights and freedoms under the Bill of Rights while the State and all laws are subject to it.⁹⁹ Also, article 201 of the Kenyan

⁹⁴ *Tax Justice Network – Africa* (n16).

⁹⁵ *Ibid.*

⁹⁶ The Constitution of Kenya (27 August 2010) <http://www.icla.up.ac.za/images/constitutions/kenya_constitution.pdf> accessed 3 April 2019.

⁹⁷ Full text of article 10 of the Constitution of Kenya is as follows:

'10. (1) The national values and principles of governance in this Article bind all State organs, State officers, public officers and all persons whenever any of them—

(a) applies or interprets this Constitution;

(b) enacts, applies or interprets any law; or

(c) makes or implements public policy decisions.

(2) The national values and principles of governance include—

(a) patriotism, national unity, sharing and devolution of power, the rule of law, democracy and participation of the people;

(b) human dignity, equity, social justice, inclusiveness, equality, human rights, non-discrimination and protection of the marginalised;

(c) good governance, integrity, transparency and accountability; and

(d) sustainable development.'

⁹⁸ Treaty Making and Ratification Act 2012 (Kenya).

⁹⁹ Full text of article 20 of the Constitution of Kenya is as follows:

'20. (1) The Bill of Rights applies to all law and binds all State organs and all persons.

(2) Every person shall enjoy the rights and fundamental freedoms in the Bill of Rights to the greatest extent consistent with the nature of the right or fundamental freedom.

(3) In applying a provision of the Bill of Rights, a court shall—

(a) develop the law to the extent that it does not give effect to a right or fundamental freedom; and

(b) adopt the interpretation that most favours the enforcement of a right or fundamental freedom.

(4) In interpreting the Bill of Rights, a court, tribunal or other authority shall promote—

(a) the values that underlie an open and democratic society based on human dignity, equality, equity and freedom; and

(b) the spirit, purport and objects of the Bill of Rights.

Constitution sets out the principles guiding public finance – specifically, article 201(b) provides that the public finance system shall ensure that the burden of taxation is shared equally. The TJN-A argued that articles 20 and 201 of the Kenyan Constitution were violated in so far as the DTA withholding rates were lower than the rates paid by Kenyan tax residents on interest, royalties and other income in terms of domestic legislation. Moreover, the DTA does not make provision for Kenya to tax the capital gains realised by non-residents thereby reducing Kenya’s ability to raise tax revenue. Accordingly, residents were required to bear an unfair portion of the tax burden. Finally, the TJN-A argued that procedurally, the DTA failed to adhere to the ratification process set out in the Treaty Making and Ratification Act and the Statutory Instruments Act.¹⁰⁰

The Kenyan authorities in turn argued that there was no violation of articles 10 and 20 of the Kenyan Constitution given that the negotiated withholding tax rates were a ‘good deal’ in DTA terms. Moreover, it was inappropriate to compare the tax position of residents and non-residents since the withholding tax imposed on residents is not a final tax, unlike the withholding tax on non-residents. As a result, non-residents may ultimately pay more tax than a resident. On the procedural point, the Kenyan authorities argued that the DTA was a ‘bilateral agreement’ in terms of section 3(4) of the Treaty Making and Ratification Act and not a ‘treaty’ under section 3(2) of that Act.

The High Court disagreed with all of the TJN-A’s constitutional law arguments, but partly agreed with the procedural argument. The High Court ruled that the publication of the DTA by way of legal notice had not met the requirement of being tabled before Parliament,¹⁰¹ and as such the legal notice was void.

Despite the media heralding this judgment a success and a win for the taxpayer,¹⁰² from a jurisprudential and tax justice

(5) In applying any right under Article 43, if the State claims that it does not have the resources to implement the right, a court, tribunal or other authority shall be guided by the following principles—

(a) it is the responsibility of the State to show that the resources are not available;

(b) in allocating resources, the State shall give priority to ensuring the widest possible enjoyment of the right or fundamental freedom having regard to prevailing circumstances, including the vulnerability of particular groups or individuals; and

(c) the court, tribunal or other authority may not interfere with a decision by a State organ concerning the allocation of available resources, solely on the basis that it would have reached a different conclusion.

¹⁰⁰ Statutory Instruments Act 2013 (Kenya).

¹⁰¹ In terms of sections 10 and 11 of the Statutory Instruments Act (Kenya).

¹⁰² V Amadala, ‘Kenya-Mauritius Double Tax Avoidance Void, High Court Rules’ *The Star* (19 March 2019) <<https://www.the-star.co.ke/business/kenya/2019-03-19-kenya-mauritius-double-tax-avoidance-void-high-court-rules/>> accessed 23 July 2019.

perspective this judgment is disappointing. The TJN-A won the case on a technicality, one which could be remedied by following the procedure of tabling the legal notice before Parliament. In fact, Kenya and Mauritius have since the judgment signed a new DTA, properly in adherence with Kenya's procedural laws.¹⁰³ The new treaty provisions are not yet publicly available as the treaty is not yet in force.

Ngina Mutava comments that even if this ratification procedure were followed in Kenya for all DTAs in future, it is unlikely to bring about real change because the DTA would have already been signed at that stage.¹⁰⁴ Moreover, she opines that once it is before Parliament, the text of the DTA is unlikely to change because parliaments do not have the expertise to navigate the technicalities of DTAs.¹⁰⁵ The procedural win is therefore a good move towards accountability – but, small in the bigger picture of the negotiation of, and commitment to, DTAs.¹⁰⁶

The real crux of the TJN-A's argument in this case is that Kenya's ability to domestically mobilize revenue is negatively affected by the concessions made in the Kenya-Mauritius DTA. The TJN-A then relied on violations of domestic law as a means to illustrate how in doing this, the Kenyan authorities were reneging on their obligations to the Kenyan people. It is this part of the TJN-A's argument which the court found to be thinly supported and poorly argued.

The author suggests that the perhaps the TJN-A would have been more successful if they had based their arguments on a violation of an international human rights instrument and not on domestic law per se. Titus and Gutuza argue that it is becoming an international norm for the design of tax policy, and particularly the decisions whether to tax or not to tax, to factor in the human rights context of those decisions.¹⁰⁷ For instance, the International Covenant on Economic, Social and Cultural Rights (the 'Covenant'),¹⁰⁸ of which Kenya is a signatory, directly links human rights to the formation of tax policy. Article 2(1) of the Covenant states:

Each State Party to the present Covenant undertakes to take steps, individually and through international assistance and

¹⁰³ 'What Next After Kenya's High Court Nullifies Mauritius-Kenya Double Tax Agreement?' (2019) <<https://www.africalegalnetwork.com/mauritius-kenya-double-taxation-agreement/>> accessed 20 July 2019.

¹⁰⁴ C Ngina Mutava, 'Reflections on the Kenya-Mauritius Tax Treaty Ratification' (28 March 2019) <<https://www.ictd.ac/blog/reflections-kenya-mauritius-tax-treaty-ratification/>> accessed 23 July 2019.

¹⁰⁵ Ibid.

¹⁰⁶ Ibid.

¹⁰⁷ A Titus and T Gutuza 'The Relationship Between Tax Incentives and Human Rights Obligations in the Drive to Attract Foreign Direct Investment: Are African Developing Countries Getting It Right?' (2018) *Acta Juridica* 149.

¹⁰⁸ International Covenant on Economic, Social and Cultural Rights (adopted 16 December 1966, entered into force 3 January 1976) 993 UNTS 3 [ICESCR].

co-operation, especially economic and technical, to the maximum of its available resources, with a view to achieving progressively the full realization of the rights recognized in the present Covenant by all appropriate means, including particularly the adoption of legislative measures.

According to the commentary on the Covenant, this article obliges countries to realise progressively the rights under the Covenant through the effective use of its available resources – which includes the funds that could potentially be raised through taxation.¹⁰⁹ Article 2 of the Covenant in essence means that signatory countries must use their tax system as effectively as possible to raise funds to realise the rights under the Covenant. Furthermore, the Covenant seeks to hold countries accountable to this obligation by requiring them to report to the United Nations on their progress in meeting their obligations.¹¹⁰

It is in this context, the author submits, that the TJN-A should argue that Kenya is in violation of its obligations under the Covenant. This claim may be lodged in a Kenyan court because the Covenant should be seen as part of Kenyan law in terms of article 2(6) of the Kenyan constitution. Article 2(6) states that ‘any treaty or convention ratified by Kenya shall form part of the law of Kenya under this Constitution.’ The Covenant is a convention that has been ratified by Kenya and thus meets the requirements of article 2(6). Argued on this basis, and using the language of the Covenant, the TJN-A may argue that the effect of the Mauritius-Kenya DTA is to restrict the tax base of Kenya and therefore Kenya has not ‘taken steps to the maximum of its available resources’¹¹¹ to realise progressively the rights under the Covenant. The author is of the view that the TJN-A may be more successful in its desire to have the Kenya-Mauritius DTA rendered void on a substantive law argument if it were to argue on the above basis.

It has been commented that the likely effect of the Tax Justice Network-Africa¹¹² case would be for the other EAC Partner States to more closely examine the procedural aspects of their DTAs coming into force.¹¹³ It is hoped that once the EAC Partner States undertake such an examination, that they may also consider whether they need to enter into DTAs at all. The following section will address some of the issues that such an enquiry would raise in an East African Federation context.

¹⁰⁹ UNCHR ‘Report of the Special Rapporteur on Extreme Poverty and Human Rights’ (2014) UN Doc A/HRC/26/28 [Special Rapporteur Report], para 25.

¹¹⁰ Art 16 ICESCR.

¹¹¹ Art 2(1) ICESCR.

¹¹² *Tax Justice Network-Africa* case (n16).

¹¹³ Ngina Mutava (n104).

4. SHOULD THE EAST AFRICAN FEDERATION ENTER INTO A DOUBLE TAXATION AGREEMENT AT ALL?

At present, there are over 3000 DTAs bilaterally concluded between countries.¹¹⁴ The majority of these follow the OECD MC.¹¹⁵ Dagan notes that this is attributable to the ‘network effect’ where new users use the format already employed by earlier users in order to be compatible with others and thereby save costs in processing information.¹¹⁶ Moreover, once DTAs have been entered into Avery Jones notes that this brings about a ‘locked in’ effect where changes to domestic law is hindered by existing DTAs and since DTAs are difficult to change, either the domestic law does not change or treaty overrides occur.¹¹⁷

Notwithstanding these issues, the main reasons countries enter into DTAs include: i) to eliminate double taxation;¹¹⁸ ii) to attract international commerce and investment;¹¹⁹ iii) to allocate taxing rights between countries;¹²⁰ iv) to reduce tax avoidance and evasion;¹²¹ v) to signal to investors that it is a safe place to invest;¹²² and vi) to promote legal certainty.¹²³

The academic literature, however, indicates that DTAs often fail to meet these aims and in most instances, other instruments would be more effective in achieving the desired outcome. This has led to bodies of work that argue against developing countries entering into DTAs.¹²⁴ The arguments against the use of DTAs are grouped into the following categories: i) the usefulness of DTAs is in doubt because its objectives could be achieved through the use of other instruments;¹²⁵ ii) the cost of entering into DTAs far outweigh their purported benefits;¹²⁶ and iii) DTAs actually facilitate tax avoidance.¹²⁷ Each of these arguments will be considered in turn.

¹¹⁴ According to the IBFD Database on double taxation agreements currently in force.

¹¹⁵ Pistone (n6) 285.

¹¹⁶ Dagan (n28) 171.

¹¹⁷ Avery Jones (n9) 4.

¹¹⁸ K Brooks, ‘Canada’s Evolving Tax Treaty Policy toward Low-Income Countries’ in AJ Cockfield (ed), *Globalization and Its Discontents: Tax Policy and International Investments* (University of Toronto Press 2010) 189, 190.

¹¹⁹ Braun and Fuentes (n50) 395.

¹²⁰ Brooks and Krever (n2) 166.

¹²¹ Easson (n4) 622.

¹²² A Christians, ‘Tax Treaties for Investment and Aid to Sub-Saharan Africa: A Case Study’ (2006) 71 Brooklyn Law Review 639, 706.

¹²³ Braun and Fuentes (n50) 385.

¹²⁴ Brooks and Krever (n2); Dagan (n1); Irish (n5); V Thuronyi, ‘Tax Treaties and Developing Countries’ in M Lang and others (eds), *Tax Treaties: Building Bridges Between Law and Economics* (IBFD 2010); Sheppard (n28).

¹²⁵ Christians (n122) 708.

¹²⁶ Dagan (n28) 100.

¹²⁷ GS Cooper, ‘Preventing Tax Treaty Abuse’ in A Trepelkov, T Tonino and D Halka (eds), *United Nations Handbook on Selected Issues in Protecting the*

Brooks and Kreyer argue that DTAs in fact fail to achieve its most important objective – the elimination of double taxation.¹²⁸ Countries typically alleviate the taxpayer's hardship of having two countries levy tax on the same income through the use of either the credit or exemption method. This is a unilateral measure and a DTA is not needed to grant such relief to the taxpayer.¹²⁹ Moreover, Brooks and Kreyer argue that DTAs are actually ineffectual in resolving the true cause of double taxation – the inconsistency in the characterization of income by contracting countries and also the inconsistency in source rules.¹³⁰ They cite the example of one country characterizing income as royalties arising from the use of intellectual property sourced in that country while another country may characterize that same income as income arising from personal services rendered and sourced in that second country.¹³¹ DTAs are not equipped to ameliorate this kind of double taxation.¹³²

In terms of the second objective of DTAs; namely, to attract foreign direct investment, Braun and Fuentes note that it is not clear whether DTAs in fact serve to bring in such investment.¹³³ Moreover, some studies suggest that it is the more developed regions that are more likely to benefit from the inflow of foreign direct investment.¹³⁴ Still other studies indicate that a country is more likely to benefit from incoming foreign direct investment if that country were to have policy decisions in place which encouraged favourable foreign direct investment spillover effects.¹³⁵ Such policy decisions may include improving domestic financial systems;¹³⁶ creating a competitive environment for foreign investors¹³⁷ and implementing measures to improve the quality of labour within a country.¹³⁸ These studies suggest that it is incumbent on the developing country to take steps to encourage the positive effects of an inflow of foreign direct investment rather than passively waiting for such

Tax Base of Developing Countries (2nd edn United Nations Publishing 2017) 329.

¹²⁸ Brooks and Kreyer (n2) 168.

¹²⁹ Dagan (n28) 98.

¹³⁰ Brooks and Kreyer (n2) 168.

¹³¹ Ibid.

¹³² Ibid.

¹³³ Braun and Fuentes (n50) 396.

¹³⁴ N Crespo and M Fontoura, 'Determinant Factors of FDI Spillovers – What Do We Really Know?' (2007) 35 *World Development* 410, 420; E Neumayer, 'Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?' (2007) 43 *The Journal of Development Studies* 1501; N Hermes and R Lensink, 'Foreign Direct Investment, Financial Development and Economic Growth' (2003) 40 *The Journal of Development Studies* 142, 158.

¹³⁵ Hermes and Lensink (n134); M Blomstrom, A Kokko and M Zejan, 'Host Country Competition, Labour Skills and Technology Transfer by Multinationals' (1994) 130 *Weltwirtschaftliches Archiv* 521.

¹³⁶ Hermes and Lensink (n134).

¹³⁷ Blomstrom, Kokko and Zejan (n135).

¹³⁸ Ibid.

benefits to materialize. Should the developing country fail to take such steps, it is possible that incoming foreign direct investment may negatively affect the recipient country. Braun and Fuentes note that the investment inflow may create independent economic pockets that are not connected to the local economy, and may also encourage the receiving country to become economically dependent on foreign direct investments.¹³⁹ Moreover, Crespo and Fontoura note that incoming foreign direct investment may create regional inequalities within the receiving country.¹⁴⁰ The pursuit of foreign direct investment through the use of DTAs should therefore form part of broader policy objectives of the developing country to improve its financial infrastructure, quality of labour force and the competitiveness of its industries.

Another objective of DTAs is to prevent tax evasion. This purpose is to be achieved through the exchange of tax information between the revenue authorities of contracting countries. Easson argues that other instruments may be used to achieve this purpose.¹⁴¹ He notes that the Convention on Mutual Administrative Assistance in Tax Matters is a multilateral instrument that could be used to facilitate the exchange of information amongst several countries.¹⁴² Moreover, he questions whether a treaty is needed at all to achieve this purpose, especially when it would be in the interest of both countries to exchange information.¹⁴³

In terms of the objective of DTAs to signal to investors that a country is a safe place to invest, commentators argue that DTAs are ineffectual in doing this.¹⁴⁴ Christians argues that bilateral investment are better suited to signaling to investors that a country follows international norms.¹⁴⁵ Moreover, Brooks and Krever argue that a country's ability to enforce the rule of law and the fact that it has an effective tax administration would far more meaningfully signal that it is a safe investment destination than a DTA would.¹⁴⁶

DTAs do, however, fulfil the function of allocating taxing rights between countries. The majority of DTAs concluded follow the OECD MC.¹⁴⁷ Given the discussion at Part 2.1 above of the unsuitability of the OECD MC to the developing country context, Irish describes the phenomenon of developing countries conceding their tax rights to developed countries under DTAs that adhere to the OECD MC as 'aid in reverse'.¹⁴⁸ Most

¹³⁹ Braun and Fuentes (n50) 395.

¹⁴⁰ Crespo and Fontoura (n134) 420.

¹⁴¹ Easson (n4) 623.

¹⁴² Ibid.

¹⁴³ Ibid.

¹⁴⁴ Dagan (n28)167; Christians (n122) 708.

¹⁴⁵ Christians (n122) 708.

¹⁴⁶ Brooks and Krever (n2) 168.

¹⁴⁷ Ibid 160.

¹⁴⁸ Irish (n5) 292.

DTAs therefore fulfil the allocation of taxing rights between countries very well, just not in the interest of developing countries.

In the light of the above, should the East African Federation enter into a DTA at all? On the one hand, it has been argued that it is actually the developed countries that need DTAs and not the developing country.¹⁴⁹ In theory, therefore, the source country is in the stronger bargaining position because it has the ability to unilaterally impose withholding taxes on the income it views as having a source within its jurisdiction.¹⁵⁰ However, this theory does not match the reality as developing countries have entered into DTAs which strip them of their right to tax income sourced within their borders.¹⁵¹

On the other hand, the East African Federation should note that the international community is recognizing the inequity of the current international tax system. There are greater and greater calls being made for more equitable rules to be introduced – not least of all for DTAs to allocate more taxing rights to the countries of source.¹⁵² Athanasiou advocates that developing countries should enter into DTAs and use this call for change to negotiate better terms in their DTAs with developed countries.¹⁵³ Thuronyi argues that developing countries should enter into a ‘light’ tax treaty which only includes a select provisions designed to assist relations between the developing and developed country without giving up the developing country’s taxing rights.¹⁵⁴ These select provisions would include: the exchange of information provision; a provision encouraging administrative co-operation between the countries; a non-discrimination provision; residence tie-breaker rules; and a mutual assistance procedure provision.¹⁵⁵ In this way, the developing nation could benefit from the formal co-operation with developed countries without sacrificing its taxing rights.

Accordingly, what are the options available to the East African Federation? First, it could choose not to enter into any DTAs at all and instead implement unilateral measures to prevent double taxation. Or second, it could enter into DTAs but use the international call for fairness to negotiate more source taxation in its DTAs. Or third, it could enter into a ‘light’ DTA which does not allocate taxing rights.

¹⁴⁹ Ibid 312.

¹⁵⁰ Brooks and Krever (n2) 162; Irish (n5) 313.

¹⁵¹ Brooks and Krever (n2) 178; Easson (n4) 624.

¹⁵² Irish (n5) 309.

¹⁵³ A Athanasiou, ‘Developing Countries Rethinking Tax Treaties’ (2014) Tax Notes International 395 (quoting Jeffrey Owens, Director of the WU Global Tax Policy Centre at the Institute for Austrian and International Tax Law).

¹⁵⁴ Thuronyi (n124) part 3.

¹⁵⁵ Ibid.

Or, are there other options that are perhaps not as conventional? Dagan suggests that there are benefits to be gained from becoming what ‘other countries fear the most’ – a tax haven.¹⁵⁶ Dagan explains that this could mean providing foreign investors with opportunities to avoid taxes in their residence country; refusing to share information with other jurisdictions or offering foreign investors weak enforcement of tax collections.¹⁵⁷ She argues that following this course would result in benefits for the tax haven country in the form of more foreign direct investment inflows; more migration of residents; and the creation of a new revenue stream as the tax haven country would be able to charge ‘toll charges’ for its tax haven services.¹⁵⁸ Moreover, as more and more countries choose to join the tax treaty network, the greater the benefits to be gained by tax havens – including a justification to raise the ‘toll charges’.¹⁵⁹

However, Chayes and Chayes argue against this route.¹⁶⁰ They argue that modern times requires sovereignty to be understood in terms of a country’s status and not in terms of a country being able to act independently according to its own self-interest.¹⁶¹ They further argue that in a globalized world often the only way a country can demonstrate its sovereignty is through involvement in the organizations that order the international system.¹⁶² They caution that countries who flout international norms will be subject to pressure from the international community that may be difficult to bear, even for powerful countries.¹⁶³

Such pressure can be substantial and, as the case studies of Hong Kong and Singapore indicate, a country’s reputation of being a safe place to invest is worth protecting at all cost.¹⁶⁴ Vogt conducted an analysis of the pressure and threat of reputational damage that the EU levelled on Hong Kong and Singapore to force these sovereign countries to adhere to the internationally agreed standard of exchange of tax information and other measures to combat tax evasion.¹⁶⁵ Vogt details how the EU Member States identified Hong Kong and Singapore as exhibiting weak exchange of tax information efforts; facilitating banking secrecy and being lax about combatting tax evasion and money laundering.¹⁶⁶ In order to force these two jurisdictions to

¹⁵⁶ Dagan (n28) 240.

¹⁵⁷ Ibid.

¹⁵⁸ Ibid.

¹⁵⁹ Ibid.

¹⁶⁰ A Chayes and A Handler Chayes, *The New Sovereignty: Compliance with International Regulatory Agreements* (Harvard University Press 1998) 27-28.

¹⁶¹ Ibid 27.

¹⁶² Ibid.

¹⁶³ Ibid 28.

¹⁶⁴ R Vogt, ‘Reputations and the Fight Against Tax Evasion: EU Pressure and Asian Financial Centres’ (2019) 95 *International Affairs* 365.

¹⁶⁵ Ibid.

¹⁶⁶ Ibid 374-5.

comply with the regulatory norms derived from the OECD, G20 and the Financial Action Task Force, the EU threatened to tarnish the jurisdictions' reputation through including Hong Kong and Singapore in its blacklist of tax havens and threatened to impose penalties.¹⁶⁷ Singapore quickly identified the tax evasion issue as politically sensitive and wasted no time in making changes to make itself compliant.¹⁶⁸ However, Hong Kong was not as swift, and the EU blacklisted it as a tax haven in 2015.¹⁶⁹ Following this, Hong Kong followed Singapore's example and implemented anti-money laundering legislation; enforced banking regulations to comply with European standards; signed and ratified the OECD's Multilateral Convention on Mutual Administrative Assistance; and signed DTAs with various countries which included provisions for the automatic exchange of tax information.¹⁷⁰ In so doing, Hong Kong was able to remove itself from the blacklist.¹⁷¹ These examples indicate how important it has become for countries to protect their reputations as being a safe investment destination. These cases also indicate how effective the EU has become in coercing countries to change their behavior through the threat of tarnishing that reputation.

Through initiatives such as the OECD's harmful tax practice,¹⁷² its Common Reporting Standard,¹⁷³ and the European Commission's blacklisting of tax havens,¹⁷⁴ tax havens have made substantial reforms. So much so, that Zielke argues that tax havens can no longer be understood as 'evil states' that facilitate illegal tax evasion.¹⁷⁵ Instead, Zielke offers a different definition of a tax haven which is more suited to the most recent developments in international tax.¹⁷⁶ The OECD had set out the indicators of tax havens as follows: i) They impose

¹⁶⁷ Ibid 380.

¹⁶⁸ Ibid 378.

¹⁶⁹ Hong Kong Government, *Allegation of Hong Kong as Non-Cooperative Tax Jurisdictions Totally Unfounded* Press Release (18 June 2015) <https://www.fstb.gov.hk/tb/en/docs/pr20150618_e.pdf> accessed 23 July 2019.

¹⁷⁰ Vogt (n164) 378.

¹⁷¹ Hong Kong Government, *Hong Kong's tax co-operation clarified by EC* Press Release (14 October 2015) <<https://www.info.gov.hk/gia/general/201510/14/P201510140706.htm>> accessed 23 July 2019.

¹⁷² OECD, *Toward Global Tax Co-operation – Progress in Identifying and Eliminating Harmful Tax Practice* (OECD Publishing 2000) <www.oecd.org/dataoecd/9/61/2090192.pdf> accessed 23 July 2019.

¹⁷³ OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (OECD Publishing 2014) <<https://doi.org/10.1787/9789264216525-en>> accessed 23 July 2019.

¹⁷⁴ European Commission, 'Common EU list of Third Country Jurisdictions for Tax Purposes' <https://ec.europa.eu/taxation_customs/tax-common-eu-list_en> accessed 23 July 2019.

¹⁷⁵ R Zielke, 'The Changing Role of Tax Havens – An Empirical Analysis of the Tax Havens Worldwide' (2011) 65 *Bulletin for International Taxation* 42, 47.

¹⁷⁶ Ibid.

no or minimal taxation; ii) They have no effective exchange of information measures in place; iii) There is a lack of transparency in their regulatory and administrative provisions and practices; and iv) They allow foreigners with only a minimal presence in their jurisdictions to establish foreign-owned entities.¹⁷⁷ According to Zielke, however, these indicators are no longer relevant today, and instead the following characteristics identify a modern tax haven: i) They impose low taxes (either foreign-sourced income is exempt or a corporate income tax rate of 15% or less is imposed); ii) They have signed DTAs with other countries; and 3) They have at least committed to the internationally agreed standard of tax information exchange and measures to combat tax evasion.¹⁷⁸

The bad reputation tax havens have acquired seems to be changing. This bad reputation came about because of the beliefs that tax havens entice economic activity away from countries who impose higher taxes, and that they erode their own tax bases and that of countries who impose higher taxes.¹⁷⁹ However, studies suggest that these claims may be unfounded, further chipping away at the bad reputation attached to tax havens. Hines notes that the evidence suggests that tax havens actually stimulate economic activity in their neighboring countries.¹⁸⁰ Moreover, it would seem that tax havens are no worse off than other countries in terms of public spending because Hines finds that the public sectors of tax havens are equal in size to that of high-tax countries.¹⁸¹ It is therefore not clear that the low taxes tax havens impose result in an erosion of their tax base to the extent that it affects their government spending.¹⁸² In so far as tax havens affect high-tax countries, Hines notes that the results are mixed.¹⁸³ The effect on high-tax countries depends on how the taxpayer uses the tax haven.¹⁸⁴ On the one hand, if the taxpayer uses the tax haven to reallocate foreign-source income from a high-tax to a low-tax jurisdiction, this would result in the reduction of the foreign tax credit the taxpayer could have claimed and thus only serves to increase the taxpayer's tax liability in the taxpayer's high-tax country of residence.¹⁸⁵ On the other hand, the high-tax country's tax base may be eroded if

¹⁷⁷ OECD, *Harmful Tax Competition – An Emerging Global Issue* (OECD Publishing 1998) 24 < www.oecd.org/dataoecd/33/1/1904184.pdf > accessed 23 July 2019.

¹⁷⁸ Zielke (n175) 43.

¹⁷⁹ JRJ Jr Hines, 'Do Tax Havens Flourish?' (2005) 19 *Tax Policy and the Economy* 65, 66; MA Desai, C Fritz Foley and JR Hines, 'Do Tax Havens Divert Economic Activity?' (2005), Ross School of Business Paper No. 1024 <<https://ssrn.com/abstract=704221>> accessed 20 July 2019.

¹⁸⁰ *Ibid.*

¹⁸¹ *Ibid.* 94.

¹⁸² *Ibid.*

¹⁸³ *Ibid.*

¹⁸⁴ *Ibid.*

¹⁸⁵ *Ibid.*

the taxpayer were to use the tax haven to decrease the taxable income declared in that high-tax country as the residence country, particularly if the high-tax country uses the exemption method.¹⁸⁶ A more positive outcome for tax havens was produced in a study by Dharmapala which indicates that despite the increased foreign direct investment flowing to tax havens, the corporate tax revenues of capital-exporting countries has increased.¹⁸⁷ This suggests that perhaps tax havens are not bringing about the corrosive effect on the tax bases of other countries as was first thought.

The evidence is, however, clear that tax havens do receive more foreign direct investment than other countries and that they consequently enjoy a boost in their economic growth.¹⁸⁸ Moreover, the economic growth of tax havens outperform that of other countries.¹⁸⁹ Dagan is therefore correct that there are distinct benefits to becoming a tax haven. However, these benefits are not enough to counter the still prevailing negative connotations attached to the label ‘tax haven’.

Perhaps such negative connotations and reputational effect could be avoided if the East African Federation were to market and place itself as a ‘safe haven’ rather than a ‘tax haven’.¹⁹⁰ This would entail the East African Federation making the policy decisions that would allow it to meet the criteria Zielke has specified. This would entail the following:

- i) Imposing low taxes – In a bid to encourage foreign investment, it is recommended that the East African Federation exempt foreign-sourced income rather than impose a corporate tax rate of 15% or less. Corporate income tax still remains an important source of revenue for African countries,¹⁹¹ and it would not be advisable to sacrifice this tax;
- ii) Conclude DTAs – the East African Federation should conclude DTAs with automatic exchange of information provisions. It is noted that Hong Kong and Singapore had to enter into comprehensive DTAs with other countries

¹⁸⁶ Ibid.

¹⁸⁷ D Dharmapala, ‘What Problems and Opportunities Are Created by Tax Havens?’ (2008) 24 *Oxford Review of Economic Policy* 661, 677.

¹⁸⁸ Ibid 662.

¹⁸⁹ Hines (n179) 66.

¹⁹⁰ The phrase ‘safe haven, not a tax haven’ seems to have originated from E Thomasson, ‘Liechtenstein Now Safe Haven Not Tax Haven-PM’ *The European* (23 May 2012) <http://www1.regierung.li/uploads/media/20120523_Reuters_Interview_RC_Klaus_Tschuetscher_english.pdf> accessed 23 July 2019; see also MA Berger, ‘Not So Safe Haven: Reducing Tax Evasion By Regulation Correspondent Banks Operating in the United States’ (2013) 12 *Journal of International Business and Law* 51.

¹⁹¹ AW Oguttu, ‘Tax Base Erosion and Profit Shifting in Africa – Part 1: What Should Africa’s Response be to the OECD BEPS Action Plan?’ (2015) 48 *The Comparative and International Law Journal of Southern Africa* 516, 526.

- in order to satisfy the EU Commission of their commitment to the internationally agreed standard. It is not therefore clear whether the East African Federation would be able to ensure that it is perceived as compliant with the international norms if it were to conclude a ‘light’ tax treaty¹⁹² as Thuronyi suggests. At the very least, the East African Federation should push for adherence to the UN model tax treaty should it enter into comprehensive DTAs;
- iii) Commit to the internationally agreed standard – The East African Federation should sign and ratify the OECD’s Multilateral Convention on Mutual Administrative Assistance; implement banking regulations similar to the European standard; and legislate laws to combat money laundering, as Hong Kong and Singapore did.
 - iv) Implement complementary non-tax domestic policies – The East African Federation should also have domestic policies in place that will bolster its attractiveness to foreign investors. These policies may include: improving the quality of its governance through investing in the education and financial sectors;¹⁹³ ensuring that the rule of law is enforced through a robust judiciary; invest in measures to improve the infrastructure and training of its revenue authority; develop programmes to upskill locals to provide competition to the businesses of foreign investors or provide foreign investors with tax incentives to upskill the local population.¹⁹⁴

The above discussion indicates that the East African Federation should enter into DTAs, preferably with strong source rules. However, the weaker bargaining position of the East African Federation may make it difficult to secure such a strong source position in its treaty negotiations. This may result in it entering into a DTA which largely follows the OECD MC. However, if this should happen, some countries have found that all may not be lost as many countries have entered into treaty positions which they may later find to be difficult to keep. Vann notes that this has led to some countries finding creative means by which to ignore their treaty obligations, either explicitly or implicitly, when the treaty outcome is detrimental for them.¹⁹⁵ Chayes and Chayes argue that countries can take advantage of the ‘zone of ambiguity’ where the uncertainty created by the language used

¹⁹² Thuronyi (n124).

¹⁹³ Hermes and Lensink (n134) (This study indicates that positive spillovers from foreign investment are more likely for countries with sophisticated financial systems).

¹⁹⁴ Blomstrom, Kokko and Zejan (n135) (This study indicates that providing a competitive climate and improving labour quality will increase the likelihood of positive spillovers from foreign investment.).

¹⁹⁵ Vann (n35) 21.

in the treaty may allow countries to justify their preferred outcome.¹⁹⁶

Dagan provides examples of how such ambiguities may arise in a DTA context.¹⁹⁷ These may be in instances where one country may regard an entity as a company in terms of its definition of a company while another country may define that entity as a partnership, thereby for deductions and income to be taxed in the hands of the partner rather than the corporation, or other instances where the countries may have differing requirements for the establishment of corporate residence resulting in dual residences.¹⁹⁸

More implicitly, some countries have managed to adhere to the letter of their treaty obligations but not necessarily the spirit. For instance, up until 2012 South Africa levelled a tax known as Secondary Tax on Companies (STC) which was a tax imposed on the company declaring a dividend and as such was a business tax. Accordingly, non-residents who paid STC could not rely on the dividend withholding tax rate contained in South Africa's DTAs because STC was not a dividend withholding tax. This was the subject of litigation in South Africa in *Volkswagen of South Africa (Pty) Ltd v The Commissioner: South African Revenue Service*.¹⁹⁹

In this case, the taxpayer (Volkswagen South Africa (Pty) Ltd) had paid a dividend to its holding company in Germany. While initially the taxpayer paid STC to the revenue authority in South Africa, it later claimed a refund to the extent that the amount paid exceeded the dividends withholding tax rate in the DTA between Germany and South Africa. The taxpayer argued that STC was a tax that was substantially similar to dividends tax and accordingly the dividend withholding tax rate as set out in article 7 of the South Africa-German DTA should be applied to the dividend paid. The High Court, however, dismissed the taxpayer's arguments and ruled that STC was a sui generis tax and was not a dividend tax as contemplated in article 7 of the DTA. The court noted that STC was a tax levied on the company and not the shareholder, and as such could not be a dividends tax. Moreover, STC was calculated differently than would have been the case in respect of a dividends tax. STC was calculated with reference to actual dividends and certain amounts deemed to be dividends in terms of section 64C(2) of the South African Income Tax Act.²⁰⁰ Also, according to the court, it is the recipient of the dividend who is entitled to enjoy the benefit of the withholding tax rate in article 7 of the DTA and not the company declaring the dividend. South Africa was

¹⁹⁶ Chayes and Chayes (n160) 13.

¹⁹⁷ Dagan (n28) 240.

¹⁹⁸ Ibid.

¹⁹⁹ *Volkswagen of South Africa (Pty) Ltd v The Commissioner: South African Revenue Service* (2008) 70 SATC 195.

²⁰⁰ Income Tax Act 58 of 1962 (South Africa).

therefore able to use STC to tax companies on the declaration of dividends at a rate sometimes as high as 12.5% without reneging on its DTA obligations of maintaining a cap on its dividends tax – which was 7.5% in the South Africa-Germany DTA. South Africa has, however, abolished STC in favour of a dividends tax in April 2012.²⁰¹

In the light of the above, should the East African Federation enter into DTAs at all then? In an ideal world where all countries had equal bargaining power and the only motivation for entering into DTAs was to avoid double taxation, it would not be necessary for the East African Federation to enter into DTAs because the unilateral relief it would provide – such as exempting foreign-sourced income or providing a tax credit for foreign taxes paid by its residents – would avoid instances of double taxation.²⁰² However, as Chayes and Chayes have noted, sovereignty no longer refers to a country's ability to independently make decisions in its own self-interest.²⁰³ Instead, sovereignty today means status and the ability to participate in international fora.²⁰⁴

Tied to this, is every country's desire to attract foreign direct investment and the need to be perceived as a safe destination of investment. A country's good reputation is therefore of utmost importance and is worthy of protection, as was seen in the Hong Kong and Singapore case studies. Moreover, in the interest of protecting such good reputation, it may perhaps be imprudent for the East African Federation to follow the examples of the countries who have taken advantage of the zone of ambiguity in an attempt to renege on their treaty obligations. Also, the East African Federation cannot afford to be labelled as an 'other' because it would seek to attract foreign direct investment. It is thus not realistic for the East African Federation to refuse to enter into any DTAs at all. It is realistic, however, for the East African Federation to be smart and thoughtful in the terms to which it agrees in a DTA. Ideally, the East African Federation should fight for more source-based taxation of income. However, in those times that this position cannot be successfully negotiated, the East African Federation should perhaps implement a practice of regularly reviewing existing DTAs to evaluate the likelihood of successfully renegotiating better terms based on any changes in global political climates.

²⁰¹ Taxation Laws Amendment Act 22 of 2012 (South Africa) section 138.

²⁰² Braun and Fuentes (n50) 413; Brooks and Krever (n2) 162; Dagan (n1) 940.

²⁰³ Chayes and Chayes (n160).

²⁰⁴ Ibid.

5. THE DEVELOPMENT OF A DOUBLE TAXATION AGREEMENT POLICY FOR THE EAST AFRICAN FEDERATION

Given that the East African Federation is most likely to enter into DTAs, the following recommendations are made to it on the formation of its tax treaty policy.

5.1. IDENTIFICATION OF OBJECTIVES

It is key that the East African Federation have clear objectives in mind of what it hopes to achieve with entering into a DTA.²⁰⁵ This would entail for instance determining whether the envisaged DTA is meant to attract foreign direct investment into the federation; to signal to international investors that the East African Federation is a safe destination for investment; to create greater legal certainty; to avoid double taxation or non-taxation; to prevent tax evasion; to facilitate greater trade volumes; or to achieve a combination of these options.

5.2. KNOW YOUR CO-SIGNATORY COUNTRY

Related to this, it would be also be ideal for the East African Federation to conduct a study to determine how much trade is actually occurring, and is expected to occur, between itself and the proposed DTA partner.²⁰⁶ This information would assist the East African Federation authorities to identify whether any issues of double taxation actually arise during the cross-border trade conducted, and would also give it an idea of the scale of the revenues which it may lose should it concede to the allocation of taxing rights of business income under article 7 of the OECD MC.²⁰⁷

5.3. CREATE A TEMPLATE OF RELEVANT QUESTIONS TO ASK

It is recommended that the East African Federation ask itself the following questions when considering whether to enter into a DTA:

- i) Does the level of trade as determined under 5.2 above justify the need for a DTA?²⁰⁸
- ii) If significant levels of trade exist, could the objectives identified at 5.1 be met through other international instruments?²⁰⁹ For instance, if the objective is to provide a signaling effect of the East African Federation as an investment destination or if the aim is to provide greater

²⁰⁵ Braun and Fuentes (n50) 415.

²⁰⁶ Thuronyi (n124) part 1.

²⁰⁷ Braun and Fuentes (n50) 415.

²⁰⁸ Thuronyi (n124) part 1.

²⁰⁹ Ibid.

legal certainty, such aims could be met through the conclusion of a bilateral investment treaty rather than a DTA.²¹⁰ Moreover, if the objective is to avoid instances of double taxation such outcome could be achieved unilaterally through the East African Federation enacting relevant legislative measures – such as granting a tax credit for foreign taxes paid or through exempting foreign-sourced income from taxation in the East African Federation.²¹¹ Furthermore, if the aim is to counter tax evasion, this could be achieved through a Mutual Administrative Assistance Treaty.²¹² Also, if the aim is to attract foreign direct investment, this could perhaps be better achieved by identifying and offering specific multinational enterprises incentives directly rather than offering it broadly to all potential investors in terms of a DTA.²¹³

- iii) If a DTA is still the preferred route, could it be possible to enter into a ‘light’ DTA?²¹⁴ Thuronyi suggests that the light DTA could include provisions such as: exchange of information, administrative co-operation, non-discrimination, residence tie-breaker rules and mutual agreement procedure.²¹⁵ A ‘light’ DTA would allow the East African Federation to obtain many of the benefits of entering into a DTA – such as allowing for administrative co-operation between revenue authorities, investor protection by ensuring that non-residents are not treated differently from residents, and a mutual agreement procedure to resolve instances of double taxation – without the negative consequences attached to a typical OECD-styled DTA – such as the conceding of taxing rights to the residence country.

5.4. DOUBLE TAXATION AGREEMENT TEMPLATE

In the event that the above line of questions nonetheless results in the decision to enter into a full-fledged DTA, the following recommendations are made bearing in mind that the East African Federation would likely be a net capital importer, and as a result adopt measures to ensure capital export neutrality:

- i) It is suggested that the federation should start its negotiations from a position of strength and present a starting negotiating position that is polar opposite to the

²¹⁰ Christians (n122) 708.

²¹¹ Thuronyi (n124) part 2; Brooks and Krever (n2) 168.

²¹² Thuronyi (n124) part 3.

²¹³ Irish (n5) 312.

²¹⁴ Thuronyi (n124) part 3.

²¹⁵ Ibid.

OECD MC²¹⁶ – that is a model convention with a strong source-bias, such as with the Andean MC.

It has been commented, however, that developing countries should not seek to adopt high levels of source taxation in their DTAs because this is likely to have a deterrent effect on international trade and investment.²¹⁷ Moreover, such high source taxation rates may have the effect of having the higher tax cost being passed on to the resident taxpayer through increased charges levied by the non-resident.²¹⁸

In response to the possible deterrent effect on investment that higher source taxation may have, the author argues that the recommendation that the East African Federation push for stronger taxation is based on the premise that the federation will offer foreign investors sound non-tax reasons to invest in the East African region. These would include the federation offering the foreign investor a quality financial sector; a quality, well-educated labour force; a robust judiciary and an accountable, transparent and responsive government. Tax issues are only one of the factors investors consider when making the decision to invest in a particular location.²¹⁹ In the event that an investor would consider the high source taxation rates as too high and therefore as enough of a deterrent for such investor to choose not to invest in the East African Federation notwithstanding the non-tax reasons that may exist which would encourage such investment, it is likely that such an investor would be classified as a footloose investor.²²⁰ Such investors, like export-orientated investors, are less interested in building lasting links with the country in which they invest and would likely disinvest from the country as soon as the tax incentives end.²²¹ These are perhaps

²¹⁶ Hearson (n84) 7.

²¹⁷ United Nations, *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries 2019* (United Nations 2019), para 43.

²¹⁸ Ibid; ECCM Kemmeren, 'Legal and Economic Principles Support an Origin and Import Neutrality-Based over a Residence and Export Neutrality-Based Tax Treaty Policy' in M Lang and others (eds), *Tax Treaties: Building Bridges between Law and Economics* (IBFD 2010), 1.4.3.

²¹⁹ P Kusek and A Silva, 'What Investors Want: Perceptions and Experiences of Multinational Corporations in Developing Countries' (2018) Policy Research Working Paper, WPS8386, World Bank Group <<http://documents.worldbank.org/curated/en/168711522241146651/pdf/WPS8386.pdf>> accessed 20 July 2019, 12; JC Anyanwu, 'Why Does Foreign Direct Investment Go Where It Goes?: New Evidence From African Countries' (2012) 13 *Annals of Economics and Finance* 425; S James, 'Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications' (2009) FIAS, World Bank Group <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1540074> accessed 20 July 2019, 13.

²²⁰ O Perera, 'Rethinking Investment Incentives' (2014) IISD Commentary, International Institute for Sustainable Development, <https://www.iisd.org/sites/default/files/publications/rethinking_investment_incentives.pdf> accessed 20 July 2019, 3.

²²¹ Ibid.

not the type of investors that the East African Federation would want to attract in any event.

In response to the concern that high source taxation rates may have the effect of passing on the payment of this to residents as an additional charge, the author argues that in such event the resident taxpayers have a choice whether to accept such terms or to contract either with other residents or other non-residents who would not impose such an additional charge. The imposition of the additional charge should be treated in the same way as any other contractual provision negotiated in cross border transactions and should fall squarely within the negotiating purview of contracting parties – rather than becoming a national and federal concern.

In the light of this, the author is of the view that the East African Federation would be in a position to push for stronger source taxation notwithstanding its objective to ensure capital export neutrality and the possible deterrent effect such taxation may have on certain types of foreign investment and trade.

- ii) As negotiations progress and compromises have to be made, it is suggested that the East African Federation make reference to the positions undertaken under the UN MC and that care is taken to not concede beyond the provisions recommended in that model convention. In particular, the East African Federation should take care when negotiating the following provisions:
 - a. Article 5 – permanent establishments: The East African Federation should seek to lower the threshold in the determination of what is a permanent establishment in order to improve its ability to tax the business income arising within its borders.²²² In this regard, it should adhere closely to the UN MC in its definition of a ‘permanent establishment’ under article 5 of the OECD MC. In particular, the East African Federation should ensure that the concept of a service permanent establishment is included as in article 5(3)(b) of the UN MC. Moreover, it should ensure that under the list of exclusions follows that of the UN MC at article 5(4), particularly 5(4)(a) and (b) to allow for the use of facilities, and the maintenance of stock, for the purposes of delivery to constitute a permanent establishment. The East African Federation should also ensure that it adopts the broader positions of a dependent agent under article 5(b) of the UN Model and the insurance permanent establishment under article 6 of the UN MC.
 - b. The East African Federation should ensure that it includes article 12A of the UN MC in its proposed DTAs.

²²² Brooks (n118) 189.

This provision would allow it to impose a withholding tax for fees paid by resident taxpayers for technical services rendered by non-residents. While the UN has not proposed a withholding tax rate, it is suggested that the East African Federation start negotiations at a high rate of 20%, and this would probably be whittled down to 10% as negotiations progress.

This provision has been described as a significant shift regarding the rules regarding the international taxation of services, and as such the negotiations regarding its possible inclusion would likely be controversial.²²³ It has been recommended that should a developing country seek to include Article 12A in its DTAs, that developing country should ensure that the revenue may be collected efficiently by putting a withholding tax system in place.²²⁴ It has also been cautioned that developing countries who argue for the inclusion of article 12A should be prepared to face pressure to make difficult concessions in other areas in order to ensure the necessary agreement for the article's inclusion.²²⁵

In making the decision whether to push for the inclusion of article 12A or not, the author recommends that the East African Federation have the necessary data in place – available before it enters into DTA negotiations – that would indicate how important this article is to the it with respect to trade with the other country. This data should be able to answer questions such as: how often do non-residents provide technical services to residents of the East African Federation? How often do these payments escape the permanent establishment rules? Is the revenue that is to be collected under article 12A more than the revenue that may be lost under possible reductions of the withholding rates for dividends, interest and/or royalties – as these would probably be the concessions the East African Federation may be pressured to make during negotiations? It is the author's view that the best manner in which the East African Federation may make such a difficult decision as to push for article 12A's inclusion or not, is to be adequately prepared for resistance. In this regard, the arguments justifying the inclusion of article 12A provided in the commentary to the UN Model²²⁶ may also be useful.

- c. The East African Federation should ensure that it imposes a royalty withholding tax rate in terms of article 12 of the UN MC. Moreover, it should ensure that it imposes a withholding tax on dividends and interest under articles 10 and 11 of the UN MC respectively. Similar to the proposed

²²³ United Nations *Manual* (n217) para 417.

²²⁴ *Ibid* para 421.

²²⁵ *Ibid*.

²²⁶ Paras 2 to 23 of the commentary on article 12A, UN Model.

- negotiating strategy for the withholding tax rate for fees paid for technical services, it is suggested that the East African Federation begin its negotiations seeking to enforce a withholding tax rate of 20% on dividends and interest. This percentage would likely be reduced to 10% as negotiations progress with 10% being the rate which most countries agree to incorporate in their DTAs.
- d. The East African Federation should also ensure that it includes in its capital gains allocation provisions a provision similar to that of article 13(5) of the UN MC. This provision allows the source country to also tax the capital gains arising from the alienation of ordinary shares if the alienator held a certain percentage shareholding in the company during the 365 days preceding the alienation. It is suggested that the participation percentage be set at 25% which is the commonly agreed rate in DTAs.
 - e. Should the East African Federation be pushed into undesirable clauses, such as a Most Favoured Nation ('MFN') clause,²²⁷ it should ensure that such clauses have termination dates and do not continue indefinitely.
 - f. Procedurally, the East African Federation should ensure that all its DTAs are properly tabled before its Parliament for its consideration for the purposes of transparency and possibly in order to meet constitutional requirements.

Should the East African Federation be successful or not in implementing the above suggestions, it should nonetheless ensure that its domestic legislation supports its claims to the taxing allocations agreed under its DTAs.

5.5. DOMESTIC LEGISLATION

The taxing rights allocated under a DTA are of little use to a country unless it has empowered itself to tax the specified income in terms of its domestic legislation. It is therefore key that the East African Federation ensure that its domestic legislation is in place to allow it to tax streams of income such as business profits, royalties and fees arising from technical services.²²⁸

Avery Jones notes that an ideal tax system would encompass a country imposing high withholding tax rates for non-residents with a good corresponding system of relief from

²²⁷ A MFN clause would be undesirable for the EAC federation because it would constitute an unnecessary restriction on the federation's treaty-making capability. While such clauses would create some certainty for foreign investors, the author is of the view that legal certainty may be ensured in other less restrictive ways for the EAC federation – such as through the conclusion of bilateral investment treaties, for instance. For more on this, see Braun and Fuentes (n50) 394.

²²⁸ United Nations *Manual* (n217) para 421.

double taxation for its own residents.²²⁹ This would create the need for other countries to conclude DTAs with it in order to ameliorate the effect of the high withholding tax rates while its existing system of domestic relief from double taxation would allow it to be relatively impervious to such demands for a DTA.²³⁰ It is argued that perhaps the East African Federation should adhere to this advice in order to strengthen its own bargaining position.

In this regard, the East African Federation could impose high withholding tax rates on dividends, interest and royalties paid to non-residents – perhaps at a domestic rate of 20% as Mongolia has done.²³¹ Moreover, it could perhaps impose an even broader definition of a ‘permanent establishment’ under its domestic legislation – perhaps even to the point of allowing a permanent establishment to be created through an enterprise merely selling goods or services within its borders, as was contemplated by the UN when drafting its UN MC.²³² The East African Federation should also include a domestic provision which would allow it to tax the fees paid for technical, consultancy or professional services to non-residents.

Taking such an expansive approach to establishing its right to tax the income generated within its borders would allow the East African Federation to be in an optimal bargaining position going into the DTA negotiations. This is because it would be able to assure its possible contracting counterpart that the incomes negotiated under the proposed DTA would be subject to tax within the federation – and thus, the spectre of double non-taxation may be removed from the negotiations. In theory, strong domestic source rules would allow the East African Federation to collect the taxes arising from the relevant income first. The retention of such taxes would be subject to successful negotiations with the foreign revenue authorities in terms of the agreed DTA. Until such successful negotiations are concluded, the East African Federation would be in possession of the collected taxes in accordance with its domestic legislative provisions. This would be in keeping with Sheppard’s observation that the rational approach for developing countries to take is to withhold taxes first and deal with queries later.²³³

It has been observed that the UN MC is becoming increasingly important for developing countries as they negotiate their DTAs.²³⁴ And, such influence should only increase as

²²⁹ Avery Jones (n9) 3.

²³⁰ Ibid.

²³¹ N Umar, ‘Mongolia – Corporate Taxation’ *Country Surveys IBFD* section 6.3, accessed 23 July 2019.

²³² SS Surrey, ‘United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries,’ (1978) 19 *Harvard International Law Journal* 1, 11.

²³³ L Sheppard, ‘Revenge of the Source Countries, Part III: Source as Fiction’ (2005) *Tax Notes International* 219, 224.

²³⁴ Luyo Acosta (n42) 149.

commentators note that developing countries should use the current drive towards more source taxation to leverage better treaty terms during the DTA negotiations.²³⁵ It is important to note, however, that the allocation of taxing rights under a DTA does not mean very much when the country does not have the domestic legislation in place to make use of such taxing right. It is important that the East African Federation spend a significant amount of time on enacting legislation that would enable it to tax and collect the income generated within its jurisdiction effectively and efficiently. It is therefore key that the East African Federation invest in ensuring the quality and experience of its revenue authority and its officials.

6. CONCLUSION

DTAs are an integral part of the international tax landscape. With over 3000 DTAs concluded worldwide, and most of these following the OECD MC, the East African Federation may seem not to have much choice when entering into DTA negotiations. However, the political climate is shifting to allow for greater taxing rights being allocated to source countries. The East African Federation would therefore have much to consider when choosing whether to enter into a DTA at all.

This chapter has asked the following questions: Should the East African Federation enter into a DTA at all? And, if yes, what should such DTA include? In terms of the first question, the political climate is such that the East African Federation may face reputational damage if it were to rebuff the invitations it was to receive from other countries to enter into DTAs. The examples of China and Singapore are directly relevant to the true choices available to the East African Federation in this regard – enter into DTAs or face the possibility of being labelled an uncooperative jurisdiction.²³⁶

Once the East African Federation has decided that it should enter into a DTA, in negotiating the terms of such agreement, it should start its negotiations from as strong a source position as possible,²³⁷ possibly through tabling the Andean MC as a starting point. As the negotiations progress, the East African Federation should seek to close its negotiations with its positions being as close to the UN MC as possible. The UN MC should not be the federation's starting position going into the negotiations. The current political climate with its increasing appetite to see greater taxing rights allocated to source countries should allow the East African Federation to start – if not end – its negotiations from a strong source position.

The current EAC Partner States have taken heed to negotiate for the UN MC to apply to its DTAs. The East African

²³⁵ Athanasiou (n153) 395.

²³⁶ Vogt (n164).

²³⁷ Hearson (n84) 7.

Federation should build on this experience as it strives to make its DTA position stronger than the current DTAs in place in the East African region. The East African Federation should seek to take full advantage in the call for greater taxation rights for source countries and with some luck, it might yet bring about variations of the Andean MC surfacing in its concluded DTAs with developed countries.

CHAPTER SIX: CONCLUSION

The aim of this thesis was to answer the question how best to design and protect a corporate income tax system for the East African Federation. This thesis has answered this question as follows:

Chapter 2 provides the East African context in which the corporate income tax policy of the East African Federation will operate. Because the EAC regional integration project has been inspired by the EU, this chapter highlights the further points of similarity between the two integration projects. The historical and possible future positions of the EU and EAC regional integration projects are discussed in this chapter.

Chapter 3 details that corporate income tax is an important source of revenue for the EAC Partner States and would likely play an equally important role in the East African Federation. The East African Federation should build on the existing corporate income tax systems in the EAC Partner States by retaining the classical corporate income tax system. The key objective of such a system would be to raise revenues for the East African Federation. This chapter recommends that this be done by broadening the tax base through adopting a system similar to the CCCTB currently proposed in the EU; creating a favourable investment climate and reducing the large informal sector in the region. Moreover, rules such as an interest limitation rule and CFC rules would do well to protect the corporate income tax base. In the design of its corporate income tax system, it is important for the East African Federation to remember that this cannot be done in isolation. Elements such as the possible influences of institutions and practical administrative capacity would also shape the implementation of the corporate income tax system in the East African Federation.

Chapter 4 designs a GAAR for the East African Federation in order to protect the corporate income tax base in a national setting. The East African Federation should have a GAAR, not least of all because the absence of one might indicate a tolerance towards avoidance strategies – something which should be avoided. The design of the GAAR as proposed in this chapter builds on the existing GAARs in the EAC Partner States while drawing best practices from the EU, Canada and South Africa. This comparative analysis produced the following recommendations for the East African Federation: First, the substance over form test should be included as an initial test. Secondly, the essential elements of a GAAR like provisions regarding the identification of a scheme, tax benefit and tax avoidance purpose should be included. Thirdly, recommendations are made to address the administrative capacity constraints the East African Federation will face, the

most important of which is that a GAAR Panel should be formed and that the East African Federation should legislate the underlying purpose and rationale of tax rules together with the actual tax rules in its fiscal legislation.

Chapter 5 designs a tax treaty policy for the East African Federation. Such design produced the following recommendations: First, it is recommended that the East African Federation should enter into DTAs in furtherance of fostering its reputation as a safe destination for investment. However, the East African Federation should be exceedingly careful and thoughtful when conducting DTA negotiations. Secondly, before entering DTA negotiations the East African Federation should create a template of questions it should answer when making the decision whether to enter into a DTA with a particular country or not. These questions are designed to determine the possible gains or losses for the East African Federation in entering into a DTA with that country. Thirdly, the East African Federation should create a DTA template and adhere to it in order to ensure consistency across the DTAs it concludes. Finally, the East African Federation should ensure that its domestic legislation supports the taxing rights it argues for and which feature in its DTAs.

The author hopes that the implications of this thesis are the following: First, it is envisaged that this dissertation will assist researchers in thinking differently about what is possible in a developing country – and particularly, an African context. It is further anticipated that this study will move the African research narrative away from the cautionary tale that African countries often present to a more positive viewing of African ideas and developments.

Secondly, it is envisioned that going forward researchers will look harder to see what solutions may come out of Africa. More research should be conducted on what African countries and practices may teach the rest of the world. Africa should not always be on the receiving end of lessons, and perhaps more should be done to discover what Africa, its people and its systems may have to teach.

The EAC is undertaking an ambitious endeavour to culminate its regional integration efforts into a political federation. The EAC is already making steps towards making such a federation a reality. The EAC as a regional integration project is unique in this encompassing objective to forsake the sovereignty of the constituent Partner States for the single sovereignty of the East African Federation. In such uniqueness, what relevance does the EAC experience bear to others?

The EAC represents a rare instance where, succeed or fail, an African experience offers rich learning opportunities to other global regional integration projects. Should the EAC succeed in its (some would say) grandiose plan to form its federation, the EAC would represent a blueprint for other

regional integration projects the world over to do the same. Should the EAC fail, it would still represent a learning opportunity for other regional integration projects from which they could build their own success on the steps taken by the EAC. The EAC is more than just another regional integration project. The author opines that perhaps the EAC may usher in a new norm in which African best practices are regarded as aspirational positions rather than as cautionary tales. All journeys begin with one step, and the EAC is journey promises to be a unique but relatable one.

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