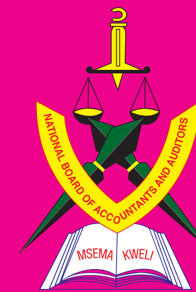
ADVANCED TAXATION

STUDY TEXT

C4

Final Level



THE NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS TANZANIA (NBAA)

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FOREWORD.

The National Board of Accountants and Auditors is a professional body in Tanzania, established under the Auditors and Accountancy Registration Act No 33 of 1972 (CAP 286 R.E.2002). The Board has been charged with among other things, the responsibility to promote, develop and regulate the accountancy profession in the country.

In fulfilling its statutory obligations, NBAA prepares National Accountancy Examination Scheme for students aspiring to sit for Accounting Technician and Professional Examinations. Further, for effective implementation of the examination scheme and improve examination results, the Board provides Study Guides for all subjects to assist both examination candidates and trainers in the course of learning and teaching.

The Study Guides have been prepared in the form of text books with examples and questions to enable the user to have comprehensive understanding of the topics. The Study Guides cover a wide range of topics in the NBAA syllabi and adequately cover the most comprehensive and complete knowledge base that is required by a leaner to pass the respective examination levels.

Furthermore, the Study Guides have been prepared to match with the Competency Based Syllabi to enable the learners to be exposed to practical understanding of issues rather than memorisation of concepts. In this case, the Study Guides are characterized by the following features:-

1. Focus on outcomes – The outcomes shown in every topic provides clear understanding on what to be learnt.

2. Greater workplace relevance – the guides emphasize on the importance of applying knowledge and skills necessary for effectively performance in a work place. This is different from the traditional training where much concern has been expressed in theoretical perspectives.

3. Assessments as judgments of competence – The assessment questions embedded in the Study Guides are adequate measures of understanding of the subject matter.

Study Guides are also useful to trainers specifically those who are teaching in the review classes preparing learners to sit for the professional examinations. They will make use of these Study Guides together with their additional learning materials from other sources in ensuring that the learners are getting sufficient knowledge and skills not only to enable them pass examinations but also make them competent enough to perform effectively in their respectively workplace.

NBAA believes that these standard Study Guides are about assisting candidates to acquire necessary skills and knowledge that will enable them to perform as professionals. The outcomes to be achieved are clearly stated so that learners may know exactly the skills and knowledge they are supposed to acquire in a particular topic.

NBAA wishes all the best to NBAA Examination candidates, trainers in their review classes, lecturers in the higher learning institutions and all other beneficiaries of these learning materials in making good use of the Study Guides towards promoting the accountancy profession in Tanzania.

CPA. Pius A. Maneno
EXECUTIVE DIRECTOR
JUNE, 2019

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C4 – Advanced Taxation

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Features of the book

‘The book covers the entire syllabus split into various chapters (referred to as Study Guides in the book). Each chapter discusses the various Learning Outcomes as mentioned in the syllabus.

Contents of each Study Guide

‘Get Through Intro’: explains **why** the particular Study Guide is important through real life examples.

‘Learning Outcomes’: on completion of a Study Guide, students will be able to understand all the learning outcomes which are listed under this icon in the Study Guide.

The Learning Outcomes include:

‘Definition’: explains the meaning of important terminologies discussed in the learning Outcome.

‘Example’: makes easy complex concepts.

‘Tip’: helps to understand how to deal with complicated portions.

‘Important’: highlights important concepts, formats, Acts, sections, standards, etc.

‘Summary’: highlights the key points of the Learning Outcomes.

‘Diagram’: facilitates memory retention.

‘Test Yourself’: contains questions on the Learning Outcome. It enables students to check whether they have assimilated a particular Learning Outcome.

Self Examination Questions’: exam standard questions relating to the learning outcomes given at the end of each Study Guide.

EXAMINATION STRUCTURE

The syllabus is assessed by a three hour paper based examination. T

Section A	One compulsory question (covering a range of syllabus content)	40 marks
Section B	Three questions out of Five	60 marks

SECTION A

INCOME TAXATION RULES APPLICABLE TO PARTICULAR TYPES OF PERSONS/BUSINESS

A1

STUDY GUIDE A1: COMPUTATION OF CORPORATE BUSINESS INCOME

Get Through Intro

To calculate total income of a person, one needs to calculate the sum of chargeable income from conduct of employment, business and investment. In this Study Guide you are introduced to computation of chargeable income from business of corporate business, the guide also explain the general and specific principles of deductions. As final points the guide discuses procedures for calculation of gain or loss on realization of business assets and liabilities and procedures for computation of depreciation allowances

Learning Outcomes

a) Compute corporate business income for tax purposes.
b) Explain the general and specific rules of deductions.
c) Explain the rules relating to calculation of gain/loss of assets and liabilities
d) Describe depreciation allowances according to the 3rd schedule.

1. Compute corporate business income for tax purposes and explain the general and specific rules of deductions. [Learning outcome a and b]

1. Corporate Business Income For Tax Purposes.

Definition

Business

'Business' includes a **trade**, concern in the nature of trade, **manufacture**, **profession**, **vocation** or isolated arrangement with a business character; and a past, present or prospective business, but excludes employment and any activity that, having regard to its nature and the principal occupation of its owners or underlying owners, is not carried on with a view to **deriving profits**.

1.1 Items of income included in calculating chargeable income from business

Business income items which are chargeable

Income in connection with businesses income (contract for service) means:

a) service fees;
b) incomings for trading stock;
c) gains from the realisation of business assets or liabilities of the business
d) Gains from realisation of the person's depreciable assets of the business;
e) amounts derived as consideration for accepting a restriction on the capacity to conduct the business;
f) gifts and other ex gratia payments received by the person in respect of the business;
g) amounts derived that are effectively connected with the business and that would otherwise be included in calculating the person's income from an investment; and
h) Other amounts including reverse of amounts as bad debts, bad debts writing off, discount allowed, fluctuations in foreign exchanges and seizures of untaken deposits and advances (Section 8(2)).

1.2 Excluded business income

According to Section 8(3) of the Income Tax Act 2004, exempt business income, final withholding payments and non-business income should be excluded in computing business income. Both exempt income and final withholding income items were covered in the employment income Section. So in this Section they are not discussed. Please take time to peruse them. In addition receipt from realisation of capital assets should be excluded as well because they are used in computing gain from realisation of assets.

1.3 Calculate chargeable income from business

By now we have learnt that not all income from business are taxable, some are final withholding payments, some are exempt income and some simply not related to business. Also we saw how to identify allowable deductions and non-deductible expenses when computing business income. This Section deals with how to establish chargeable income from business. The business income of sole trade is can be computed on cash or accrual basis unless specifically required by tax laws, while corporations compute their business income on accrual basis.

Definition

'Chargeable business income' of resident person, includes all his or her income for the year of income irrespective of the source of the income, while chargeable income of non-resident persons income only to the extent that the income has a source in the United Republic. Finally, chargeable income of a resident corporation which has perpetual unrelieved loses for the last consecutive two years is the turnover of such corporation for a year of income, expect those in agriculture, health or education businesses.

However, all business persons prepare their accounting records using General Accepted Accounting Practices (GAAPs). So for tax purposes, we do not establish new financial statements. But we adjust profit or losses shown by the accounting statements by adding items which are not taken into accounting by GAAPs and deducting items which are not allowed by tax laws but included by the GAAPs. The statement below can help us when computing taxable employment income.

Computation of Chargeable Business Income

Items		**TZS**
Profit or loss as per account		XX
Add: None allowable expenses		
• Consumption expenditure	xx	
• Excluded expenditure	xx	
• Capital expenditure	xx	xx
Add: Business income not included		
• Compensation	xx	
• Loss on realization of business assets/liabilities	xx	xx
Less: Non taxable business income		
• Final withholding payments	xx	
• Gain on disposal of fixed assets	xx	(XX)
Less: Business expenses not deducted		
• Capital allowances	xx	(XX)
Taxable business income		XX

2. General And Specific Rules Of Deductions

2.1 General principles of deduction

Then after knowing elements which constitute business income the next step is to understand deductible corporate business expenses. In fact it is very important to understand these allowable expenses because they affect how much is left for business/investment income taxes.
In general all expenses incurred 'wholly and exclusively' in the production of income are allowable expenses (Section 11(3)). Therefore, only expenditure incurred for sole purposes of producing business are allowable expenses and expenditure incurred not wholly and exclusively for business purposes are not allowable.

However, deduction of capital, consumption and excluded expenditures is not allowed (Section 11). Yet, the capital expenditures on depreciable assets are deductible in form of depreciable annual allowance under the third schedule Income Tax Act Cap 332. Therefore, depreciation charges calculated under taxpayers' accounting policies are not allowed too.

Definitions

'**Consumption expenditure**' means any expenditure incurred by any person in the maintenance of himself, his family or establishment, or for any other personal or domestic purpose.

"**Expenditure of a capital nature**" means expenditure that secures a benefit lasting longer than twelve months;"
'**Excluded expenditure**' means:

a) tax payable under this Act except skills and development;
b) bribes and expenditure incurred in corrupt practice;
c) fines and similar penalties payable to a government or a political subdivision of a government of any country for breach of any law or subsidiary legislation;
d) expenditure to the extent to which incurred by a person in deriving exempt amounts or final withholding payments;
e) distributions by an entity or

2.2 Specifically allowable deductions.

(a) Interest expense

Interests bearing external financing activities are normal in any business or investment venture. Therefore, Interest incurred by a person during a year of income under a debt obligation shall be considered to have been incurred wholly and exclusively in the production of income from a **business or investment** if the debt obligation was incurred wholly and exclusively in the production of income from the business or investment. Likewise, interest incurred on non-monetary debts is also deductible when the debt obligation was incurred wholly and exclusively in the production of income from the business or investment (Section 12(1)(b)). However, when interest incurred on foreign currency debt obligation is deductible only when they are actually paid (39(g)).

Nevertheless, interest expenses incurred wholly and exclusive in production of **business or investment** income for exempt controlled resident entity are restricted. In fact, interest expenses deducted by an exempt-controlled resident entity must not exceed sum of interest equivalent to debt-to-equity ratio of 7 to 3 (Section 12(2). In case of changes in debt or equity amounts; the amount of the equity or debt should be the average of balances of amount of debt or equity at the end of each period (Section 12(4)).

Definitions

‘An exempt-controlled resident entity’ for a year of income if it is resident and at any time during the year of income 25% or more of the underlying ownership of the entity is held by entities exempt under the Second Schedule, approved retirement funds, charitable organisations, non-resident persons or associates of such entities or persons.

Section 12(4)

‘Debt’ means any debt obligation excluding: a non-interest bearing debt obligation, a debt obligation owed to resident financial institution and a debt obligation owed to a non-resident bank or financial institution on whose interest tax is withheld in the United Republic. While

‘Equity’ includes: paid up share capital, paid up share premium and retained earnings on an unconsolidated basis determined in accordance with generally accepted accounting principles.

Section 12(5)

‘Period’ means a month or part of month

Section 12(5)

‘Parastatalorganisation’ means: a local authority of the United Republic, a body corporate established by or under any Act or Ordinance of the United Republic other than the Companies Act, and any company registered under the Companies Act where –

a) in the case of a company limited by shares, not less than 50 percent of the issued share capital of the company is owned by the Government or an organisation which is a parastatal organisation under this definition; or
b) in the case of a company limited by guarantee:
   i] the members of the company include the Government or an organisation which is a parastatal organization under this definition; and
   ii] such members have undertaken to contribute not less than 50 percent of the amount to be contributed bymembers in the event of the company being wound up.

Section 12(5)

(b) Trading stock allowance

Costs of goods sold are tax deductible **business** expenses. They are calculated by taking the opening value of trading stock of the business for the year of income; plus expenditure incur red by the person during the year of income that is included in the cost of trading stock of the business; less the closing value of trading stock of the business for the year of income (Section 13(2)). The closing stock should be valued at the lower of the cost of the trading stock of the business at the end of the year of income; or the market value of the trading stock of the business at the end of the year of income (Section 13(4).

Definition

The opening value of trading stock of a business for a year of income is the closing value of trading stock of the business at the end of the previous year of income.

Section 13(3)

(c) Repair and maintenance expenditure

Revenue expenses incurred on repair and maintenance of **depreciable assets** owned and employed by the person wholly and exclusively in the production of income from the **business** are deductible. But, expenditures incurred to improve lives of assets or repairs and maintenance of capital nature should be capitalised in the costs of assets rather than be deducted as revenue expenses (Section (14)(2)).

(d) Agriculture improvement, research development and environmental expenditure

Agriculture improvement, research development and environmental expenditure are deductible expenses when incurred for **business** purposes (Section 15 (1)). In addition mining business might make a provision allowance account under environmental expenditure and apply for their deductions to the Commissioner; if approved they become deductible expenses (Section 15(3)).

Definitions

‘**Agricultural improvement expenditure’** means expenditure incurred by the owner or occupier of farm land in conducting an agriculture, livestock farming or fish farming business where the expenditure is incurred in clearing the land and excavating irrigation channels; or planting perennial crops or trees bearing crops.

‘Environmental expenditure’ means expenditure incurred by the owner or occupier of farmland for prevention of soil erosion”;
‘Research and development expenditure’ means expenditure incurred by a person in the process of developing the person's business and improving business products or process and includes expenditure incurred by a company for the purposes of an initial public offer and first listing on the Dar es Salaam Stock Exchange but excludes any expenditure incurred that is otherwise included in the cost of any asset used in the use in any such process, including an asset referred to in paragraph 1(3) of the Third Schedule .

From definitions of agriculture improvement expenditure, the expenditure can be deducted by a person conducting agriculture business while, environmental expenditure are deductible by both those in agriculture for the reason explained in the definitions. Finally, the research and development expenditure can be deducted by any type of business.

Definition

‘Agricultural business’ means the practice of rearing of crops or animals including forestry, beekeeping, acqua-culture and faming with a view to deriving a profit but excludes extraction of natural resources o processing of agricultural produce other than preparing such produce for the purpose of sale in its original form.

(e) Contribution and donations

Contribution and donations made by taxpayers are generally not incurred wholly and exclusive for business purposes, then generally all these expenses should not be deducted. However, contribution and donations made under Section 12 of the Education Fund Act and amount paid to local government authority, which are statutory obligations to support community development projects, are deducted 100%. Conversely, deduction of amounted contributed to a charitable institution or social development project should not exceed 2% of the person's income from the business calculated without such deduction (Section 16(2).

'Charitable organisation' means a resident entity of a public character that satisfies the following conditions:

(i) the entity was established and functions solely as an organisation for: the relief of poverty or distress of the public, the advancement of education or the provision of general public health, education, water or road construction or maintenance; and
(ii) the entity has been issued with a ruling by the Commissioner under Section 131 currently in force stating that it is a charitable organisation or religious organisation.

Others donations and contributions can only be deducted if they are incurred wholly and exclusively for the purposes of business. For instance, contributions to trade organisations can be deductible if the trade association furthers the businesses of its members (Lochgelly Iron and Coal Co Ltd v Crawford [1913] 6 TC 267). Similarly, contribution to charitable organisations of clothes with businesses' advertisements or to support exhibition might qualify as deductible expenses (Morley v Lawford [1928] 14 TC 229). Also costs incurred on businesses entertainment for the purposes of business might be allowable expenses (Bentleys Stokes &Lowless v Beeson [1952] 33 TC 491).

(f) Depreciation allowances for depreciable assets

Depreciation allowance for depreciable assets owned and employed by the person during the year of income wholly and exclusively in the production of the person's income from the business the allowances granted under the Third Schedule of the Income Tax Act Cap 332 is allowable expenses (Section 17); this part is covered in the next Section. So, depreciable allowance of depreciable assets basing on taxpayer's accounting policies is not deductible.

(g) **Losses on realisation of business assets and liabilities**

Losses from realisation of a business asset of the business that is or was employed wholly and exclusively in the production of income from the business; a debt obligation incurred in borrowing money, where the money is or was employed or an asset purchased with the money is or was employed wholly and exclusively in the production of income from the business; or a liability of the business other than a debt obligation incurred in borrowing money, where the liability was incurred wholly and exclusively in the production of income from the business are all deductible expenses (Section 18).

(h) **Losses from a business or investment**

Similarly losses incurred by businesses with exceptional of partnership or a foreign permanent establishment are deductible expenses. These losses include any unrelieved loss of the year of income of the person from any other business and any unrelieved loss of a previous year of income of the person from any business (Section 19(1)).

Additionally, unrelieved losses from other foreign source losses can be deducted only in calculating the person's foreign source income and unrelieved loses from agriculture business can only be deducted from calculating business income from agriculture.

Definition

'Loss' of a year of income of a person from any business or investment is the excess of amounts deducted in calculating the person's income from the business or investment over amounts included in calculating such income.

'**Unrelieved loss'** means the amount of a loss that has not been deducted in calculating a person's income.

(i) Capital receipts

Proceeds from sale of depreciable assets would be treated in computation of gain from realisation of depreciable assets as required in the schedule of the Income Tax Act ,Cap 332. Likewise, receipts from disposal of investment income should be used in calculating investment capital gain and the investment income not in computing business income.

(j) Foreign currency exchange gain

Gain or loses from foreign exchanges if related to business transactions are taxable income and deductible expenses respectively. Yet the computation of foreign exchange gains should be done when there is actual receipt of the foreign currency. Because it is at that point the foreign currency debt is realised (Section 40(2) (c)). Nevertheless exchange gains or losses on translation of foreign owned operation are not allowed.

(k) Insurance claims

When there are receipts from insurance compensation relating to depreciable assets; they should be treated as incoming from realisation of the depreciable assets and used from computation of gain or loss from realization of depreciable assets. Also insurance compensation relating to investment assets are used in computing capital loss or gain from that investment assets. However, any receipt of insurance against current assets, business losses and other accident are taxable business income.

(l) Legal and accountancy charges

Expenses incurred in preparation of financial accounts and tax returns are generally allowable expenses.

However, legal and expenses incurred in tax appeal are not deductible (Smiths Potato Estates Ltd v Bolland1948 30 TC 267). In that case, the judge argued that they not incurred wholly and exclusive in production of income but in ascertaining tax liabilities therefore the expense were disallowed.

(m) Business entertainment and gifts

Expenses and gifts incurred in entertaining employees in relationship to their employment are generally allowed as they constitute employment income. But, those expenses incurred for non-employee persons are disallowed expenditures if they are not wholly and exclusively incurred for businesses purposes.

(n) Pension scheme contributions and other employee benefits

Payment made to both approved and unapproved pension schemes and other employee' benefits are deductible businesses expenses so long as they payments are included in calculations of employment income (Income Tax Regulation 4). In addition, any employment benefits as training costs and redundancy incurred by employers are deductible expenses provided they are included in employees' income.

(o) Legal and other expenses

Legal and other expenses in connection with normal business or investment activities and they are incurred wholly and exclusive for business purpose are deductible expenses. However, those expenses incurred in connection of acquisition of capital assets should be capitalised in the costs of assets and therefore they are not deductible expenses (Section 37).

(p) Other losses and defalcations

Only losses from business or investment activities incurred wholly and inclusive for businesses purposes are allowable expenditures. These losses might include fire, burglary, accident and loss of profits and when there is insurance against them insurance costs are deductible too. However, losses arising from loss of capital assets are not straight deductible from business income. They have either to go to the computation of gain or loss from realisation of business, depreciable or investment assets. But, insurance expenses against depreciable assets are allowable expenses.

On the other hand, when employees defraud their employers the loss incurred is deductible expenses, while defalcations by directors, sole traders or partners in partnership are not deductible (Curtis v J & G Oldfield Ltd [1925] 9 TC 319). In this case, the judge argued that misappropriations of assets by persons in control of businesses are allocations of profit of the businesses not trade activities of the businesses; therefore these losses are not deductible.

(q) Bad and doubtful debts

Businesses' bad debts of revenue nature are deductible expenses when they become bad and actually written off (Section 25(4); Section 39). Therefore, general provision for doubtful debts is not deductible expenses. Yet, provision for specific doubtful debt may be allowed. Furthermore, a bad debt arising out of business or investment activities and its associated costs is not allowable (Curtis v J & G Oldfield Ltd [1925] 9 TC 319).

2. Explain the rules relating to calculation of gain/loss of assets and liabilities; and describe depreciation allowances according to the 3rd schedule. [Learning outcome c and d]

3. Rules Relating To Calculation Of Gain/Loss Of Assets And Liabilities

The need to calculate gains or losses on realisation of assets or liabilities for taxation purposes is established in many provisions of the Income Tax Act, Cap 332. e.g section 8 (2) (c) requires the inclusion of gains from the realisation of business assets or liabilities of the business in calculating a person's gains or profits from conducting a business for a year of income. While section 18 grant the deduction in respect of any loss of the person, from the realisation during the year of income of :-

(a) a business asset of the business that is or was employed wholly and exclusively in the production of income from the business;
(b) a debt obligation incurred in borrowing money, where the money is or was employed or an asset purchased with the money is or was employed wholly and exclusively in the production of income from the business; or
(c) a liability of the business other than a debt obligation incurred in borrowing money, where the liability was incurred wholly and exclusively in the production of income from the business.

3.1 Calculation of gain (loss):

- a person's gain from the realization of an asset or liability is the amount by which the sum of the incomings from the asset or liability exceeds the cost of the asset or liability at the time of realization
- a person's loss from the realization of an asset or liability is the amount by which the cost of asset or liability exceeds the sum of the incomings (amount received) for the asset or liability at the time of realization

3.2 Net gains from the realization of investments assets

Section 36(3) provides the basis of calculating net gains from the realization of investment assets of an investment of a person for a year of income. The net gains are the sum of all gains from the realization of investment assets of the investment during the year reduced by:-

(a) The total of all losses from the realization of investment assets of the investment during the year
(b) Any unrelieved net loss of any other investment of the person for the year; and
(c) Any unrelieved net loss for a previous year of income of the investment or any other investment of the person.

Example

Mr. Mapana a resident individual owns various investment assets, including shares in companies A, B, C and D and interest inland and buildings. During the year of income he disposes of some of his shares in the companies as indicated below. Calculate the net gain received on realization of those shares.

Coy shares	**Sale Price**	**Cost**	**Gain/(Loss)**
Coy A shares	TZS. 17,000,000	TZS. 15,800,000	TZS. 1,200,000
Coy B shares	TZS. 26,100,000	TZS. 25,000,000	TZS. 1,100,000
Coy C shares	TZS. 18,000,000	TZS. 18,200,000	TZS. (200,000)
Coy D shares	TZS. 16,400,000	TZS.16,500,000	TZS. (100,000)

Unrelieved net loss from realization of investment assets previous year 200,000

Calculation of net gains from the realization of investment assets of an investment of a person for a year of income is calculated as illustrated in the following example:- (All companies are resident in the United Republic)

Gains obtained from sale of shares in Company **A**	TZS.	1,200,000/=
Gains obtained from sale of shares in Company **B**	TZS.	1,100,000/=
Total	**TZS.**	**2,300,000/=**
Less: Total losses from realization of investment asset		
Loss obtained from sale of shares in company **C**	200,000	
Loss obtained sale of shares in company **D**	100,000	
	300,000	
Less: Unrelieved net loss from realization		
of investment assets previous year	200,000	
		500,000/=
Gains to be included in calculating total income (S. 9(2) (b)) Shs.		**1,800,000/=**

The sum of losses incurred in realization of the shares in companies C and D are set off against the gains derived from the realization of shares in companies A and B.

3.3 Realization of Assets

Realisation of assets is dealt with Section 39. According to this Section an asset is said to have been realized when:

a) the person parts with ownership of the asset including when the asset is sold, exchanged, transferred, distributed, cancelled, redeemed, destroyed, lost, expired or surrendered. This part does not apply to assets of deceased individuals.
b) in the case of an asset of a person who ceases to exist, excluding a deceased individual, immediately before the person ceases to exist;
c) in the case of an asset other than a Class 1, 2, 3, 5, 6 or 8 depreciable asset or trading stock, where the sum of the incomings for the asset exceeds the cost of the asset;
d) in the case of an asset that is a debt claim owned by a financial institution, when the debt claim becomes a bad debt as determined in accordance with the relevant standards established by the Bank of Tanzania and the institution writes the debt off as bad;
e) in the case of an asset that is a debt claim owned by a person other than a financial institution, the person reasonably believes the debt claim will not be satisfied, the person has taken all reasonable steps in pursuing the debt claim and the person writes the debt off as bad;
f) in the case of an asset that is a business asset, depreciable asset, investment asset or trading stock, immediately before the person begins to employ the asset in such a way that it ceases to be an asset of any of those types;
g) in the case of a foreign currency debt obligation, when such debt is actually paid;
h) in the case of an asset owned by an entity whose the underlying ownership of an entity changes by more than 50% as compared with that ownership at any time during the previous three years, the entity would be treated as realising any assets owned by it immediately before the change.

From the definition of realisation of assets above, it can be said that an asset is realised when it is written off from accounting records because of transaction that lead to transfer of risks and rewards associated with the asset. Also, realisation of assets occurs when a transaction leads to reduction of value of assets because of significant change in risks and rewards over an asset there is realisation of the assets. However, decrease in value of assets because of depreciation or impairment loss does not result in realisation of assets because the decrease does no result from transaction. Yet, besides realisation of assets through transactions it is possible to realise an asset on occurrence of events like fire, thieves and others mentioned above.

Definition

'Underlying ownership', in relation to an entity, means membership interests owned in the entity, directly or indirectly through one or more interposed entities, by individuals or by entities in which no person has a membership interest; or in relation to an asset owned by an entity, means the asset owned by the persons having underlying ownership of the entity in proportion to that ownership of the entity.

Section 3 of ITA, 2004

'Asset' means a tangible or intangible asset and includes currency, goodwill, know-how, property, a right to income or future income and a part of an asset.

Section 3

'Corporation' means any company or body corporate established, incorporated or registered under any law in force in the United Republic or elsewhere, an unincorporated association or other body of persons, a government, a political subdivision of a government, a parastatal organisation, a public international organisation and a unit trust but excludes a partnership.

Section 3

'Business asset' means an asset to the extent to which it is employed in a business and includes a membership interest of a partner in a partnership but excludes:

a) trading stock or a depreciable asset;
b) an interest in land held by an individual that has a market value of less than 10 million shillings at the time it is realised and that has been used for agricultural purposes for at least two of the three years prior to realisation;
c) the beneficial interest of a beneficiary in a resident trust; and
d) shares and securities listed on the Dar es Salaam Stock Exchange that are owned by a resident person or by a non-resident person who either alone or with other associates controls less than 25% of the controlling shares of the issuer company.

Section 3

'Depreciable asset' means an asset employed wholly and exclusively in the production of income from a business, and which is likely to lose value because of wear and tear, obsolescence or the passing of time but excludes goodwill, an interest in land, a membership interest in an entity and trading stock.

Section 3

'Entity' means a partnership, trust or corporation.

Section 3

'Foreign currency debt claim' means a debt claim that is denominated in a currency other than Tanzanian shillings.

Section 3

On the other hand realisations of liabilities are regulated by Section 40(2) of the Income Tax Act 2004. Actually liabilities of a person are deemed realised when:

a) the person ceases to owe the liability including when the liability is transferred, satisfied, cancelled, released or expired. This part does not apply to liabilities of deceased individuals
b) in the case of a liability of a person who ceases to exist, excluding a deceased individual, immediately before the person ceases to exist;
c) in the case of a foreign currency debt obligation, when such debt is actually paid.
d) in the case of a liability of an entity whose underlying ownership of an entity changes by more than 50% as compared with that ownership at any time during the previous three years, the entity is treated as realizing any liabilities owed by it immediately before the change; and

e) in the case of a liability owed by a resident person, immediately before the person becomes a non-resident person, other than liabilities owed by the person through a permanent establishment situated in the United Republic immediately after becoming non-resident.

3.4 Incomings from realisation of assets and incurring liabilities

Specifically, incomings from realisation of an asset of a person means amounts derived by the person in respect of owning the asset including amounts derived from altering or decreasing the value of the asset; and amounts derived under the asset including by way of covenant to repair or otherwise; and amounts derived or to be derived by the person in respect of realising the asset (Section 38). While the incoming from incurring liabilities are the amount derived from incurring the liability (Section 40(1) (b)).

Definition

'Amount derived' means a payment received by a person or that the person is entitled to receive;- Section 3

Example

Robots and Assembler Design makers borrowed money from a bank for the purpose of her business. The loan amount was Tshs14,000,000 but she received Tshs10,000,000 after deduction of bank charges and loan insurance.

Required:

Determine the incoming from incurring the business liability.

Answer

The incoming of liability is the amount received or to be received from the loan, in this case the incoming is Tshs10,000,000.

3.5 Costs of assets and liabilities

Costs of assets or liabilities represent its monetary values. According to Section 37 and Section 40 costs of assets or liabilities constitute a total of:

(i) expenditure incurred by the person in acquiring the asset including, where relevant, expenditure of construction, manufacture or production of the asset;
(ii) expenditure incurred by the person in altering, improving, maintaining and repairing the asset;
(iii) expenditure incurred by the person in realising the asset or liabilities;
(iv) incidental expenditure incurred by the person in acquiring and realising the asset or liability; and
(v) any amount to be directly included in calculating the person's income; or that is an exempt amount or final withholding payment of the person; but excludes consumption expenditure, excluded expenditure and expenditure to the extent to which it is directly deducted in calculating the person's income or included in the cost of another asset or liability.

Furthermore, the cost of trading stock should not include repair, improvement or depreciation of depreciable assets; and determined under the absorption-cost method (Section 37(1)).

Furthermore, trading stocks should be valued consistently using either the first-in-first-out method or the average-cost method, and these method can be used valuating non-trading stock fungible assets (Section 37(2)).

Definitions

'Absorption-cost method' means the generally accepted accounting principle under which the cost of trading stock is the sum of direct asset costs, direct labour costs and factory overhead costs.

Section 37(7)

'Depreciable asset' means an asset employed wholly and exclusively in the production of income from abusiness, and which is likely to lose value because of wear and tear, obsolescence or the passing of time but excludes goodwill, an interest in land, a membership interest in an entity and trading stock.

Section 3

'Incidental expenditure' incurred by a person in acquiring or realising an asset or liability includes: advertising expenditure, taxes, duties and other expenditure of transfer; and expenditure of establishing, preserving or defending ownership of the asset or liability, and the expenditure referred to any related remuneration for the services of an accountant, agent, auctioneer, broker, consultant, legal advisor, surveyor or valuer Section 37(7)

Example

The following information relates to the production of certain trading stocks. Your duty is to determine the costs of a single stock if 100,000 of them were produced.

Raw materials Tshs6,000,000

Labor Tshs2,000,000

Depreciation costs Tshs700,000

Repairs Tshs1,000,000

Other factory overhead Tshs2,000,000

The costs of trading stocks should not include depreciation or repair costs, so the cost of producing that batch was Tshs10,000,000. Using average cost method the cost of a single stock would be Tshs100.

Still, the costs of inherited assets from deceased individuals are the market values of that asset at the time of such acquisition (Section 37(4)). Likewise, a cost of non-domestic asset of a person who becomes a resident of the United Republic for the first time is the market value of the asset immediately before becoming a resident (37(5)).

3.6 Special Rules On Deemed Disposal

There are times when although no disposal has actually taken place a person is deemed to have disposed of an asset (taxation concept only). There are special ways of determining costs and incoming of assets resulting from deemed realisation of assets as discussed below:

1. **Realisation with retentiaon of asset**
   When, a person realises an asset of the business in any of the manners described in (d) to (h) above, the realisation is name realisation with retention of assets. However, the person is treated as having parted with ownership of the asset and deriving an amount in respect of the realisation equal to the market value of the asset at the time of the realisation; and the person is treated as reacquiring the asset and incurring expenditure of the same amount (Section 42).
2. **Transfer of asset to spouse or former spouse**
   When there is transfer of assets to spouse or former spouse because of divorce settlement or bona fide separation agreement, an individual transferring the assets is treated as deriving an amount in respect of the realisation equal to the net cost of the asset immediately before the realisation; and the spouse or former spouse receiving the assets is treated as incurring expenditure of the same amount in acquiring the assets (Section 43). However, this Section works on at the discretion of the couple and the couple should apply for this application in writing (Section 43).

   Example
   During the year Mr. Kashumba , divorced his wife, by Court Order he was instructed to transfer some of investments to his wife. He decided to transfer the following

Land costing Tshs 2,000,000 purchased on 2010, compound wall was constructed for Tshs. 200,000. The compound wall had damaged due to flood and repair cost Tshs 100,000 on 20X3. The neighbor land owner paid Tshs 50,000 for a small piece to make boundary straight.

Net cost

In this case, cost= 2,300,000 (2,000,000+200,000+100,000) and incomings is Tshs. 50,000.

Net Cost is the actual investment of asset at any particular point of time.

i) Net Cost is

	Tshs.
Cost	2,300,000
Less: Incomings	(50,000)
Net Costs	2,250,000

ii) Incoming =Net cost
Therefore Incoming = Tshs 2, 250,000

Gain (loss) =2,250,000-2,250,000=0

Note

The net cost of an asset is the deemed consideration on the disposal by the transferor

3. **Transfer of asset to an associate or for no consideration**
   Except in divorce settlement, any transfer of asset to an associate or for no consideration is treated as realisation of assets at the greater of the market value of the asset or the net cost of the asset immediately before the realisation; and the recipient is treated as acquiring the assets at the same value (Section 44(1)).

Nevertheless, when the transfer involves business asset, depreciable asset or trading stock, by way of transfer of ownership of the asset to an associate of the person and

a) either the person or the associate is an entity;
b) the asset or assets are business assets, depreciable assets or trading stock of the associate immediately after transfer by the person;
c) at the time of the transfer the person and the associate are residents; and the associate or, in the case of an associate partnership, none of its partners is exempt from income tax;
d) there is continuity of underlying ownership in the asset of at least 50 %; and
e) both the person and the associate in writing applied to use this method.

The person making the transfer is treated as deriving an amount in respect of the realisation equal to the net cost of the asset immediately before the realisation and the associate acquiring the assets at the same value (Section 44(2)).

Definitions

'Net cost of a depreciable asset' at the time of its realisation is equal to its share of the written down value of the pool to which it belongs at that time apportioned according to the market value of all the assets in the pool .

Section 44(3)

'Associate' in relation to a person, means another person where the relationship between the two is :

a) that of an individual and a relative of the individual, unless the Commissioner is satisfied that it is not reasonable to expect that either individual will act in accordance with the intentions of the other;
b) that of partners in the same partnership, unless the Commissioner is satisfied that it is not reasonable to expect that either person will act in accordance with the intentions of the other;
c) that of an entity and:
   i] a person who either alone or together with an associate or associates under another application of this definition; and whether directly or through one or more interposed entities, controls or may benefit from 50 percent or more of the rights to income or capital or voting power of the entity; or
   ii] under another application of this definition, is an associate of a person to whom subparagraph (i) applies; or
d) in any case not covered by paragraphs (a) to (c), such that one may reasonably be expected to act, other than as employee, in accordance with the intentions of the other.

Section 3

4. **Involuntary realisation of asset with replacement**

   In case of involuntary realisation of assets either by involuntary sell, exchange, transfer, distribution, cancellation, redeem, destroy, loss, expiry or surrender and replace the asset involuntary realised within a year; the person can be assumed deriving an amount in respect of the realisation equal to: the net cost of the asset immediately before the realisation; plus the amount, if any, by which amounts derived in respect of the realisation exceed expenditure incurred in acquiring the replacement asset. Addition, the person is assumed incurring expenditure in acquiring the replacement asset equal to the net cost of the asset immediately before the realisation plus the amount, if any, by which expenditure incurred in acquiring the replacement asset exceed amounts derived in respect of the realisation (Section 45). Yet, this Section applies only to taxpayers who apply to the Commissioner to use it.

5. **Realisation by separation**

   Excluding where an asset is transferred under finance lease where the parties derive and incur market value of assets immediately before transfer of the assets (Section 32(5)); where rights or obligations with respect to an asset owned by one person are created in another person including by way of lease of an asset or part thereof, permanently the person is treated as realising part of the asset but is not treated as acquiring any new asset or liability; and when the creation is temporary or contingent, the person is not treated as realising part of the asset or liability but as acquiring a new asset (Section 46).

Definition

'Lease' means an arrangement providing a person with a temporary right in respect of an asset of another person, other than money, and includes a licence, profit-a-prendre, option, rental agreement, royalty agreement and tenancy.

Section 3

3.7 Apportionment of costs and incomings of assets

Apportionment problem happens when multiple assets are transferred at the same time or in a single deal/price.

In that case, we might be interested in knowing the costs of individual assets. According to Section 47 when multiple assets are acquired or realised the market values of assets at the time of acquisition should be used to apportion the amount incurred or derived. While, when an asset is partly realised the net cost of the asset immediately before the realisation should be apportioned between the parts of the asset realised and the part retained according to their market values immediately after the realisation (Section 47(3).

Example

Robots and Assembler Design Ltd acquired the following assets after paying a single price of Tshs20,000,000:

Asset Market value at the time of acquisition

Car Tshs7,000,000

Tractor Tshs6,000,000

Office furniture Tshs.2,000,000

Required:

Calculate costs of each asset.

Answer

The costs of assets should be apportioned on the market value at the time of acquisition as shown below;

Asset	**Tshs**	**Costs apportioned Tshs**
Car	7,000,000	14,583,333
Tractor	600,000	1,250,000
Office furniture	2,000,000	4,166,667
Total	9,600,000	20,000,000

3.8 Gains from the realisation of businesses assets and liabilities

Now we know what constitute costs of assets or liabilities and incoming from realisation of assets or incurring of liabilities. So we can determine gain from realisation of business assets or liabilities. However, those incomings which are exempt amounts or a final withholding payment or incomings from sales of stocks should be excluded (Section 38). The incomings from sales of trading stocks are excluded in computation of gain from realisation of businesses assets because they are used in the calculation of business income and they are legally not business assets.

Definition

'Gain' from realisation of an asset or liability is the excess of the incomings for the asset or liability over the cost of the asset or liability at the time of realization, Section 36 (1).

Example

Robots and Assembler Design makers disposed a business asset for Tshs2,000,000 after incurring selling costs of Tshs800,000 and transport expenses of 100,000.

Required:

If the cost of the asset was Tshs400,000, determine gain or loss from the realisation of the assets.

Answer

Gain or loss of realisation of assets = Incomings less cost of the assets less realisation expenses. Therefore,

Gain = Tshs2,000,000 – Tshs800,000 – Tshs100,000 - Tshs400,000 = Tshs700,000.

4. Depreciation Allowances According To The 3rd Schedule.

The Income Tax Act, Cap 332, provides that for the purposes of calculating a person's income from any business there shall be deducted in respect of depreciable assets owned and employed by the person during the year of income wholly and exclusively in the production of the person's income from the business, the depreciation allowances granted under the Third Schedule to the Act.

4.1 Depreciable assets

Depreciable asset means an asset employed wholly and exclusively in the production of income from a business, and which is likely to lose value because of wear and tear, obsolescence or the passing of time but excludes goodwill, an interest in land, a membership interest in an entity and trading stock.

Classification of Depreciable Assets

There are 8 classes of depreciable assets as far as Income Tax Act Cap 332. These are as follows:

Class 1

Computers and data handling equipment together with peripheral devices, Automobiles, buses and minibuses with a seating capacity of less than 30 passengers, goods vehicles with a load capacity of less than 7 tonnes; Construction and earth-moving equipment

Class 2

Buses with a seating capacity of 30 or more passengers, heavy general purpose or specialized trucks, trailers and trailer-mounted containers; other self-propelling vehicles, Railroad cars, locomotives and equipment; Vessels, barges, tugs and similar water transportation equipment;Aircraft;Plant and machinery (including windmills, electric generators and distribution equipment) used in manufacturing or mining operations; specialized public utility plant and equipment; and machinery or other irrigation installations and equipment.

Class 3

Office furniture, fixtures, all equipment except for those listed in Class 2, Any asset not included in another Class

Class 4

Natural resource exploration and production rights, Expenditures incurred wholly and exclusively in respect of natural resource prospecting, exploration and development

Class 5

Buildings, structures, dams, water reservoirs, fences and similar works of a permanent nature used in agriculture, livestock farming or fishing farming;

Class 6

Buildings, structures and similar works of permanent nature other than those mentioned in Class 5

Class 7

Intangible assets other than those in Class 4

Class 8

Plant and machinery (including windmills, electric generators and distribution equipment) used in agriculture and electronic fiscal device purchased by a non Value Added Tax registered trader, Equipment used for prospecting and exploration of minerals or petroleum

4.2 Pools of Depreciable Assets

In order to determine depreciation allowance, assets must be added to a pool of depreciable assets. Depreciation allowance is then determined for a pool of assets and not for an individual depreciable asset. There are two types of pools of depreciable assets

(i) General Pools

This is a pool which comprises of all assets of the same class. This means all depreciable assets belonging to, say, class 1 are all pooled to one pool. In this case a class becomes a pool. However, this applies for all classes except class 7 assets and moveable tangible assets used by a person in conducting international transportation business [land, sea, or air] –transporting passengers, mail, livestock or other moveable tangible assets. These assets are pooled using specific pools.

(ii) Specific Pools

In this pooling strategy each individual asset forms a pool of its own different from assets of its class. An asset, say copy rights, plane, bus, vessel, etc, each form its own pool. Therefore, depreciation allowance will be calculated for each copy rights, plane, bus, vessel, etc. All the assets that do not follow general pooling strategy will fall under specific pooling.

4.3 Adding Depreciable Assets in the Pools of Depreciable Assets

Depreciation allowance is charged on depreciable assets which are found within the pool. Depreciable assets outside the pool cannot be charged depreciation allowances. Not every depreciable asset owned by the person qualifies for addition in the pool. There are conditions to fulfil. These are:

i] The depreciable asset must have been employed by the person wholly and exclusively in the production of business income of a person in the year of income.

ii] The person claiming the deduction must be beneficial owner and not the legal owner of the asset. The beneficial owner is the person who incurred the qualifying expenditure to or paid to acquire the depreciable asset.

4.4 Types depreciation allowances

There are 3 types' depreciation allowance charges:

i] Initial Allowance

ii] Annual Allowance

iii] Terminal allowance

4.5 Initial Allowance

There are some depreciable assets which will be granted depreciation allowance immediately when added to the pool of depreciable assets. These depreciable assets are:

i] each item of plant or machinery which

ii] Qualifies to be added in the person's Class 2, 3 or 8 pools of depreciable assets.

There are conditions however for an initial allowance to be granted to these assets. The assets above shall be:

i] used in manufacturing processes and fixed in a factory;

ii] used for providing services to tourists and fixed in a hotel

The amount of depreciation allowance is 50% of the net cost of the asset for assets belonging to class 2 or 3;. In the year in which initial allowance is charged, the asset granted this allowance will not be included in computation of annual allowance. In other words, the asset granted initial allowance will not be added in the pool of depreciable assets until after the preceding year.

The initial allowance granted to a person shall be available in two portions as follows -

i] the first portion shall be available in the year of income in which the asset is added to the person's pool of depreciable assets; and

ii] The remaining portion shall be available during the year of income following that in which the first portion is added.

4.6 Annual Depreciation Allowance

This is the annual charge of depreciation allowance from assets which are already in the pools of depreciable assets.

Depreciation Methods

Depreciation allowance shall be calculated using reducing balance method in the case of Class 1, 2 and 3 pools, and according to straight line method in the case of Class 4, 5, 6 and 7 pools.

Depreciation Formula

The depreciation formula put forward by the Act is the following:

Annual Depreciation Allowance = A x B x C/365

Where -**A** is the **depreciation basis** of the pool at the end of the year of income;

B is the **depreciation rate** applicable to the pool; and

C is the **number of days** in the person's year of income the asset was employed

Depreciation Basis – Reducing Balance Method

Depreciation basis of Class 1, 2, 3 or 8 pools of a person at the end of a year of income is computed as follows:

Depreciation Basis at the end of the year	=	Written Down Value at the start of the year	+	Additions to the Cost of the Asset	-	Incomings for the assets

Where by:

Written Down Value at the start of the year

= Closing Depreciation Basis for last year – Last Year Annual Depreciation

Additions = Cost of assets added in the pool during the year

Incomings = Proceeds from disposal of assets from the pool during the year

Depreciation basis in this case can only be reduced to zero but not below it. If it turns to be negative, then the pool is considered as written-off (non-existent).

Moreover, if the depreciation basis at the end of year is below TZS 1,000,000, the depreciation of the pool shall be equal to the depreciation basis at the end of that year [i.e. the figure below TZS 1,000,000].

Depreciation Basis – Straight Line

According to the Act, the depreciation basis of Class 4, 5, 6 or 7 pools of depreciable assets of a person at the end of a year of income shall be:

Depreciation Basis at the end of the year	=	Depreciation basis at the start of the year	+	Additions to the Cost of the Asset	-	Incomings for the assets

Depreciation basis for these classes can only be reduced to zero but not below it. That means, if the depreciation basis turns to be negative, then it shall instead be reported as zero.

Moreover, if the depreciation basis at the end of year is below TZS 1,000,000, the depreciation of the pool shall be equal to the depreciation basis at the end of that year [i.e. the figure below TZS 1,000,000].

On top of that the annual depreciation allowance granted to a person for a year of income with respect to a Class 4, 5, 6 or 7 pool of depreciable assets shall not exceed the Written Down Value of the pool at the end of the year of income.

Annual Depreciation of the pool ≤ Written Down Value of the pool at the end of the year of income.

Written Down Value for a pool of assets falling under class 4, 5, 6 or 7 is computed as follows:

Ending Written Down Value = Ending Depreciation Basis – Previous Years Accumulated Depreciation

You may notice differences in the Written Down Value formula for Class 4, 5, 6, or 7 pools vs Class 1, 2, 3 or 8 pools shown above.

4.7 Terminal allowances on Pool Disposal

Where the pool of assets is disposed of and the disposal proceeds are less than the tax written down value of the pool of assets, the disposer is entitled to claim the difference as addition allowance; or This allowance is granted in case of pool disposed physically but there is +ve figure of Opening + Addition- Disposal‟, this amount is granted as addition depreciation allowance based on residual concept of transactional tax treatment. If there is -ve figure of „Opening + Addition- Disposal‟, this amount shall be included in Profit or Gain u/s 8(2)(d).

Depreciation Rates

The depreciation rates applicable to each pool are as follows:

CLASS	RATE
1	37.5%
2	25%
3	12.5%
4	20%
5	20%
6	5%
7	1 ÷ useful life
8	100%

The useful life of the asset used in class 7 shall be rounded down to the nearest half year. For example a useful life of 5 years and 3 months shall be rounded down to 5 years, while a useful life of 7 years and 7 months shall be rounded down to 7.5 years.

Addition of Non-Commercial Vehicles

Commercial vehicle means a road vehicle designed to carry loads of more than half a tonne or more than thirteen passengers or a vehicle used in a transportation or vehicle rental business. Where a person acquires a non-commercial road vehicle whose value exceeds TZS 30,000,000, the amount of the expenditure allowed to be

added to the pool in respect of the vehicle shall be only TZS 30,000,000. Any expenditure in excess of TZS 30,000,000 shall not be recognised.

Question 1

TKY LTD is a local company based in Dar es Salaam along Kilwa road. The company deals in selling imported plastic and metal toys wholesale.

The following is the Profit and Loss Account as at 31st December 2018 in respect of the above company.

	Notes	**Tshs.**	**Tshs.**
Gross Profit			41,000,000
Interest on Current account – Azania Bank		350,000	
Dividends from TCC (resident corporation)		400,000	
Gross rent income		250,000	1,000,000
			42,000,000
Less Expenses			
Salaries and wages		5,000,000	
General expenses	**1**	3,600,000	
Telephone and Electricity		1,000,000	
Depreciation	**4**	800,000	
Income Tax		900,000	
Motor car expenses	**2**	5,000,000	
Bad and doubtful debts	**3**	500,000	
Repairs		850,000	
Promotion and advertising	**5**	700,000	18,350,000
Net Profit			**23,650,000** ========

Additional Notes

1. General expenses include the following: -
   (a) Travel expenses for company directors to Ngorongoro Crater to see the wild animals – Tshs.500,000.
   (b) Medical expenses for Utipa H, one of the company directors – Tshs.100,000.

   (c) Legal costs and stamp duty on acquisition of a godown in November, 2016 – Tshs.400,000.
2. It is estimated that $^{1}/_{5}$ of the motorcar expenses represented personal and private use of the manager of the company.
3. Bad and doubtful debts.
   The whole amount represented a provision for bad and doubtful debts.
4. The amount of depreciation included an amount of Tshs.100,000 which is of articles and tools.
5. Promotion and advertising includes a sign board which was installed along Kilwa Road at the cost of Tshs.300,000.
6. The company bought a station wagon car at the cost of Tshs.45,000,000.
7. Tax written down values balances at 1 January 2018 were:-

	Class I Tshs.	**Class III Tshs.**
TWDV as at 1.1.2018	2,400,000	1,700,000

Required

Compute the taxable business income of TKY Ltd. for the year 2018.

Question 2

Kigongo Company Limited was incorporated in Tanzania and commenced its business on 1st February 2018 as a retailer of audio-visual products in Tanzania. It has drawn up its first accounts to 31st December 2018, the draft of which together with the additional information was as follows:

	Notes	Tshs. "000"	Tshs. "000"
Sales	1	950,000	
Dividends	2	5,000	
Interest income	3	12,000	
Contractual penalties	4	5,000	972,000
Expenses:			
Directors fees	5	320,000	
Salaries		300,000	
Interest expenses	6	80,000	
Rent and rates		220,000	
Legal and professional fees	7	20,000	
Contributions to retirement fund	8	15,000	
Depreciation	9	120,000	
Traveling and entertainment		22,000	
Provisions	10	28,000	
Insurance		18,000	
Sundries	11	10,000	1,153,000
Loss for the year			**(186,000)**

Additional notes:

1. Sales figure includes Tshs.1,000,000 for sale of furniture which was used by the company.
2. The company had bought some shares from City Stock Exchange. These were shares of Sungura Cement Company which distributed dividends during the period.
3. The Company earned Tshs.8,000,000 as interest from its bank deposits and another Tshs.4,000,000 from a director to whom the company had extended a personal loan. The Director used the loan to acquire a building in Kenya.
4. The amount was received as a result of a business contract which the other party breached it.
5. Directors fees were paid to the following persons:

Mr A.	Tshs.200,000,000
Mrs A (wife of Mr A)	Tshs.50,000,000
Mr B (Mr A's brother)	Tshs.70,000,000
	Tshs.320,000,000

6. Interest expenses:

Interest paid to bank on overdraft	Tshs.20,000,000
Finance charge on hire purchase agreements	Tshs.50,000,000
Interest on failure to pay previous years' value added taxes	Tshs.10,000,000
	Tshs.80,000,000

7. Legal and professional fees:

Audit fees	Tshs.10,000,000
Legal fees for staff contracts and retirement funds	Tshs.6,000,000
Amount paid to Tender Board members to facilitate winning a bid	Tshs.4,000,000
	Tshs.20,000,000

8. Employees contributions Tshs.7,500,000
   Employer's contributions Tshs.7,500,000
   Tshs.15,000,000

   The contributions were made to an approved retirement fund.

9. The company acquired the following assets:
   On 15th February 2018 - Furniture and equipment Tshs.100,000,000
   On 15th February 2018 - Computers and accessories Tshs.300,000,000
   On 1st September 2018 - Motor car (station wagon) Tshs.200,000,000

   The computers were acquired on hire purchase terms for 12 months. The down payment of Tshs.120,000,000 was made on 15th February 2018 and the first monthly instalment of Tshs.20,000,000 was due on 15th March 2018. The cash price of the computers was Tshs.300,000,000.

10. Provision for debtors (specific) Tshs.11,000,000
    Provision repairs (estimated) Tshs.8,000,000
    Provision for stock obsolescence Tshs.9,000,000
    Tshs.28,000,000

11. Sundries included a traffic fine of Tshs.3,500,000. The balance was general consumables used by the office.

Required:
Based on the information available, determine the taxable income of Kigongo Company Limited and its tax liability for the year of income 2018.

Question 3
The following information relates to Black Berry Trader (T) Ltd. for the year ended on 31st March 2019. All figures are in 000's.

Sales			283,165
Factory cost of sales			127,337
Factory profit			155,382
Expenses:	General administration	37,021	
	Marketing	28,197	
	Distribution	16,031	
	Financial	22,000	103,249
			52,583
	Non-sales revenue		14,723
	Profit before tax		67,306
	Corporation tax		30,000
	Profit after tax		37,306
	Dividends paid and proposed		23,000
	Retained profits for the year		14,306
Additional information:			
Factory cost of sales includes:			
	Depreciation		17,832
	Partitioning works office		3,179
	Repairs to new premises		1,621
General expenses include:			
	Legal costs of tax appeal		627
	Legal costs of share issue		175
	Stamp duty – property		1,200

	Fine on employees' motor vehicles		250
Marketing expenses include:			
	Trade debts written off		1,211
	Loan to employee written off		250
	Increase in general bad debt provision		5,000
	Increase in specific bad debt provision		1,000
	Promotion gifts,		1,800
	Advertising on TV		6,000
Financial expenses include:			
	Bank interest		1,100
	Bank charges		238
	Donation to political party		250
	Subscriptions to trade associations		1,250
	Redundancy payments		11,000
Non-sales revenue comprises:			
	Profit on sale of assets		323
	Bad debts recovered		1,700
	Agency commission		12,700

Required:
Compute the adjusted profits and tax, ignore capital allowance:
Question 4

Bagachwa Ltd, a resident company, always prepares accounts for all the years it has been in business.

The company recently received a letter from the Commissioner responsible for Income Tax requesting to call at the Income Tax office to discuss its income tax returns and accounts. The Commissioner stated that the company had incorrectly added-back or deducted several items to the profit which should have been deducted or disallowed for income tax purposes.

Bagachwa Ltd's detailed Statement of Income for year 2019 is given below:

	Tshs	**Tshs**
Sales		786,640,000
Sales of motor vehicle		4,800,000
NBC bank interest		275,200
Dividends received from –TATEPA Ltd (resident entity)		1,200,000
Stock destroyed by fire		1,600,000
		794,515,200
Less:		
Staff salaries and wages		188,000,000
Business portion of motor expenses		97,600,000
Depreciation: motor vehicle and equipment		32,160,000
Light and heating		60,000,000
Newspaper advertising		3,460,000
Donations:		
Staff sports club	4,000,000	
Solidarity walk	1,600,000	5,600,000
Repairs and maintenance		9,600,000
New shop front–structural alteration		64,000,000
Balance of income tax paid 2018		2,400,000
Telephone		1,920,000

Court fine-motoring		1,600,000
Legal fees		8,000,000
Directors fees		13,280,000
Gratuities to staff		12,800,000
Loss on part exchange of business van		8,800,000
Salaries and wages		6,400,000
Insurance premium - premises		16,000,000
General provision – bad debts		4,800,000
Bad debts written off		800,000
Extension to rear of shop		105,600,000
Amortization of shop freehold		3,200,000
Charges for preparation of accounts		6,432,000
Sundry expenses		1,760,000
Net profit		**140,303,200**

Required:

Compute taxable income of Bagachwa Ltd for the year of income 2019 if the acceptable depreciation allowance is Tshs.56,000,000 and assuming its year of income starts from 1st January each year.

Question 5

ABACOMBI Tours Ltd runs a tourist trade in Manyara. The following information has been extracted from the company's books of account and is made available to you for scrutiny as a tax expert for the tax year 2019.

I. Expenses deducted during the period

	Tshs.
- Salaries and wages	18,400,000
- Telephone and electricity	1,200,000
- Insurance	10,000,000
- Repairs and maintenance	20,000,000
- Advertising and promotion	2,800,000
- Depreciation	3,160,000
- Professional charges	8,000,000
- Management and consultancy fees	24,000,000
- Travelling and transport	16,000,000
- Motor vehicle expenses	26,000,000
- General administration	1,400,000

II. Net loss during the same period after deductions (under I) above was loss; (Tshs.30,960,000/=)

III. Additional information relating to the period:

(a) Telephone and electricity

	Tshs.
- Local and international calls	240,000
- Purchase of second hand switchboard	800,000
- Repairs of intercom	160,000

(b) Repairs and maintenance

	Tshs.
- Cost of fire extinguisher	10,000,000
- Uniforms for staff	4,000,000
- Cost of fire alarm system	5,000,000
- Repairs of shed and painting	1,000,000

(c) Advertising and Promotion

	Tshs.
- Newspaper advertising	400,000
- Tourist sightseeing	1,600,000
- Large Neon Sign: Hotel name	800,000

(d) Depreciation charges

	Tshs.
- Loose tools	160,000
- Fixed assets	3,000,000

(e) Professional charges

	Tshs.
- Audit and Accountancy fees	2,000,000
- Registration of Property	5,000,000
- Tax Penalty	1,000,000

(f) General and Administration

	Tshs.
- Bad debts written off	400,000
- Donation to a political party	300,000
- Provision for uncollectible accounts	240,000
- Exchange loss on foreign loan	460,000

(g) The 3rd schedule depreciation allowances for depreciable assets have been agreed at Tshs.24,000,000.

Required:

Calculate the company's business income for tax purpose for the accounting period covered by this information

Question 6

The following information is extracted from ABA Ltd's trading activities for the year of income ended on 30/09/2018

ITEM	TZS.
Sales	56,000,000
Repatriated Income	12,000,000
Disposal of Fixed Assets	2,000,000
Subtotal	70,000,000
Less: Cost of Goods Sold	18,000,000
Gross Profit	52,000,000
Less: Operating Expenses	69,000,000
Operating Loss	(17,000,000) =========

Additional Notes

(i) Closing stock includes TZS.1, 200,000 being the market value less cost to sell of stock in transit. Their cost were TZS 1,500,000

(ii) Operating expenses include the following:

	TZS.
• Salaries and wages	23,000,000
• Provision for bad debts	4,500,000
• Bad debts-Loan to staff written off	1,800,000
• Transport costs	9,000,000
• Selling expenses	6,900,000
• Discount	3,300,000
• Donation to a charitable organization	7,500,000
• Stationery	3,500,000
• Initial allowance for items of plant and machinery	12,000,000

Required:

Calculate the total income from business.

Question 7

Kadogo Business Engineering (T) Ltd, a construction engineering company, submitted the following profit and loss account covering the period 1st January, 2016 to 31st December, 2016.

	TZS.	TZS.
Gross profit b/f		480,000,000
Dividends		30,000,000
Rent income		90,000,000
		600,000,000
Less expenses		
Salaries and wages	210,000,000	
Electricity and water	29,300,000	
Repairs and maintenance	46,700,000	
Registration and licenses	1,750,000	
Audit fees	500,000	
Bank charges	800,000	
Subscriptions and donations	700,000	
Legal expenses	4,000,000	
Office rent	12,000,000	
Depreciation	59,000,000	
Sundry expenses	11,000,000	375,750,000
Net profit		**224,250,000**
		=========

Notes to the accounts

1. Repair and maintenance

	TZS.
Repair on vehicles	19,000,000
Iron gate (MD's private residence)	800,000
Fuel and lubricants	8,500,000
Tyres and tubes	19,300,000
New terrazzo floor (Office)	9,000,000
	46,700,000 ========

2. Subscription and donations

	TZS.
Professional associations	300,000
Periodicals & Newspapers	100,000
Deaf & Dumb School	100,000
Sundry	200,000
	700,000 ========

3. Legal Expenses

	TZS.
Formation of business	1,400,000
Registration of Title Deeds	800,000
Acquisition of land for staff canteen	1,800,000
	4,000,000 ========

4. Sundry expenses
   Various miscellaneous expenses 11,000,000

5. The Company acquired the following assets for its business and were used in 2016 unless indicated otherwise: (TZS)

a) Office building 34,000,000
b) Workshop 12,500,000
c) Work in progress 80,000,000
d) Furniture and fittings 15,000,000
e) Computers and data handling equipment 12,500,000
f) Plant and equipment (earth moving) 20,000,000

Required:

(a) Compute the depreciation allowance as per the third Schedule of the Income Tax Act, Cap 332.

(b) Commencing with the net profit figure, compute the chargeable income of the Company for the year of assessment 2016.

Question 8

Rombo Kwetu Ltd is a resident company, which is in the business of direct selling and marketing of products with the brand name 'Rombo'. It makes up its accounts to 30th June annually.

Rombo's Statement of Profit or Loss for its financial year ended 30th June 2017 is as follows:

	Note		TZS in Million
Sales			110,000
Less: Cost of sales	1		(78,000)
Gross profit			32,000
Add: Other income			
Interest income	2	2,300	
Interest income from overdue trade receivables		36	
			2,336
Total Income			34,336
Less: Expenses			
Selling and distribution expenses	3	1,140	
Administration expenses	4	21,600	
Finance costs	5	2,006	
			(24,746)
Profit before tax			9,590

Notes:

(1) Cost of sales includes the following:

	TZS 'million'
Amortization and depreciation of plant, property and equipment	7,330
Acquisition of proprietary rights (note (i))	200
Rental of factory premise (note (ii))	360

Note (i):

In January 2017, Rombo Kwetu acquired a proprietary right for TZS.200,000,000 from a foreign owned company as part of its business development strategy. This right has been protected for 15 years.

Note (ii)

On 1st December 2016, Rombo Kwetu entered into a three-year rental agreement for a factory premise for TZS.10,000,000 per month and it was agreed that Rombo would pay the total rental for the three-year period of TZS.360,000,000 to the landlord in advance. The rental agreement is non-renewable.

(2) The interest income from government bonds

(3) Selling and distribution expenses include:

	TZS 'million'
Sponsorship of domestic trade fairs	50
Registration of an overseas patent for the promotion of exports	14
Entertainment expenses – luck drawn prizes given to purchasers of goods as part of a sales promotion campaign	360
Realized foreign exchange gain arising from the settlement of trade receivables	(41)

(4) Administration expenses include:

	TZS 'million'
Statutory audit fees	6
Fees paid for payroll processing services	5
Entertainment expenses for a staff meeting	2
Donation of computers to the approved charitable institutions	12

(5) The finance costs relate to the interest paid on a loan borrowed from a resident bank.

(6) The capital allowances for the year of assessment 2017 have been computed as TZS.85,000,000 as per the Third Schedule of Income Tax Act, Cap 332.
Required:

Commencing with the profit before tax figure, compute the chargeable income of Rombo Kwetu Ltd for the year of assessment 2017.

Question 9
In year 200X, the Commissioner for Large Taxpayers received a return of income of KK Limited showing a net profit of Tshs214,136 computed after making the following deductions:

	Tshs
Sales	273,970,710
Cost of sales	150,000,355
Gross Profit	123,970,355
Operating expenses	27,000,000
Other expenses	96,756,219
Net income	214,136

Included in the other expenses item is a list of the following:

a) Exchange loss of Tshs42,143,000 on the importation of raw materials
b) Compensation to terminated employees – Tshs618,500
c) Amortised amount to replace a roof – Tshs4,733,000
d) Payments made to remove erroneous terms of a loan contract- Tshs821,000
e) Penalties for VAT – Tshs3,500,000
f) Managing Director's personal visitors entertainment expenses – Tshs3,880,000
g) Political parties contributions - Tshs1,007,450
h) Board meeting expenses – Tshs4,753,205
i) Incentives – Tshs1,473,741
j) Treasury loan used by Director to go abroad on vacation – Tshs3,543,123
k) Cost to prepare revised accounts – Tshs1,232,456
l) Construction cost of a new laboratory – Tshs13,520,620
m) Cancellation of contract – Tshs8,326,124
n) Salaries for future services – Tshs6,577,000
o) Legal cost for unsuccessful recovery of salaries from terminated employees – Tshs627,000

Assume you are in charge of one of the Audit Teams at the Large Taxpayers Department and the Commissioner for Large Taxpayers has assigned you the tax file of KK Limited.

Required:
Establish the taxable income of company for the year.

Question 10
Mzalendo Limited which is engaged in the manufacture of electric appliances for domestic use and export has provided the following accounts to the Tanzania Revenue Authority (TRA) for the year ended December 31, 2014.

	TZS	TZS
Gross Profit for the year		272,960,000
Add: Profit on sale of non current assets	50,000,000	
Dividend received	25,500,000	75,500,000
Gross Profit		348,460,000
Deduct: Depreciation	21,550,000	
Legal expenses	18,736,000	
Provision for doubtful debts	3,030,000	
Audit fees	7,200,000	
Salaries and wages	28,410,000	

Administrative expenses etc	39,020,000	
Plant maintenance expenses	8,160,000	
Utilities	14,232,000	
Stationery	2,400,000	
Subscription and donations	22,914,000	
Repairs of vehicles, office etc	25,968,000	
Rent and rates	17,500,000	
Fuel and lubricants	10,500,000	219,620,000
Net profit		128,840,000

The notes to the accounts of the company showed the following details and breakdowns:

(i) General provision of TZS.2,000,000 is included in the amount declared as provision for doubtful debts.

(ii) The amount paid in respect of subscriptions and donations is made up of:

	TZS
Subscription to Chamber of Commerce	2,900,000
Tumaini orphanage	5,000,000
Malaria Campaign	15,014,000
	22,914,000

(iii) Repair of vehicles, office etc includes an amount TZS.15,560,000 spent on new iron gates for the factory.

(iv) Legal expenses is made up of :

	TZS
Income tax appeals	5,700,000
Sale of property	3,200,000
Current company matters	9,836,000
	18,736,000

(v) Capital allowances available to the company for the current year amounts to TZS.25,500,000.

(vi) The company incurred a loss of TZS.38,000,000 in the preceding year.

Required:

Determine the company's chargeable income as well as tax liability for the 2014 year of assessment. The corporate tax rate is 25%.

Question 11

G&G Hotel had constructed a modern eleven-storey tourist hotel building for Tshs 800,000,000. The construction of this hotel was completed on 31st December 2015, and it was formally opened and certified by the Minister for Finance and Planning on 1st January 2016, when it started operating at full capacity.

(i) Addition to the main building, the hotel during the same time constructed:

- A car park adjacent to the hotel structure for Tshs 30,000,000
- A swimming pool for Tshs 17,000,000
- Small huts for Tshs 21,000,000

These were used from the same date as the main hotel building

(ii) The hotel had the following assets, which were used from the day of its inception:

- Automatic laundry machine, installed in the basement for Tshs 12,000,000.
- A cold storage plant for Tshs 20,000,000
- An air-conditioning plant Tshs 22,150,000
- Cookers and other permanent kitchen wares Tshs 18,000,000
- Mobile serving wheels trays Tshs 2,800,000
- Cups, tools and other utensils for Tshs 8,000,000
- Furniture Tshs 99,000,000

(iii) To keep the small huts clean, three mowers costing Tshs 5,000,000 each were purchased

(iv) In addition , during the 2015, the hotel acquired and used the following:

- A scania bus (35 seats) for Tshs 260,000,000. This was purchased on the 2nd April, but was used from the 1st June.
- A second hand delivery van was purchased for Tshs 5,900,000 during May.
- A new Rolls Royce for the General Manager was acquired for Tshs 180,000,000 which was wholly used for business. The company also purchased a Range Rover for Tshs 140,000,000, this was for the Hotel Accountant while on duties.
- In order to encourage the hotel industry, and hence tourism, the Ministry of Tourism awarded hotel a twin otter aircraft, which was purchased for Tshs 1,700,000,000. The company incurred additional expenditure of Tshs 140,000,000 to make the aircraft operational.
- Zilipendwa Orchestra was officially inaugurated on the 15th July 2015. This was solely for the entertainment of the hotel guests in G&G hotel. The music instruments had cost the hotel Tshs 21,000,000
- As a control against frequent power cut by TANESCO, a generator was purchased was purchased for Tshs 20,000,000 during August. This was installed in the hotel on 15th August 2016.
- The General Manager's Royce was sold on 10/11/2015 for Tshs 50,000,000

Required

Calculate depreciation allowance admissible to G&G Hotel (T) under the 3rd schedule of the ITA, Cap 332 for the year of income 2015

Question 12

Zulfkar Ltd is a resident company based in Dar es Salaam engaged in manufacturing business since 1.1.2019. During the year of income the company acquired the following assets to be used for the business purposes.

Four computers to be used for business, each had a cost of TZS 800,000. During the same year, the company constructed four factories and two godowns at a cost of TZS 40,000,000 each and TZS 25,000,000 respectively. Plant and machinery worth TZS 50,000,000 were also purchased and installed in the factory during the same year. The company also acquired office fixtures for at a cost of TZS 2,000,000.

To make easy the transportation of workers to and from their workplace, the company purchased a 25 seater minibus for TZS 25,000,000. Also during the same year of income, the company purchased a two tons pick up at a total cost of 7,000,000. Moreover, to make easy the transportation of finished products to neighboring regions the company during the same year acquired two trailers and three trailer mounted containers at a cost of TZS 25,000,000 in total. For the same purpose, a four tons truck was acquired for TZS 27,000,000. All these assets were acquired during January 2019.

During March the same year, the company also acquired the following assets. One saloon car to be used by the managing director exclusively for business purposes for TZS 26,000,000, another fixture and fittings were purchased for TZS 2,500,000 and one Toyota Hilux pick up for TZS 28,000,000 (3.5 tones).

In May 2019 the company also acquired the following assets; two Leyland Diesel Lorries (ten tons) purchased for TZS 70,000,000 in total, a second hand cressina aircraft for TZS 130,000,000 and one caterpillar for TZS 65,000,000.

During the same year of income, the following assets were sold:

- Part of fixtures and fittings for TZS 800,000;
- The 25 seater minibus for TZS 20,000,000 due to its unsuccessful performance, and

Required:

On the basis of the above information, calculate the depreciation allowances for which the company is entitled to claim for the year of income 2019.

Question 13

TWENDEPAMOJA Company Limited is a resident company, which carries on business in the country as a class 1 building contractor.

The depreciation bases of the pools of depreciable assets (in TZS.) as at 1st January, 2015 were as follow:

Class I	Class II	Class III	Class IV	Class V	Class VI	Class VII
12,000,000	1,500,000	11,000,000	NIL	NIL	NIL	NIL

During January 2015 the company acquired the following:

- Two caterpillar tractors for TZS.100 million each
- A second hand pick-up for TZS.20 million
- Fixtures and fittings TZS.79 million
- Constructed a building for the storage of imported building materials for TZS.500 million. This was built parallel (mutually) to another building to be used as an office, where the cost of the office was estimated at 20% of the total cost of the storage building. Commissioner, by exercising his discretionary power to the best of his judgment estimated the cost of constructing the office at TZS.150 million

All these assets were used from 31st January 2015

On 1st June, 2015 the company decided to expand its business by establishing the plant for the manufacture of glass for windows and doors as well as tiles to be used in the company's business and for sale. For this purpose, it purchased a new building for TZS.400 million on 1st July 2015 from PENCOS, a construction company, whose cost of construction was TZS.300 million.

Plant and Machinery to be installed in the building arrived on the same date and it was immediately installed in the building. The new factory plant and machinery had cost the company TZS.60 million. The new factory commenced production on the 1st August 2015.

On 1st September 2015, the company acquired and used the following immediately:

- Two new lorries at a cost of TZS.450 million in total.
- A used cessna aircraft for business for TZS.350 million.
- Mowers for cleaning the compound of the business premises for TZS.190 million.
- An air condition system set for the storage building and the office for TZS.160 million in total.
- Three (3) computers and their accessories to be used in the office, each TZS.4 million.

The following assets of the pool were sold during the month of December 2015

- Second hand pick-up for TZS.15 million.
- Both caterpillars' tractors for TZS.160 million.
- Lorries for TZS.520 million
- A used cessna air craft for TZS.400 million.

Required:

Compute depreciation allowance admissible to TWENDEPAMOJA Co. Ltd for the year of income 2015 as required under the Third Schedule of Income Tax Act (ITA), 2004.

Answers to Self-Examination Questions

Answer to SEQ 1

TKY Ltd
Income Tax Computation

		Tshs.
Net profit per accounts		23,650,000
Add:		
General expenses	500,000	
Depreciation (800,000 – 100,000)	700,000	
Income Tax	900,000	
Motor car expenses (1/5) private	1,000,000	
Bad and doubtful debts	500,000	
Promotion sign board	300,000	
Medical expenses	100,000	4,000,000
Sub-total		27,650,000
Less:		
Depreciation allowances	12,400,000	
Dividends (FWP)	400,000	12,800,000
		14,800,000

W1) **Depreciation allowances**

Class	1	2	Total depreciation
Rates	37.50%	12.50%	
TWDV as at 1.1.2018	2,400,000	1,700,000	
Additions			
Station wagon car	30,000,000		
Signboard		300,000	
Sub total	32,400,000	2,000,000	
Depreciation allowances	12,150,000	250,000	12,400,000
TWDV at 31.12 2018	20,250,000	1,750,000	

Answer to SEQ 2

Computation of taxable income of Kigongo Company for the year of income 2018

Net loss for the Year			Tshs. (186,000,000)
Add:	Directors fees	(NIL)	
	Penalties (VAT)	10,000,000	
	Tender Board expenses	4,000,000	
	Employees contribution	7,500,000	
	Depreciation	120,000,000	
	Provisions	28,000,000	
	Traffic fine	3,500,000	173,000,000
			(13,000,000)
Deduct:	Sales of furniture	1,000,000	
	Dividends (final withholding)	5,000,000	
	Interest Income	NIL	
	Business Contract penalties	NIL	
	Depreciation allowances:		
	(Working No.1)	136,125,000	142,125,000
	Tax losses		(155,125,000)

(*Working* – Computation of Depreciation allowance No.1)

	Class 1	Class 3	
	37.50%	**12.50%**	**Total**
Computer	300,000,000		
Motor Car	30,000,000		
Furniture & Equipment		100,000,000	
Sale of furniture (incomings)		(1,000,000)	
Depreciation Basis	330,000,000	99,000,000	
Depreciation Allowance	123,750,000	12,375,000	136,125,000
TWDV 31/12/18	206,250,000	86,625,000	

Computation of Tax Liability
No tax liability since there are tax losses.
These tax losses are deductible expenses in the next year of income.
Answer to SEQ 3

Profit before tax		67,306
Add back: Non-allowable deductions		
Depreciation	17,832	
Partitioning	3,179	
Legal cost on appeal	627	
Legal cost on share issue	175	
Stamp duty – property	1,200	
Fines	250	
Loans to employees w/off	250	
Increase on general b/debts	5,000	
Promotion gifts	1,800	

Donation to political party	250	
Subscription to trade associations	1,250	31,813
		99,119
Less: Allowable deductions		
Subscriptions U/S 16		
99,119 X 2% = 1,982.38		
Compare with total subscriptions and donations		
1,250 + 250 = 1,500		1,500
∴ Adjusted profits		97,619
Tax at 30%		29,285.7

Answer to SEQ 4

Name of Tax Payer : Bagachwa Ltd
Year of Income : 2019
Residential Status : Resident Corporation

		TSHS
Net Profit		140,303,200
Add Back: Non Allowable Deductions:	TSHS.	
Depreciation	32,160,000	
Donations	5,600,000	
New shop structural alteration	64,000,000	
Income Tax	2,400,000	
Court Fine-Motoring	1,600,000	
Loss on exchange Van	8,800,000	
Provision for bad debts	4,800,000	
Extension to Real of shop	105,600,000	
Amortization of shop freehold	3,200,000	
		228,160,000
		368,463,200
LESS:		
Sale of motor vehicle		(4,800,000)
Dividends		(1,200,000)
Depreciation Allowance		(56,000,000)
TOTAL TAXABLE INCOME		**306,463,200**

Answer to SEQ 5

Determination of taxable income for ABACOMBI Tours Ltd for the year 2019

Net loss as per accounts		(30,960,000)
Add back disallowable expenses:		
Switch board	800,000	
Fire extinguisher	10,000,000	
Fire alarm system	5,000,000	
Depreciation-Fixed asset	3,000,000	
Registration of property	5,000,000	
Tax penalty	1,000,000	
Donations to political parties	300,000	
Provisions for uncollectible accounts	240,000	

Sub-total		25,340,000
Net loss before allowable deductions		(5,620,000)
Less: allowable deductions		
Depreciation allowances for depreciable assets		24,000,000
Taxable income for the year (loss)		*(29,620,000)*

Answer to SEQ 6

Business Loss per accounts	(17,000,000)
Add Back: Non-Allowable Expenses	
Provision for bad debts	4,500,000
Donations	7,500,000
Bad debts	1,800,000
	(3,200,000)
Less: Non-Allowable Expenses	
Repatriated Income	12,000,000
Disposal	2,000,000
Business Income (before donation expenditure)	10,800,000
Allowable Donations (2% of 10,800,000)	216,000
Adjusted Business Income	10,584,000

Answer to SEQ 7

(a) COMPUTATION FOR DEPRECIATION ALLOWANCE

Particulars	**Class 1 (37.5%)**	**Class 3 (12.5%)**	**Class 6 (5%)**
Depreciation Basis at 1st January	-	-	-
Additions			
Office buildings	-	-	34,000,000
Workshop	-	-	12,500,000
Furniture and Fittings	-	15,000,000	-
Computers and Data handling equipments	12,500,000	-	-
Plant and Machinery (earth moving)	20,000,000	-	-
New Terrazzo floor			9,000,000
Basis for annual allowance	**32,500,00**	15,000,000	55,500,000
Annual allowance	**12,187,500**	**1,875,000**	**2,775,000**
TWDV at 31st December 2012	20,312,500	13,125,000	52,725,000

Therefore depreciation allowance is TZS.16,837,500

(b) COMPUTATION FOR CHARGEABLE BUSINESS INCOME

TAXPAYER: KADOGO BUSINESS ENGINEERING (T) LTD
SOURCE OF INCOME BUSINESS
YEAR OF INCOME: DECEMBER 2016

PARTICULARS	AMOUNT (TZS)	AMOUNT (TZS)
Net profit		224,250,000
Add back:		
Depreciation	59,000,000	
Iron gate	800,000	
New terrazzo floor (office)	9,000,000	
Subscription for periodicals and Newspaper	100,000	
Subscription for Deaf and Dumb school	100,000	
Sundry Subscription	200,000	
Legal fee for title deed	800,000	
Legal fee for acquisition of Land	1,800,000	71,800,000
		296,050,000
Less: Depreciation allowance		(16,837,500)
Chargeable business income		**279,212,500** ==========

Answer to SEQ 8

Name of taxpayer	Rombo Kwetu	
Resident Status	**Resident**	**TZS million**
Computation of taxable business income		
Profit before tax		9,590
Add: Back		
Amortization and depreciation of plant and equipment	7,330	
Acquisition of property right	200	
Rental prepaid (360 – 70)	290	
Registration of patent right	14	
Donation to approved Charitable institution	12	7,846
Less:		
Depreciation allowance		- (85)
Profit before deduction of donation		7,761
Deduction: donation		
The lower of 12m vs 2% x 7,761m (i.e155.22m)		- (12)
Adjusted taxable income		7,749

Answer to SEQ 9

The taxable income of the company was Tshs36,975,329 as shown below:

Tshs	Tshs	
Net income as per account		214,136
Add: None allowable expenses		
Amortized roof	4,733,000	
VAT penalties	3,500,000	
Managing director' vistors	3,880,000	

Political part contributions	1,007,450	
Treasury loan	3,543,123	
Construction of new laboratory	13,520,620	
Salaries for future services	6,577,000	36,761,193
Taxable income		36,975,329

Note:

a) Managing director's personal entertaining costs and treasury loan are assumed to have not been included in his/her employment income. So are not wholly and exclusively incurred for business income.

b) Salaries for future services are a loan though term 'salary' therefore not wholly and exclusively incurred in producing the current year income.

c) A construction cost of a new laboratory is capital expenditure therefore not deductible.

Answer to SEQ 10

Mzalendo Limited

Determination of Chargeable Income and Tax Liability 2014

Year of Assessment Basic Period: 1/01/2014 – 31/12/2014

	Tshs.	Tshs.
Net Profit per accounts		128,840,000/=
Less: Profit on sale of fixed assets	50,000,000/=	
Dividend received	25,500,000/=	75,500,000/=
		53,340,000/=
Add Back: Depreciation	21,550,000/=	
Legal Expenses on: Income Tax Appeals	5,700,000/=	
Sale of Property	3,200,000/=	
General provision for doubtful debts	2,000,000/=	
Subscriptions and donations to: Tumaini orphanage	5,000,000/=	
Malaria campaign	15,014,000/=	
New iron gates for factory	15,560,000/=	68,024,000/=
Assessable Income		121,364,000/=
Deduct: Loss brought forward from 2004		38,000,000/=
		83,364,000/=
Less: Capital allowances		25,500,000/=
Chargeable Income		57,864,000/=
Tax thereon @ 25% of 57,864,000		14,466,000/= ==========

NOTE: TREATMENT OF CURRENT MATTERS IF ASSUMED TO BE REVENUE IN NATURE ALLOWABLE, BUT IF CAPITAL IN NATURE ADD BACK TSHS 9,836,000/=

Answer to SEQ 11

Alternative solution

Class	**CLASS 1**	**CLASS 2**	**CLASS 3**	**CLASS 6**	
Rate	37.5%	25.0%	12.5%	5.0%	
TWDV at start	-	-	-	-	
Additions for the year					
Hotel building				800,000,000	

Car park				30,000,000	
Swimming pool				17,000,000	
Small huts				21,000,000	
Cookers and kitchen equipments			18,000,000		
Mobile Serving wheel trays			2,800,000		
Cups, tools, and implements			8,000,000		
Furniture			99,000,000		
Mowers (3@ 5,000,000)			15,000,000		
Delivery van		5,900,000			
Scania bus		260,000,000			
Air craft (Grant cost plus additional expenditure)		1,840,000,000			
Roll Royce (restricted price)	15,000,000				
Range Rover (restricted price)	15,000,000				
Music instruments			21,000,000		
	30,000,000	**2,105,900,000**	**163,800,000**	**868,000,000**	
Realization					
Roll Royce (restricted proceeds) **note 2**	(4,166,667)	-	-	-	
Depreciation basis	**25,833,333**	**2,105,900,000**	**163,800,000**	**868,000,000**	
Annual depreciation allowances	9,687,500	526,475,000	20,475,000	43,400,000	**600,037,500**
TWDV at end	**16,145,833**	**1,579,425,000**	**143,325,000**	**824,600,000**	

Total depreciation allowances

Annual depreciation allowances	600,037,500
Initial depreciation allowances(note 1)	18,537,500
	618,575,000

Note 1

During the year the following assets qualify for initial allowances. They are not added in the pool, to avoid charging annual depreciation allowances in the same year when the initial allowance is being offered. Initial allowance is granted in two portions; the first portion is available in the year the asset is first put to use and the remaining (second portion) is available 12 months after the first portion was available.

Automatic laundry machine	12,000,000
A cold storage plant	20,000,000
Air conditioning plant	22,150,000
Electricity generator	20,000,000
Sub-total	74,150,000
Initial Allowance (50% thereof)	**37,075,000**
1/2 of the initial allowance	**18,537,500**

Note 2

Because the cost for tax depreciation is restricted, the sale proceeds upon sale of the road vehicle are also restricted accordingly.

Restricted proceeds =15,000,000/180,000,000*50,000,000=4,166,667

Answer to SEQ 12

	Class 1	**Class 2**	**Class 3**	**Class 6**
Additions				
Computers	3,200,000			
Factories				80,000,000
Godowns				50,000,000

Minibus	25,000,000			
Plant and Machinery (qualify for initial allowance)		NIL		
Fixtures			2,000,000	
Pick-up van	7,000,000			
Trailers and containers		25,000,000		
Truck	27,000,000			
Saloon car	15,000,000			
Fixture and fittings			2,500,000	
Toyota HiluxPick up	28,000,000			
Leyland Lorries		70,000,000		
Air craft		130,000,000		
Caterpillar	65,000,000			
	170,200,000	225,000,000	4,500,000	130,000,000
Less: **Incomings (Disposals)**				
Fixtures			800,000	
Minibus	20,000,000			
Depreciation Basis	150,200,000	225,000,000	3,700,000	130,000,000
Depreciation rate	37.50%	25.00%	12.50%	5.00%
Annual Allowance	56,325,000	56,250,000	462,500	6,500,000
1st portion of initial allowance(1/2×25,000,000)		12,500,000		
Total Annual Allowance	56,325,000	68,750,000	462,500	6,500,000

Answer to SEQ 13

Computation of depreciation allowance admissible to TWENDEPAMOJA Co. Ltd for the year of income 2012

Class	**Assets and amount**	**Depreciation allowance**
Class 1 (rate 37.5%)		
Opening balance	12,000,000	
Additions:		
Caterpillars	200,000,000	
Pick-up	20,000,000	
Computers	12,000,000	
Total	**224,000,000**	
Less: Disposal/sales		
Pick-up	15,000,000	
Caterpillars	160,000,000	
Total sales	**175,000,000**	
Depreciation basis for the year	69,000,000	
Depreciation allowance @ 37.5%	25,875,000	25,875,000
Depreciation basis c/d	43,125,000	
Class II (Rates 25%)		
WSV b/f	1,500,000	
Additions during the year		
Lorries	540,000,000	
Air craft	350,000,000	
Total assets	**801,500,000**	
Less: Disposal/sales		
Lorries	520,000,000	
Air craft	400,000,000	
Total sales	**(920,000,000)**	
Balance, (Taxable Trading receipt)	118,500,000	0.00
Depreciation basis at the end of year	0	
Class III (rate 12.5%)		

WDV b/f	11,000,000	
Fixtures and fittings	79,000,000	
Plant and machinery	60,000,000	
Mowers	190,000,000	
Air condition system set	160,000,000	
Depreciation basis for the year	500,000,000	
Depreciation basis for the year @ 12.5%	62,500,000	62,500,000
Depreciation basis of the pool c/d	437,500,000	
Class VI		
Building materials Storage building		
(1/1/2012)	500,000,000	
Duration in days	335	
Depreciation allowance @ 5%	500,000,000 x 335/365 x 5% =	22,945,205.50
WDV c/d	477,054,794.50	
Second Building	400,000,000	
Duration in days	183	
Depreciation allowance @ 5%	400,000,000 x 183/365 x 5% =	10,027,397.30
WDV c/d	389,972,602.30	
TOTAL DEPRECIATION ALLOWANCE		**95,472,602.80**

From the above computations the depreciation allowance admissible to the company is 95,472,602.80. however, there will be taxable trading receipt on class **II** of TZS.118,500,000.00. Which will ultimately dissolve class **II**.

SECTION A

INCOME TAXATION RULES APPLICABLE TO PARTICULAR TYPES OF PERSONS/BUSINESS

A2

STUDY GUIDE A2: TAXATION OF TRUSTS

Get Through Intro

Unlike in the case of a partnership which is not liable to pay income tax a trust is liable to pay tax. The Act treats a trust as an entity separate from its beneficiaries, like a company, which is liable to tax in its own right. It follows therefore that a trust is a person and accordingly chargeable to tax under section 4. Paragraph 3(1) of the First Schedule to the Act provides the rate of tax for the total income of a trust to be 30 per cent. Section 52 of the Act provides the rules for taxation of trust and their beneficiaries. This guide discusses the meaning and taxation principles of Trusts

Learning Outcomes

a) Explain the meaning of trust, unit trusts and trustees
b) Discuss the taxation principles of trust and its members

1. Explain the meaning of trust, unit trusts and trustees [Learning outcome a]

1. Meaning Of Trust, Unit Trusts And Trustees

In common law legal system a trust is an arrangement whereby money or property is managed by one person (or persons or organization for the benefit of another, but is owned by the "Trust". A trust is created by a Settlor who entrusts some or all of his or her property to people of his choice (the trustees). The trustees are the legal owners of the trust property (or trust corpus), but they are oblige to hold the property for the benefit of one or more individuals or organizations (the beneficiaries). Usually specified by the Settlor. The trustees owe a fiduciary duty to beneficiaries who are the beneficial owners of the trust property. The trust is governed by the terms of the trust document, which is usually written and in deed form. .

Section 3 of the Income Tax Act Cap 332 define a "trust" as an arrangement under which a trustee holds assets but excludes a partnership and a corporation

Section 3 of the Income Tax Act Cap 332 also define a trustee

a) Means an individual or body corporate holding assets in a fiduciary capacity for the benefit of identifiable persons or for some object permitted by law and whether or not the assets are held alone or jointly with other persons or the individual or body corporate is appointed or constituted trustee by personal acts, by will, by order or declaration of a court or by other operation of the law; and

b) includes:-

(i) any executor, administrator, tutor or curator

(ii) any liquidator, receiver, trustee in bankruptcy or judicial manager

(i) any person having the administration or control of assets subject to a usufruct, fidei commissum or other limited interest;

(ii) any person who manages assets under a private foundation or other similar arrangements;

Moreover section 3 of the Income Tax Act Cap 332 also defines a "unit trust" as:

(a) an arrangement under which a trustee holds assets for the benefit of at least 20 persons; and

(b) where the entitlements of the persons to participate in the income or capital of the arrangement are divided into units such that the entitlements are determined by the number of units owned;

Basic principles:

Property of any sort can be held on trust. Be it real or personal tangible or intangible, it often, forex, real estate, shares or cash. The uses of trusts are many and varied. Trusts can be created during a person's life (usually by a trust instrument) or after death in a WILL.

A trust is created for any lawful purpose. The purpose is lawful unless it is:

(a) Forbidden by law.
(b) Is of such a nature that, if permitted, it would defeat the provisions of any law.
(c) Is fraudulent, or
(d) Involves or implied injury to the person or property of another.
(e) The court regards it as immoral or opposed to public policy.

Every trust of which the purpose is unlawful is void. And where a trust is treated for two purposes, of which one is lawful and the other unlawful and the two purposes cannot be separated, the whole trust is void.

Formalities:

Generally, a trust required three ***Certainties,*** as determined in "knight vs knight" 1840.

1. **Intention**
   There must be a clear intention to create a trust, i.e. a trust is created when the author of the trust indicates with reasonable certainty by any words or acts an intention on his part to create thereby a trust.

   Illustration

   "A" bequeaths certain property to "B" hearing the fullest confidence that he will dispose of it for the benefit of C. This creates a trust so far as regards "A" and "C".

2. **Subject matter**
   The property subject to the trust must be clearly identified. One cannot for example settle the majority of my estate, as the precise extent cannot be ascertained.

   Illustrations

   "A" bequeaths certain property to "B", desiring him to divide the bulk of it among C's children. This does not create trust for the trust property is not indicated with sufficient certainty. "A" bequeaths "such sum as is necessary to enable "C" to live in comfort" is uncertain and there is no trust.

3. **Objects**
   The beneficiaries of the trust must be clearly identified, or at least be ascertainable. Note: In the language of trust the "objects" of a trust are beneficiaries who benefit from it. The settler must identify or supply the means of identifying the persons whom are to be recognize as the beneficiaries of the trust.

   Illustrations:

   "A" bequeaths certain property to "B", requesting him to distribute it among such member's of C's family as" B" should think most deserving. This does not create a trust, for the beneficiaries are not indicated with reasonable certainty.

   "A" bequeaths certain property to B, hoping he will continue it in the family. This does not create a trust, as the beneficiary is not indicated with reasonable certainty.

   Question 1

   In connection with creation of a trust, the "three certainties" are usually necessary. Describe what is meant by the three certainties giving an example of each type and indicate the effect of failure of each certainty.

   TYPES/CLASSIFICATION OF TRUSTS:

1. **Express Trusts**
   Are those trusts which are created in express words by the settler, are intentionally created by act of the settler either orally, but more usually, in writing. Express trust arises where a settler deliberately and consciously decides to create a trust, over his or her assets, either now or upon his or her later death. In these cases this will be achieved by signing a trust instrument, or upon his or her later death. In these cases this will be achieved by signing a trust instrument which will either be a will or a trust deed. Almost all trusts dealt within the trust industry are of this type for an express trust to exist; there must be all certainties of trust.

   (i) Certainty of words.
   (ii) Certainty of subject matter.
   (iii) Certainty of objects.

   Express trusts may be public or private trust.

(i) Public trusts

Public or charitable trusts are created for a general charitable purpose e.g. advancement of education or improving health conditions. These trusts are established for the benefit of large and fluctuating group of people. Charitable trusts may be also called as purpose trusts, because these are created for some specific purposes.

(i) The relief of poverty.
(ii) The advancement of education.
(iii) The advancement of religion.
(iv) Other purposes beneficial to community.

(ii) Private trusts

Private trusts also private express trust is created by a settler for the benefit of a particular person or group of persons and not for some institution or public purpose. Private trusts may be further classified as:-

a) Discretionary trusts.
b) Non discretionary trusts.
c) Protective trusts.

a. Discretionary trust

Are those trusts in which the trustee may have discretionary power vested in them either by the trust instrument or by general law. In such trusts, the trustees are given discretion to pay or apply all or part of the trust income for the benefit of beneficiaries as they think fit.

b. Non-discretionary trusts

Are those trusts in which the trustees are required to follow the terms stated in the trust instrument strictly. If a settlor cares his property to trustee for the benefit of A, B and C and it is further stated this property should be distributed equally among A, B, and C then it in called as non-discretionary trust.

c. Protective trusts

Are those trusts which give some protections to the beneficiaries against some misfortunes. Such trusts normally give the beneficiaries life interest in the trust properties which terminates on the happening of a specified event, such the bankruptcy of the beneficiary or any attempt by him to dispose of his interest (which may never occur and are avoidable by him if he is wise).

2. Trusts Created By Operation Of Law

These trusts may further classified as under:-

(i) Statutory trusts.
(ii) Implied trusts.
(iii) Constructive trusts.

(i) **Statutory trusts**

Are those trusts which created by law as an automatic consequence of certain circumstances. For example if land is conveyed to two or more persons, the legal owners hold the land on trust for sale.

(ii) **Implied trust**

Is a non-express trust which is based on the presumed intentions of the settlor; is created where some of legal requirements for an express trust are not met; but an intention on behalf of the parties to create a trust can be pressured to exist. Implied also **resulting trusts** instrument is not properly drafted and a portion of the equitable title has not been provided for. In such a case the law may raise a resulting trust for the benefit of the creator of the trust in deemed to be a beneficiary of the portion of the equitable title that was not properly provided in the trust document.

(iii) **Constructive trusts**

Unlike an express or implied trust, a constructive trust is not created by an agreement between settlor and trustee. A constructive trust is imposed by the law as an “equitable remedy”. This generally occurs due to

some wrong doing, where the wrong doer has acquired legal title to some property and cannot in good conscience be allowed to benefit from it. i.e. the court gives the authority to a person in good faith to perform the duties of a trustee. This person is appointed by the count to a trust already constituted.

2. Discuss the taxation principles of trust and its members [Learning Outcome b]

2. Taxation Principles Of Trust And Its Members

Section 52(1) provides that a trust or unit trust shall be liable to tax separately from its beneficiaries and separate calculations of total income shall be made for separate trusts regardless of whether they have the same trustees.

The law provides that a trust is distinct from its beneficiaries for income tax purposes. It will be noted that the charge of tax in section 4 is on any 'person' and in section 3 a 'person' is defined to mean and individual or any entity. An entity is defined in the same section 3 to mean a partnership, trust or a corporation. It follow therefore that a trust is a persons and accordingly chargeable to tax under section 4. Paragraph 3(1) of the First Schedule to the Act provides the rate of tax for the total income of a trust to be 30 per cent. Thus unlike in the case of a partnership which is not liable to pay income tax a trust is liable to pay tax. The Act treats a trust as an entity separate from its beneficiaries, like a company, which is liable to tax in its own right.

Treatment of distributions made by a trust to its beneficiaries

Section 52(2) provides for the treatment of distributions made by a trust to the trusts beneficiaries as follows:-

Distributions of a resident trust or unit trust are tax exempt in the hands of the trust's beneficiaries; while distributions of a non-resident trust or unit trust are included in calculating the income of the trust's beneficiaries that is taxable on the beneficiaries.

Residential status of a trust is defined in section 66(3) of the Act as:

"a trust is a resident trust for a year of income if:-

(a) it was established in the United Republic;

(b) at any tie during the year of income, a trustee of the trust is a resident person; or

(c) at any time during the year of income a resident person directs or may direct senior managerial decisions of the trust, whether the direction is or may be made alone or jointly with other persons of directly or through one or more interposed entities.

It will be noted that the conditions stated above are alternatives. Thus fulfillment of either of them would make a trust resident. For more details regarding the determination of residence of a trust, please see application notes for section 66(3).

Treatment of amounts derived and expenditure incurred by a trust or a trustee in the capacity of trustee

Section 52(3) provides that, amounts derived and expenditure incurred by a trust or a trustee in the capacity of trustee (other than as a bare agent), whether or not derived or incurred on behalf of another person and whether or not any other person is entitled to such an amount or income constituted by such an amount, shall be treated as derived or incurred by the trust and not any other person.

The term "in the capacity of trustee" would mean acting on behalf of the beneficiaries of the trust and not on behalf of the personal name of the trustee as an individual entity.

Therefore amounts derived and expenditure incurred in any transaction carried out by a trustee in the capacity of a trustee shall be treated as income derived or expenditure incurred by the trustee, except when the trustee acts a bare agent.

Assets owned and liabilities owed by a trust or a trustee in the capacity of trustee

Section 52(4) provides that assets owned and liabilities owed by a trust or a trustee in the capacity of trustee (other than as a bare agent) shall be treated as owned or owed by the trust and not any other personal.

In general terms, a trustee is personally liable for any debts he may incur in the course of his activities as trustee. As the trust is not a separate legal entity, such debts are incurred by the trustee himself. However, provided the trustee acts in the proper exercise of the powers under the trust instrument or otherwise as provided by law, in incurring the debts, he will have a right to be indemnified out of trust assets in respect thereof i.e.; he may properly utilize trust assets to discharge the relevant debts and need not pay them himself.

Position of the trust where a receiver referred to in section 116(5) of the Act is a trustee

Section 52(5) provides that, where a receiver referred to in section 116(5) is a trustee:-

(a) the trust shall be treated as conducting or continuing the activities of the person whose assets come into the possession of the receiver; and

(b) amounts derived and expenditure incurred by the trust shall be included in calculating the income of the trust in the same manner as they would have been included in calculating the income of the person if they were derived or incurred by the person prior to the even resulting in the appointment of the reliever.

Section 116(5) defines “receiver” for the purpose of section 116 to mean any person who, with respect to an asset situated in the United Republic is:-

(a) a liquidation of an entity
(b) a receiver appointed out of court or by a court in respect of an asset or entity;
(c) a trustee of a bankrupt person;
(d) a mortgagee in possession’
(e) an executor or administrator of a deceased individual’s estate; or
(f) conducting the affairs of an incapacitated individual

When a trustee of a trust acts on any other capacities of a receiver within the meaning of those provisions in the capacity of a trustee of the trust than the trust of which the receiver is a trustee shall be treated as conducting the activities of the person whose assets come into the possession of the receiver. The amounts derived and expenditure incurred shall be included or deducted in calculating the income of the trust in the source manner as they would have been in calculating the income of the person prior to the appointment of the receiver.

Arrangements between a trust and its trustees or beneficiaries

Section 52(6) provides that subject to Part IV and Division of Part III or the Act arrangements between a trust and its trustees or beneficiaries are recognized as transactions between distinct persons.

Self Examination Questions

Question 1

The following is the Income Statement of RUTAG TRUST for the year ended 31st December, 2012

ITEM	TSHS.
Yetu receipts	28,000,000
Sponsorship	1,500,000
Donations	2,400,000
Income on bank deposits	3,000,000
Investment Income	5,200,000
Other income	600,000
	40,700,000
Administrative And Education Expenses	
Direct Education expenses	19,000,000
Direct Health Services expenses	700,000
Head office depreciation	850,000 **20,550,000**
Other Income/Expenditure	
Unrelieved Loss from previous year of income	558,000
Loss/Gain on disposal of non-current assets	9,000
Depreciation allowance	258,000 **825,000**
Surplus/Deficit for the year	**19,325,000**
Other Comprehensive Income/Loss for the year	-
Total Comprehensive Income/Loss for the year	**19,325,000**

Additional Notes:

(i) RUTAG Trust was established in Zambia in 2009 and in the financial year 2012, all of its trustees were non-residents of the United Republic of Tanzania. In the same year of income, RUTAG Trust hired Mr. Jameson to provide managerial advice to the trust. However, Mr. Jameson is a Canadian who came to Tanzania for the first time in his life in 2009 and stayed for 250 days and left. He came again in Tanzania in 2010 and stayed for 290 days. On 6th July, 2011, he obtained another consultancy work in Tanzania and was forced to come back in Tanzania and stayed up to 25th January, 2012 and left.

(ii) Yetu receipts includes receipts Tshs.5,000,000 of ZAMOYONI Trust which belongs to the same trustees of RUTAG Trust.

(iii) Income on bank deposits relates to interest received from CRB Bank Ltd.

(iv) Investment income includes the following:

- Interest received from QWS, a non-financial institution which is located in Zambia, Tshs.4,000,000.
- Rent received from MchaMungu who is a resident individual of United Republic of Tanzania and does not conduct business, Tshs.1,200,000.

(v) The whole amount of other income is a business income from a foreign source.

(vi) Total comprehensive income was distributed to the beneficiaries of the Trust as follows:

Beneficiary A	6,500,000
Beneficiary B	7,200,000
Beneficiary C	5,625,000

Required:

(a) With reference to appropriate sections of ITA, Cap 332, determine the residential status of RUTAG Trust for the year of income 2012.

(b) Calculate the taxable income from business of RUTAG Trust for the year of income 2012, using the ITA, Cap 332.

(c) Calculate the taxable income from investment of RUTAG Trust for the year of income 2012, using the ITA, Cap 332.

(d) Calculate the total foreign income of RUTAG Trust as per the ITA, Cap 332.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) **RESIDENTIAL STATUS (SECTION 66)**

Residential status of Mr. Jameson who provided trust with managerial advise

Year of Income	**Number of Days**
2010	290 days
2011	178 days
2012	25 days
Total	493 days
Average	164 days

Conclusion: Since Mr Jameson who provided trust with managerial advise is resident for the Year of Income (YOI) 2012, then for the same period, RUTAG Trust is also a **resident trust** [(Section 66(3)(c)]

(b) TAXABLE INCOME FROM BUSINESS

TAXABLE INCOME FROM BUSINESS	
Details	***TShs***
Total Comprehensive Income	19,325,000
Add back: Non-Allowable Expenses	
Head Office Depreciation	850,000
Loss/Gain on Disposal of Non-Current Assets	9,000
	20,184,000
Deduct: Non-Business Income	
Receipt of Zamoyoni Trust	5,000,000
Income on Bank Deposits	3,000,000
Investment Income	5,200,000
Total Business Income	**6,984,000**
less: Business Income from Foreign Source of Income	600,000
Business Income from Domestic Source	**6,384,000**

(c) TAXABLE INCOME FROM INVESTMENT

TAXABLE INCOME FROM INVESTMENT	
Details	***TShs***
Income on Bank Deposits	3,000,000
Rent Received from MchaMungu	1,200,000
Total Investment Income from Domestic Source	4,200,000
Investment Income from Foreign Source, Zambia	4,000,000
Total Investment Income	**8,200,000**

(d) TOTAL FOREIGN INCOME

TOTAL FOREIGN INCOME	
Details	***TShs***
Business Income from a Foreign Source-Other Income	600,000
Investment Income from Foreign Source, Zambia	4,000,000
Total Foreign Income	**4,600,000**

(e) TOTAL TAX LIABILITY FOR BENEFICIARIES

According to Section 52(2) (a) of the Income Tax Act, Cap 332 Distributions of a resident trust or unit trust shall be exempt in the hands of the trust's beneficiaries. Therefore, there is no tax liability in the hands of beneficiaries

SECTION A

INCOME TAXATION RULES APPLICABLE TO PARTICULAR TYPES OF PERSONS/BUSINESS

A3

STUDY GUIDE A3: TAXATION OF PARTNERSHIP

Get Through Intro

A partnership just like a sole proprietorship is not a separate legal entity from its owners and as such it is not a taxpayer. The partners are liable to tax on the partnership profits in their individual capacities. This guide describes the meaning principles of partnership business taxation

Learning Outcomes

a) Explain the meaning of Partnership
b) Explain taxation principles of partnership business

1. Explain the meaning of Partnership and Explain taxation principles of partnership business [Learning outcome a and b]

1. Meaning Of Partnership

According to the ITA, Cap 332 Partnership ''means any association of individuals or bodies corporate carrying on business jointly, irrespective of whether the association is recorded in writing''.

2. Taxation Principles Of Partnership Business

A partnership is not liable to pay income tax with respect to its total income and is not entitled to any tax credit with respect to partnership income.

Partnership income or a partnership loss of a partnership shall be allocated to the partners in accordance.

Amounts derived and expenditure incurred by partners in common shall be treated as derived or incurred by partnership and not the partners.

Assets owned and liabilities owed by partners in common shall be treated as owned or owed by the partnership and not the partners and shall be treated as –

- in the case of assets, acquired when they begin to be so owned;
- in the case of liabilities, incurred when they begin to be so owed; and
- realized when they cease to be so owned or owed.

All activities of a partnership shall be treated as conducted in the course of the partnership business.

Arrangements between a partnership and its partners shall be recognized other than the following, which are taken into account in determining a partner's share

- loans made by a partner to a partnership and any interest paid with respect thereto; and
- services provided by a partner to a partnership, including by way of employment, and any service fee or income from employment payable with respect thereto.

On the change of partners in a partnership at least two existing partners continue, the partnership shall be treated as the same entity both before and after the change.

Partnership income or loss

Partnership income from a business of a resident or non-resident partnership for a year of income shall be the chargeable income of the partnership for the year of income from the business calculated as if the partnership were a resident partnership.

A partnership loss from a business of a resident or non-resident partnership for a year of income shall be the loss of the partnership for the year of income from the business

Where a trade, business, profession or vocation is carried on by more than one persons in partnership the statutory income from the sources are computed by applying the law and practice prevailing in determining such profits as one entity and apportioned among the partners.

In arriving at the divisible profit that is to be apportioned among the partners certain adjustments are required to be made. These amounts will however be taken into account in apportioning the divisible profits or loss among the partners.

The profits and income from other sources of income (i.e. other than Trade, business, profession or vocation) will be apportioned among the partners separately.

Partnership losses are determined in the same manner as for determination of profits.

The amount of any ground rent, interest, annuity or royalty is added to the total loss to arrive at the divisible loss. Any sum paid as partner’s salary or interest on partner’s capital will be taken into account in determining the divisible loss.

Taxation of partners

For the purposes of calculating a partner's income from a partnership for a year of income of the partner there shall be –

- included the partner's share of any partnership income; and
- deducted the partner's share of any partnership loss, for a year of income of the partnership ending on the last day of or during the year of income of the partner.

Partnership income or a partnership loss allocated to partners

- shall retain its character as to type and source;
- shall be treated as an amount derived or expenditure incurred, respectively, by a partner at the end of the partnership's year of income; and
- shall be allocated to the partners proportionately to each partner's share, unless the Commissioner, by notice in writing, permits otherwise.

At the time partnership income is treated as derived by partners , any income tax or foreign income tax paid or treated as paid by the partnership with respect to the partnership income shall be allocated to the partners, proportionately to each partner's share, and treated as having been paid by them.

"partner's share" is equal to the partner's percentage interest in any income of the partnership as set out in the partnership arrangement.

Cost and incomings of partner’s membership interest in partnership

The following costs and incomings shall be included in the cost of a partner's membership interest in a partnership, namely

- amounts included in calculating the partner's income , at the time of that inclusion; a
- the partner's share of exempt amounts and final withholding payments derived by the partnership at the time the amount or payment is derived.

The following shall be included in the incomings for a partner's membership interest in a partnership: amounts deducted in calculating the partner's income , at the time of deduction;

- distributions made by the partnership to the partner, at the time of distribution; and
- the partner's share of consumption or excluded expenditure incurred by the partnership, at the time the expenditure is incurred.

Determination of Individual Partners Taxable Income:

Distribution

Partners may agree to share profits and losses in any manner irrespective of capital interest.

The agreement of this matter should be complete and specific to avoid misunderstanding and dispute.

Profit and loss is generally divided in the following ways.

- Equally
- In the absence of an express agreement partnership laws provides that profit and loss shall be divided equal regardless of assets and services contributed.

Arbitrary Ratio

Partners to their own discretion may agreed each other to share profit and loss at the agreed ratio. e.g. A: B - 1:4, 5:2, 3:4 etc

Ratio of Partners Capital

When properties invested by the partners represent significant contribution to the success of the firm, partners may agreed to divide profits and losses in the ratio

Original capital

Capital at the beginning of each fiscal period

Capital at the end of each fiscal periods

Average of capitals for each fiscal period.

Steps involved in determining partners' income from partnership

1) Adjust partnership income , the same as any other business income using provisions of s. 11-19 e.g
    - Add back :non allowable expenses
    - Also add back all emoluments received appropriated by the partners
      (Like partner's salaries, interest on capital, interest on loan etc)
    - Less : all allowable expenses and non allowable income

    Note

    All payments made to partners are not deductible; however deduction of rent paid by a partnership to a partner is allowable but would be restricted to the market rental value of the relevant property

2) Appropriation of partners income , so as to determine "Distribution profits /Loss
   Since each partner is separately and individually liable to tax the partnership's taxable profits should be shared among the partners. This is done using the profit and loss sharing arrangements in the partnership agreements

3) Determine the partners income from partnership

    - Distribute the Profit /Loss using agreed P/L sharing ratio
    - Add all other appropriated income, to get partners income from partners from partnership
    - Then add other income (rent ,royalties, interest etc) to get total income

    Hence each partner's total income will be taxed in his/her own hands.

Note

Loss of a partner brought forward can only be used to set-off against his subsequent share of profit

Example 1

Assume a partnership of partners **A and B.** The partnership agreement provides that A is to be paid a salary of Tshs. 10,000,000 p.a. B advanced a loan to the partnership and is entitled to an interest of Shs. 4,000,000 p.a. The balance of profits or losses (after charging A's salary and B's interest on loan) is to be shared equally. Assume that the partnership profits after payment of the salary and interest n loan is Tshs. 16,000,000. The partnership income and the partners' share of the partnership income are determined as under.

Step 1

Adjust partnership income

Partnership income: Partnership profits		16,000,000
Add back:	Partners salary	10,000,000
	Partners interest on loan	4,000,000
Adjusted partnership income		30,000,000

Step 2

Appropriation of partner's income

Adjusted partnership income		30,000,000
Less:	Partners salary	(10,000,000)
	Partners interest on loan	(4,000,000)
	Partnership profits to be shared equally	16,000,000

Step 3

Determine the partner's income from partnership

Partner	A	B
Salary	10,000,000	Nil
Interest on loan	Nil	4,000,000
Share of profits	8,000,000	8,000,000
Total	**18,000,000**	**12,000,000**

Self-Examination Questions

Question 1

Chiley Tali and Ndaja are in partnership trading as manufacturer of ladies garments. The results of which were as follows for 12 months year ended 31st December 2016.

Sales	633,025,000
Discount received	34,000,000
Stock at 1/1/2016	75,000,000
Purchases	474,775,000
Returns inwards	1,225,000
Stock at 31/12/2016	72,500,000

Rent and Insurance	1,212,500
Wages	37,000,000
Repairs and motor vehicle maintenance	11,550,000
Commission	9,325,000
Interest	4,825,000
Depreciation	8,575,000
General expenses	8,500,000
Travelling expenses	10,900,000
Partner's salaries	24,875,000

Additional information

1) 20% of rent and insurance expenses represent private use of business premises by Chiley.
2) During the year 2016, the partnership received insurance money of Tshs 5,000,000 in respect of compensation from Tai Insurance to cover stock of clothes destroyed by fire 2 years ago.
3) Wages includes Chiley's wife salary, Tshs 500,000 per month who is employed as cleaner.
4) General expenses include Tshs 3,500,000 paid to Ms,Shibalala as management consultancy fee and Tshs 400,000 as loss on sale of motor vehicle.
5) Interest expenses included interest paid on partner's capital :Chiley, Tshs 1,000,000 ,Tali Tshs 1,250,000 and Ndaja , Tshs 500,000
6) Commission includes Tshs 1,250,000 as commission paid to Mrs Chiley during the year 2016
7) Partners were entitled to monthly salaries. During the 2016 annual salaries were: Chiley,Tshs 7,375,000, Tali Tshs 7,500,000 and Ndaja, Tshs 10,000,000.
8) It was agreed that Chiley would take 50% of the profit (or loss) and the remaining share will be shared equally among the other 2 partners

Required

(a) Calculate adjusted partnership income for the year 2016
(b) Determine taxable income in the hands of partners

Question 2

Mr. Kula, Mr. Lala and Mr. Faulu are partners trading under the name KLF Enterprise. They share profit and losses in the ratio 5:3:2 respectively. Given below is the Profit and Loss account of the partnership for the year ended 31st December 2013.

	TZS		**TZS**
Office expenses	612,000	Gross profit	6,900,000
Installment tax paid	135,000	Discount received	240,000
Rent and rates	450,000	Profit on sale of shares	300,000
Salaries and wages	840,000	Rent from property	396,000
Printing stationery	192,000	Miscellaneous receipts	450,000
Advertisement	219,000	Interest on fixed deposit	360,000
Interest on capital:			

Kula	180,000		
Lala	210,000		
Faulu	240,000		
Commission to partners			
Kula	135,000		
Lala	105,000		
Legal charges	246,000		
Depreciation	276,000		
Bad debts	204,000		
Donation to famine relief	300,000		
Electricity	138,000		
General reserve	360,000		
Showroom expenses	351,000		
General expenses	297,000		
Net profit	3,156,000		________
	8,646,000		**8,646,000**

The partners have provided the following information in support of the accounts:

(i) It has been the practice to value the stocks at cost price, however, the closing inventory (at 31st December 2013 – TZS.540,000) has been valued at a market price which is less by 10% of its cost price.
(ii) Salaries and wages include 'salaries' amounting to TZS.120,000 paid to Lala.
(iii) Advertising includes TZS.30,000 spent on advertising campaign to introduce a new product in the market.
(iv) Legal charges include TZS.36,000 paid as a fine and penalty.
(v) Capital allowance has been agreed with the Commissioner of Income Tax Department at TZS.270,000.
(vi) Mr. Lala has got no other income.
(vii) Mr.Kula's other income includes TZS.360,000 from rent. He has brought forward business loss of TZS.405,000 from the assessment of the year of income 2012 of the partnership.
(viii) Mr. Faulu has income of TZS.600,000 from gamble winnings. He has brought forward business loss of TZS.405,000 from the assessment of the year of income for 2012 partnership.

Required:

(a) Compute the total taxable income from the partnership business.
(b) Distribute the profit amongst the partners for the year 2013.
(c) Ascertain the taxable income of each partner for the year of income 2013.

Question 3

ABC Modern Builders Enterprise is a partnership of three professional building contractors. On 1st January 2013 there were three partners namely Abdi, Bernard, and Charles sharing profits or losses in the ratios 3:1:1 respectively. The partnership's income and expenditure for the calendar year 2013 showed a net profit of TZS.555,820,000/= as given below. The firm closed its first twelve months accounts on 31st December 2013.

ABC Modern Builders Enterprise

Income and Expenditure Account for the year ended 31st December, 2013

		TZS.
Gross contract income		642,000,000
Profit on sale of motor vehicle		800,000
Interest (1)		600,000
		643,400,000
Less:		
Salaries to partners @ 12 m/ p.a.		36,000,000
Interest on capital		
Abdi (A)	4,000,000	
Bernard (B)	3,000,000	
Charles (C)	2,000,000	9,000,000
Interest on loan – Charles (commercial rate)		5,600,000
Life Insurance premiums to partner's life policies	30,000	
Depreciation on assets	1,750,000	
Partnership office rent	720,000	
Motor vehicle expenses (2)	2,500,000	
Commission – Bernard (B)	3,600,000	
Staff salaries, labour costs	20,000,000	
Supplies and materials	6,000,000	
Sundry expenses (3)	2,015,000	
Telephone, telex, postage	350,000	
Electricity and power (4) Total expenses	15,000	36,980,000 87,580,00
Net Profit		555,820,000 =========

Notes

(i) Interest

	TZS.
Savings account ……………	200,000
Fixed deposit ……………….	400,000
	600,000

(ii) Motor vehicle expenses

25% relates to private use and benefits of the partners

(iii) Sundry expenses

The amount includes:

- Cost of a pick-up for the Chairman of the Tender Committee TZS.2,000,000. This was a necessary cost in order to secure a vital contract for the firm.
- Tax consultant's fee for a successful appeal against estimated 2013 assessment issued on the partners for late filing of their return of income TZS.15,000.

(iv) Electricity and power

TZS.5,000 relates to electricity bills paid for partners' private residence and TZS.50,000 private telephone call for partners.

Required:

Determine the taxable income of each partner.

Question 4

The following information summarizes a return of income of a partnership firm (SOKATU) during the year of income ended 31st December, 2012. The firm is engaged in selling male garments. By December 2012 there were three active partners namely, Sonia, Kala and Tunda.

	Tshs.
Stock (1.1.2012)	30,000,000
Purchases during the year	189,910,000
Sales	252,720,000
Sales discounts	1,360,000
Stock (31.12.2012)	29,000,000
Rent received	4,800,000
Wages	14,800,000
Partners' salaries	9,950,000
Rent, rates and insurance	4,850,000
Electricity	930,000
Repairs	1,060,000
Maintenance of vehicles	3,560,000
Commission	3,730,000
Depreciation	3,430,000
Interest	1,930,000
Loss on sale	160,000
Advertisement	1,470,000
Bad debts	1,600,000
General expenses	1,930,000
Travelling expenses	4,360,000

Additional information

(a) Reported interest (Tshs.1,930,000) include interest on capital to partners, Tshs.400,000 for Tunda; Tshs.500,000 for Kala and Tshs.200,000 for Sonia
(b) Rent, rates and insurance expenses were in respect of business premises, in which one fifth of the premises was occupied by Sonia.
(c) Wages include Tshs.200,000 per month in respect of Sonia's husband.
(d) Commission reported in the accounts include Tshs.500,000 paid to Sonia's husband during the year.
(e) Loss on sale represent loss on sale of motor vehicle during the year.
(f) Salaries Tshs.9,950,000 is distributed at Tshs.2,950,000 for Tunda; Tshs.3,000,000 for Kala and Tshs.4,000,000 for Sonia.
(g) During September 2012, Tshs.2,000,000 was received from insurance company in respect of compensation for goods stolen. This amount has been credited in the partners' drawing accounts.
(h) General expenses (Tshs.1,930,000) include trade losses from previous period - Tshs.630,000, Tshs.150,000 represents defalcation by Sonia, a director to the partnership.
(i) Sonia was entitled to half of any gains from the partnership, the other two partners sharing equally the residual.

Required:

(i) Prepare adjusted partnership income for tax purposes for the year 2012.
(ii) Compute the partners' taxable income for the year 2012.

Question 5

Elisha & co. is carrying on the business of manufacturing furniture including leasing business since 1/1/2015. The business consists of three partners, Elisha, Eliah and Elizah, whose profit and loss sharing in the business are 45%, 40% and 15%.

An Audited Income Statement for the year ended 31st December, 2015 is as follows;

	Tshs.	**Tshs.**
Gross profit		1,800,000
Less: Operating costs		
Salaries and wages	125,000	
Brokerage fees	128,000	
Interest on equity capital	130,000	
Interest on debt capital	124,000	
Utilities	136,000	
Reserve for gratuity	124,000	
Bad debts reserve	112,000	
Depreciation	190,000	
Income tax	125,000	
General establishment charges	250,000	1,444,000
Profit		356,000

After thorough examination of accounts, the following additional information was revealed in the same period;

(i) Salaries scheme was made for Elisha Tshs. 30,000; Eliah Tshs. 25,000; Elizah Tshs. 20,000 and Mrs. Elisha who is a secretary Tshs. 35,000.

(ii) Brokerage fees included payments to partners in the following arrangements; Elisha Tshs. 10,000; Eliah Thss. 5,000 and Elizah Tshs. 14,000.

(iii) The interest on equity capital includes the following payments to partners; Elisha Tshs. 10,000; Eliah Tshs. 15,000 and Elizah Tshs. 21,000.

(iv) The interest on debt capital includes the payments to Elisha Tshs. 15,000 and Eliah Tshs. 25,000.

(v) Utilities include an additional sum of Tshs. 35,000 paid to the landlord of the shop for structural alterations made to the shop by him in April 2015. The rent was not increased by the landlord after this alteration.

(vi) The Partnership leased the machinery to XYZ Co. Ltd costing Tshs. 30,000,000 for which it received Tshs. 6,880,000 per annum, the amount has not been included in the assessment.

Required:

Compute the total taxable income of all partners in that period with particular reference to the Income Tax Act, Cap 332.

Answers to Self-Examination Questions

Question 1

a) Computation of taxable partnership income:

Sales		633,025,000
Add: Discount received		3,400,000
Less: Returns inward		(1,225,000)
Net sales		635,200,000
Less: COGS		
Opening stock	75,000,000	
Purchases	474,775,000	
	549,775,000	
Less: Closing stock	(72,500,000)	477,275,000
Gross profit		157,925,000
Other income		
Insurance compensation		5,000,000
Expenses		
Rent and insurance (12,125,000 – 2,425,000)	9,700,000	

Wages	37,000,000	
Commission	9,325,000	
Repair and maintenance	11,550,000	
Interest expenses (4,825,000 – 2,750,000)	2,075,000	
General expenses (8,500,000 – 400,000)	8,100,000	
Travelling expenses	10,900,000	88,650,000
		74,275,000

Note

The following expenses are not allowed hence should not be deducted from the gross profit

- Private rent and insurance-business premises (20%*12,125,000) 2,425,000
- Depreciation 8,575,000
- Loss on sale of motor vehicle 400,000
- Interest on partners capital (1,000,000 + 1,250,000 + 500,000) 2,750,000
- Partner's salary (7,375,000+7,500,000+10,000,000) 24,875,000

b) Taxable income in the hands of partners

	Chiley	**Tali**	**Ndaja**
Salary	7,375,000	7,500,000	10,000,000
Private rent and insurance	2,425,000		
Interest on capital	1,000,000	1,250,000	500,000
Distributable profit (50%: 25%: 25%)	37,137,500	18,568,750	18,568,750
Taxable gains	**47,937,500**	**27,318,750**	**29,068,750**

Answer to SEQ 2

(a) KLF Enterprises computation of Taxable Income:

	TZS	**TZS**
Reported Net profit as per Income Statement		3,156,000
Add back: Non allowable deductions		
Loss on valuation of closing inventory(100/90 x 540,000 – 540,000)	60,000	
Salary-Lala	120,000	
Instalment tax paid	135,000	
Interest on capital:		

Kula	180,000	
Lala	210,000	
Faulu	240,000	
Fine and penalty	36,000	
Commission:		
Kula	135,000	
Lala	105,000	
Depreciation	276,000	
Donation	300,000	
General Reserve	360,000	
Error in P & L (3,156,000 – 3,120,000)	(36,000)	2,121,000
		5,277,000
Less: Income exempt or not related:		
Rent from property	396,000	
Profit on sale of shares	300,000	
Interest on deposits	360,000	1,056,000
Less: Allowable deductions		4,221,000
Depreciation allowable as per ITA 2004		270,000
Adjusted Partnership Income		**3,951,000** ========

(b) **Distribution of income among Partners:**

Particulars	Kula	Lala	Faulu	Total
Salary	-	120,000	-	120,000
Interest on capital	180,000	210,000	240,000	630,000
Commission	135,000	105,000	-	240,000
Share of balance	1,480,500	888,300	592,200	2,961,000
Taxable Income	1,795,500	1,323,300	832,200	3,951,000

c) **Calculations of Taxable Income:**

	Kula	Lala	Faulu	Total
	TZS	TZS	TZS	TZS
Income from partnership	1,795,500	1,323,300	832,200	3,951,000
Rent from property 5:3:2)	198,000	118,800	79,200	396,000
Rental Income	360,000	-	-	360,000
Profit on sale 5.3.2	150,000	90,000	60,000	300,000
Interest on Fixed Dep. 5.3.2	180,000	108,000	72,000	360,000
	2,683,500	1,640,100	1,043,400	5,367,000
Less:				
Business Loss b/f	405,000 ----------	- ----------	405,000 -----------	810,000 -------------
Taxable Income	2,278,500 =======	1,040,100 =======	638,400 ======	4,557,000 =======

Answer to SEQ 3

Determination of taxable income of ABC – Modern Builders enterprise partnership for the year 31st December, 2013

	Net Profit as per accounts		555,820,000
	Add back disallowable:		
	Motor vehicle expenses (private)	625,000	
	Cost of pick-up	2,000,000	
	Tax consultant fee	15,000	
	Electricity (private portion)	5,000	
	Telephone	50,000	
	Salaries to partners	36,000,000	
	Interest on capital	9,000,000	
	Insurance premiums	30,000	
	Depreciations	1,750,000	
	Commission	3,600,000	53,075,000
			608,895,000
	Deduct:		
	Profit on sale of asset	800,000	
	Interest (total)	600,000	
	Depreciation allowance (class 1 37.5% on Pick-up)	750,000	(2,150,000)
	Adjusted profit		606,745,000

	Adjusted profit		606,745,000
	Deduct:		
	Salaries to partners	36,000,000	
	Interest on capital	9,000,000	
	Commission – B	3,600,000	(48,600,000)
	Distributable profits		558,145,000
	Share of profits:		
	A (3/5)		334,887,000B
	B (1/5)		111,629,000
	C (1/5)		111,629,000

	Allocation of total income to partners		
	A	B	C
Salary	12,000,000	12,000,000	12,000,000
Interest on capital	4,000,000	3,000,000	2,000,000
Commission		3,600,000	
Interest on loan			5,600,000
Share of profits	334,887,000	111,629,000	111,629,000
Taxable income	350,887,000	130,229,000	131,229,000

Answer to SEQ 4

Preparation of adjusted partnership income and partners' taxable income

(i) Adjusted partnership income

Computation of gross profit			
Sales		252,720,000	
Add: Discounts		1,360,000	
		254,080,000	
Less: COGS			
Opening Stock	30,000,000		
Add: Purchases	189,910,000		
COGAS	219,910,000		
Less: Closing Stock	29,000,000		
COGS		(190,910,000)	
Gross Profit		**63,170,000**	
Add: Insurance Compensation		2,000,000	
Gross Income		**65,170,000**	
Adjusted Partnership Income			
Gross Profit		65,170,000	
Deduct: Allowable expenses:			
Interest expenses [1,930,000 – (400,000 + 500,000+ 200,000)]		830,000	
Wages		14,800,000	

Rent, rates, insurance		4,850,000	
Electricity		930,000	
Repairs		1,060,000	
Maintenance of vehicles		3,560,000	
Commission		3,730,000	
Depreciation		3,430,000	
Advertisement		1,470,000	
Bad debts		1,600,000	
General expenses 1,930,000 – (630,000 + 150,000)		1,150,000	
Travelling expenses		4,360,000	
Total deductible expenses		(24,090,000)	
Adjusted partnership income		41,080,000	

(ii) Partners' taxable income

	Sonia	**Kala**	**Tunda**
Salary	2,950,000	3,000,000	4,000,000
Interest on capital	400,000	500,000	200,000
Rent, rates, insurance (1/5*4,850,000)	970,000		
Wage (Sonia's husband 200,000*12)	2,400,000		
Commission (Sonia's husband)	500,000		
Profit share (1.2:1/4)	20,540,000	10,270,000	10,270,000
Taxable income	**27,760,000**	**13,770,000**	**14,470,000**

Answer to SEQ 5

Step 1:- Adjusting Net Profit

Profit as per accounts		356,000
Lease Income		6,880,000
		7,236,000
Add Back: Non-Allowable Deduction		
Partners salaries	75,000	
Brokerage fees to partners	29,000	
Interest on Equity Capital	46,000	
Interest on Debt Capital	40,000	
Utilities – Structural alterations	35,000	
Reserve for gratuity	124,000	
Bad Debts Reserve	112,000	
Income Tax	125,000	586,000
Adjusted Net Profit		**7,822,000**

Step 2:-Appropriated Partners Income

Partners salaries (25,000 + 20,000 + 35,000)	75,000
Brokerage Fees (10,000 + 5,000 + 14,000)	29,000
Interest on Equity Capital (10,000 + 15,000 + 21,000)	46,000
Interest on debt Capital (15,000 + 25,000)	40,000
Appropriated Income	**190,000**

Adjusted Income		7,822,000
Less: Appropriated Income		190,000
Distributed Profits (To be apportioned using sharing ratios)		7,632,000

Step 3:- Total income

	Elisha	**Eliah**	**Elizah**
Sharing Ratios	45%	40%	15%
Profit Share	3,434,400	3,052,800	1,144,800
Salaries	30,000	25,000	20,000
Brokerage Fees	10,000	5,000	14000
Interest on Equity Capital	10,000	15,000	21,000
Interest on Debt Capital	15,000	25,000	-
Partners' Profits	**3,499,400**	**3,122,800**	**1,199,800**

SECTION A

INCOME TAXATION RULES APPLICABLE TO PARTICULAR TYPES OF PERSONS/BUSINESS

A4

STUDY GUIDE A4: CORPORATE INVESTMENT INCOME

Get Through Intro

Investment income comes from holding an asset for a certain period in anticipation of getting periodic income /and or getting capital gain from its realisations. It is very closely related to business activities, but it differs in two aspects: it is just a minor undertaking of a person and there is no close link to business activities. This Study Guide is specifically aimed at elucidating items which are included in computation of investment income and those items which are excluded when computing investment income.

In doing so, it covers sections in the Income Tax Act to enable you to establish correct taxable investment income. Sections from Income Tax Act Cap 332 are being referred to throughout this Study Guide. Knowledge of determining investment income is essential in understanding how investors are taxed.

Learning Outcomes

1. Explain the meaning of Investment and its differences from business
2. Describe inclusions /component of investment income
3. Describe exclusions /income not Included in Investment income
4. Explain allowable and non allowable deductions of investment income
5. Establish chargeable Investment Income

1. **Explain the meaning of Investment and its differences from business; describe inclusions /component of investment income; and describe exclusions /income not Included in Investment income. [Learning outcome a, b, and c]**

1. Meaning Of Investment And Its Differences From Business

1.1 Investment

Section 3 of the Act provides definitions of the term **investment** as the owning of one or more assets of a similar nature or that are used in an integrated fashion, on similar terms and subject to similar conditions, including as to location

Investment can be
- (i) past,
- (ii) present and
- (iii) prospective investment,

But investment does not include
- (i) Business,
- (ii) Employment and
- (iii) The owning of assets, other than investment assets, for personal use by the owner

This definition covers any assets unless they are held primarily for personal use by the person who owns them and are not used in the production of profits. The definition of investment excludes employment or business. If the issue arises as to whether certain activities of a person constitute one or more investments, there are two tests to check it. The first is whether the assets held are of a similar nature. *For example: A block of shares may constitute a single investment.*

The second test is whether the assets are used in an integrated fashion, on similar terms, and subject to similar conditions, including as to location. *For example: A house that is held passively and rented out with associated furniture will constitute a single investment.*

Any liabilities incurred with respect to the asset or assets held are also part of the investment.

1.2 Differences of Investment and business

It is important to differentiate when someone is doing business or investment because of difference in tax rates. Unlike a business person who expects benefiting from regular or many frequent transactions, someone making an investment normally takes a long term view of his/her activities. For example, shareholders of a corporate might hold shares for expectation of getting periodic dividends and long term capital gains after disposing of the shares. However, share brokers in most cases buy shares in order to profit from short term rises or falls in share prices. So if the share brokers get dividends or capital gain from realisation of shares, these incomes are more likely to be business incomes than investment income.

Furthermore, another important distinction between business and investment activities is that business activities are normally the major occupations of a person while investment activities are subsidiary ones. Take an example of interest income; the interest income received by an individual from a saving or fixed deposit account might be investment income, while, the interest income received by financial institutions or money lenders is definitely business income. Likewise, rent income received by property management company is business income, the same income received by a trading company owning a few properties may be investment income.

Finally, it is important to look at the substance of the income, not the form of it. For instance, interest received from the business accounts is business income not investment income. Also income from short term investments using business funds are business income not investment income as income from letting extra business space.

2. Inclusions /Component Of Investment Income

According to section 9 (1) of the Income Tax Act Cap 332, the following items are investment income.

(a) Dividend,
(b) Distribution of a trust,
(c) Gains of an insured from life insurance,
(d) Gains from an interest in an unapproved retirement fund,
(e) Interest,
(f) Natural resource payment,
(g) Rent
(h) Royalty;
(i) Net gains from the realisation of investment assets of the investment
(j) Amounts derived as consideration for accepting a restriction on the capacity to conduct the investment.

Definitions

'Royalty' means any payment made by the lessee under a lease of an intangible asset and includes payments for:

(a) the use of, or the right to use, a copyright, patent, design, model, plan, secret formula or process or trademark;
(b) the supply of know-how including information concerning industrial, commercial or scientific equipment or experience;
(c) the use of, or right to use, a cinematography film, videotape, sound recording or any other like medium;
(d) the use of, or right to use, industrial, commercial or scientific equipment;
(e) the supply of assistance ancillary to a matter referred to in paragraphs (a) to (d); or
(f) a total or partial forbearance with respect to a matter referred to in paragraphs (a) to (e), but excludes a natural resource payment.

Section 3

'**Natural resource'** means minerals, petroleum, water or any other non-living or living resource that may be taken from land or the sea.

Section 3

'Natural resource payment' means any payment, including a premium or like amount, for the right to take natural resources from land or the sea or calculated in whole or part by reference to the quantity or value of natural resources taken from land or the sea.

Section 3

'Interest' means a payment for the use of money and includes a payment made or accrued under a debt obligation that is not a repayment of capital, any gain realised by way of a discount, premium, swap payment or similar payment.

'Gains of an insured from life insurance . Section 60(3) provides the meaning of the term "gains of an insured from life insurance" as the extent to which proceeds from life insurance paid by an insurer exceed premiums paid to the insurers with respect to the insurance

'Gains from an interest in an unapproved retirement fund'

Gains from an in interest in an unapproved retirement fund" is defined in section 63 to mean the extent to which retirement payments made by an unapproved retirement fund in respect of an interest in the fund exceed retirement contributions made to the fund in respect of the interest.

Net gain from realisation of investment assets

The net gain from realisation of investment assets is calculated as follows:

(a) Total of all gains from the realisation of investment assets during the year
(b) Less

(i) Total of all losses from the realisation of investment assets of the investment during the year;
(ii) Any unrelieved net loss of any other investment of the person for the year.
(iii) Any unrelieved net loss of an investment for a previous year of income (Section 36(3)).

Definitions

'Investment asset' means shares and securities in a corporation, a beneficial interest in a non-resident trust and an interest in land and buildings but does not include:

(a) business assets, depreciable assets and trading stock;
(b) a private residence of an individual that has been owned continuously for three years or more and lived in by the individual continuously or intermittently for a total of three years or more, other than a private residence that is realised for a gain in excess of 15,000,000 shillings;
(c) an interest in land held by an individual that has a market value of less than 10,000,000 shillings at the time it is realised and that has been used for agricultural purposes for at least two of the three years prior to realisation; and
(d) shares or securities listed on the Dar es Salaam Stock Exchange that are owned by a resident person or a non-resident person who either alone or with other associate controls less than 25% of the controlling shares of the issuer company.

'**Unrelieved net loss**' of an investment for a year of income is the excess of losses over gains from the realisation of investment assets of the investment during the year of income.

3. Exclusions /Income Not Included In Investment Income

Section 9(3) provides that the following amounts are to be excluded in calculating gains or profits from conducting an investment:-

(i) Exempt amounts
(ii) Final withholding payments; and
(iii) Amount that are in calculating the person's income from any employment or business.

2. Explain allowable and non-allowable deductions of investment income and establish chargeable Investment Income [Learning outcome d and e]

4. Allowable And Non Allowable Deductions Of Investment Income

4.1 Allowable deductions

As it was for business income, taxable investment income is established after deducting allowable deductions. Almost all the criteria for allowing or not allowing expenses we saw in business income apply here as well. In short, only expenses incurred 'wholly and exclusively' in the production of business income are allowable expenses (Section 11(3)). Therefore, only expenditure incurred for sole purposes of producing investment income are allowable expenses and expenditure incurred not wholly and exclusively for business purposes is not allowable.

4.2 Non-allowable deductions

Likewise, deduction of capital, consumption and excluded expenditures are not allowed (Section 11). Also, unlike business persons who are allowed to deduct depreciation annual allowance under the third schedule of Income Tax Act Cap 332, investors cannot claim depreciation charges on their investment assets. Therefore, depreciation charges of investment assets calculated under taxpayers' accounting policies are not allowed too.

5. Chargeable Investment Income

By now we have learnt that not all income from investment are taxable, some are final withholding payments, some are exempt income and some are simply not related to investment. Also we saw how to identify allowable deductions and non-deductible expenses when computing investment income.

This section deals with how to establish chargeable income from investment activities. The investment income of a sole trader can be computed on cash or accrual basis unless specifically required by tax laws, while corporations compute their investment income on accrual basis.

'**Chargeable investment income'** of resident person, includes all his or her income for the year of income irrespective of the source of the income, while **chargeable income** of non-resident persons income only to the extent that the income has a source in the United Republic.

Self-Examination Questions

Question 1

SETC (T) LTD is a non-resident corporation with the following sources of income during the year of income ended December 31, 2018:

(i) Sold shares of MAJIB Ltd, a non resident (Listed shares in the Dar es Salaam Stock Exchange - DSE) whereby the company owns 35% of the controlling shares. These shares were bought at Tshs.24,000,000 and sold for Tshs.34,000,000.

(ii) Received bank interest in relation to a fixed deposit with YXZ Bank Ltd of Tshs.10,300,000.

(iii) Received Tshs.10,000,000 for sale of a land situated at Dar es Salaam. This land was acquired in 2015 for Tshs.2,000,000. The corporation used it for agricultural purposes from 2016 – 2018.

(iv) Received dividend of Tshs.7,000,000 from HK Ltd. This was a resident corporation where the company owned 28% of the shares.

(v) Paid dividends to WISE Ltd of Tshs.23,000,000. This is a non-resident corporation owning 35% of the shares of the company.

(vi) Received rent (in conducting business) of Tshs.20,000,000. This came from an investment building located at Igunga, Tabora. This building was constructed at Tshs.450,000,000. During the year, the company acquired furniture and fixtures for the building worth Tshs.23,000,000. Apart from that, the company incurred Tshs.3,000,000 to repair the building in order to increase its lifespan.

(vii) Sold 10,000 shares of MAJURA Ltd, a resident corporation (unlisted in the DSE). These were acquired at Tshs.300 each and sold for Tshs.500 each.

(viii) Received dividends of Tshs.32,000,000 from ABC Ltd, a non resident corporation where SETC Ltd owns 40% of the shares of this company.

(ix) Sold a residential house of the company which had been occupied for three years for Tshs.25,000,000. The house was bought in Igunga for Tshs.26,000,000.

(x) Dividends amounting to Tshs.5,000,000 were received from CHEMA Ltd, a non resident corporation, which is listed in DSE and 20% of its shares is owned by KET Ltd, a resident company.

Required:

With respect to SETC (T) Ltd, calculate for the year of income ended December 31, 2018 chargeable investment income

Question 2

During the year, Magic Company Limited conducted the following transactions:

(i) Received dividend from TTT Limited, a resident corporation, amounting to Tshs5,500,000. Magic Limited owns 45% of the shares of TTT Limited.

(ii) Dividends amounting to Tshs2,500,000 were received from HP Williamson Limited, a non-resident company.

(iii) Dividends amounting to Tshs1,550,000 received from Chuwa Company Limited, a resident corporation.

(iv) Magic Company Limited has its office on Ali Hassan Mwinyi Road; the office was underutilized. The company decided to rent the front part of its office to Juma Bakari, a businessman, who used it as a shop. Mr. Bakari paid Tshs800,000 as rent.

(v) During the year the company received Tshs300,000 as rent from Mr. Chagula, a Tanzanian, with respect of a house occupied by Mr. Chagula situated at Mabibo – Dar es Salaam.

(vi) Also the company received a royalty from Mazimbu Limited amounting to Tshs4,500,000 out of lease of videotapes used for promotion.

(vii) During the year, Magic Company Limited sold 5 hectares of land, which was at Mikocheni and received Tshs20,000,000. This land was purchased for Tshs3,000,000 in 1980. 3 years prior to its sale, this land had been used as agricultural land.

Required:

Identify items included in investment income for the year 200X.

Answers to Self-Examination Questions

Answer to SEQ 1Amount

Net gain from realization of investment assets	19,000,000
Bank Interest [Exempted)	10,300,000
Dividends (HK Ltd) [Final Withholding Payment]	NIL
Dividends (WISE Ltd) [Not Income]	NIL
Rent (Igunga Building)	20,000,000
Dividends (ABC Ltd)	32,000,000
Dividends (CHEMA Ltd)	5,000,000
Chargeable Income	**86,300,000**

Note 1-It is not individual investment assets gain which are included in the computation of investment income but net gain of realizing investment assets

Net gain from realization of investment assets	
Land [10,000,000 – 1,200,000]	8,000,000
Shares (MAJIB) [34,000,000 – 24,000,000]	10,000,000
Shares (MAJURA Ltd) [200 x 10,000]	2,000,000
Residential Building (Igunga) [25,000,000 – 26,000,000]	(1,000,000)
	19,000,000

Answer to SEQ 2

- Dividend received from TTT Limited is final withholding payments
- Dividend received from HP Williamson Limited is chargeable investment income
- Dividend from Chuwa Company Limited is final withholding payments
- Capital gain from realisation of land at Mikocheni is taxable investment income
- Rent received from Mr. Chagula is taxable investment income
- Royarly received from Mazimbu Limited is taxable investment income
- Rent received from Mr.Bakari is business income not investment income

SECTION A

INCOME TAXATION RULES APPLICABLE TO PARTICULAR TYPES OF PERSONS/BUSINESS

A5

STUDY GUIDE A5: TAX ACCOUNTING FOR LONG TERM CONTACTS

Get Through Intro

For many businesses, revenue and costs are easily divisible into a 12-month accounting period. For example, a retailer will recognise revenue when realised throughout the year, and match costs in accordance with the accruals concept. For some businesses, however, traditional revenue recognition methods (ie 'show revenue when realised') are not applicable. Many such organisations are in the construction industry and their business dealings involve contracts that are usually long-term in nature or span at least one accounting year end. This guide describes taxation rules for construction projects under the Income Tax Act, Cap 332 .

Learning Outcomes

1. Describes the accounting for revenue and expenses under long-term contracts
2. Explain the rules for accounting long term contracts transactions for income tax purposes
3. Explain the treatment of unrelieved loss under long-term contract

1. **Describes the accounting for revenue and expenses under long-term contracts; and explain the rules for accounting long term contracts transactions for income tax purposes [Learning outcome a and b]**

1. Accounting For Revenue And Expenses Under Long-Term Contracts

Section 26(1) of the Act provides that where a person accounts for income tax purposes on accrual basis, and amounts to be included or deducted in calculating income that relates to a long-term contract shall be taken into account on the basis of the percentage of the contract completed during each year of income. When an outcome of a long term contract can be estimated reliably, contract income and expenses related to the contract shall be recognized as income and expenses respectively by reference to the stage of completion of the contract at the end of the year of income. An expected loss can be recognized as an expense immediately .

2. Rules for accounting long term contracts transactions for income tax purposes

Section 26(2) provides the method of calculating the percentage of completion at the end of the year of income. This subsection provides specific rules for accounting for revenue and expenses under long term contracts in order to avoid confusion, particularly for persons accounting for income tax purposes on accrual basis, about the recognition time of income and expenses. In accounting for revenue and expenses under a long-term contract the percentage of completion of the contract completed during the year of income shall be used to calculate the income and expenses related to the year of income. Under this method expenditure allocated to the contract and incurred during the year of income is compared with the estimated total contract expenditure as determined at the commencement of the contract. The assumption is that, contract costs incurred for work performed during the year of income has relation to the estimated total costs. Note should be taken that, progress payments and advances received do not constitute nor reflect the value of work performed, hence they should not be taken as a basis of determining income for tax purposes when accounting for long term contracts. The principal concern under the percentage of completion method is how to measure the percentage of the contract completed during the year of income. An administrable rule is to assume that the percentage of the contract completed during the year of income. An administrable rule is to assume that the percentage of completion equals the percentage of total costs during year. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, hence determining the amount of gains or profits derived or loss incurred which can be attributed to the portion of the contract completed for the year of income. Therefore under the accounting method contract revenue is recognized as income in the year of income in which the work is performed and the expenses attributed to the portion of the work complete.

Methods of determining stage of completion

The stage of completion of a contract may be determined in various ways. The methods used are that measures reliably the work performed or completed in a given period of time during the period of the contract. For income tax purposes the period of time is a year of income. Depending on the nature of the contract work, the methods may include:

(i) the proportion that contract costs incurred for work performed to date bears to the estimated total contract costs;

(ii) survey of work performed; or

(iii) completion of a physical portion of the contract work.

Cost allocation

When the stage of completion is determined by reference to the contract costs incurred to date, only those contract costs that reflect the work performed to date are included in the cost incurred amount.

> **2. Explain the treatment of unrelieved loss under long-term contract**
> **[Learning outcome c]**

3. Treatment Of Unrelieved Loss Under Long-Term Contract

Section 26(3) provides that, where on completion of a long-term contract the person has unrelieved loss (determined under section 19) for a year of income that is attributable to the long-term contract, the Commissioner may allow that loss to be carried back to a previous year of income or treated as unrelieved loss for that year. That is, the Commissioner may, at the time of completion of the long-term contract allow to be carried back the amount of unrelieved loss for the year of income to a previous year of income and treated as unrelieved loss for that year.

The ceiling of unrelieved loss deduction

Section 26(4) puts a limit on an amount to be carried forward that is treated as unrelieved loss for the year of income as provided under section 26(3)(b) of the Act. That is, the loss to be carried forward shall be limited to the amount of deduction in that year of income.

Unrelieved loss attributable to a contract

Section 26(5) provides the extent to which unrelieved loss might be attributable to a long-term contract. Under this subsection, unrelieved loss for a year of income attributable to a long-term contract shall be the excess of deductions over the amounts accounted as derived when determining the business income from that contract.

Where the provisions of this section apply, an assessment shall be adjusted accordingly, subject to the time limit for issuance of an assessment as provided for in the Act, and the limits set in section 19 as regards to loss from a business or investment.

Example:

The following example illustrates determination of long term contract income for a year of income based on percentage of the contract completed during the year of income.

Total contract price for construction of a hospital at Kinyerezi is Shs. 450,000,000/=. The estimated total costs for contract are Shs. 400,000,000/=. The contract is estimated to last for 3 years. The percentage of completion of the contract is 25 percent at the end of year 1; 75 percentage at the end of year 2 and 100 percentage at the end of year 3. There is not other information available.

Formula = Total Expenditure allocated to the contract and incurred during the year

Over

Estimated to be contract expenditure determined at commencement

Workings:

	Year 1	**Year 2**	**Year 3**
Total Revenue	450,000,000	450,000,000	450,000,000
Contract Costs incurred to date	100,000,000	300,000,000	400,000,000
Contract Cost to Completion	300,000,000	100,000,000	-
Total estimated cost	400,000,000	400,000,000	400,000,000
Percentage of profit completion			

Amount to be recognized for Revenue purposes:

Year 1 (25 percent completion)

Revenue	450,000,000 x 25%	=	112,500,000/=
Expenses	400,000,000 x 25%	=	100,000,000/=
	Profit		12,500,000/=

Year 2 (75 percent completion)

Revenue	450,000,000 x (75% - 25%)	=	225,000,000/=
Expenses	400,000,000 x (75% - 25%)	=	200,000,000/=
	Profit		25,000,000/=

Year 1 (100 percent completion)

Revenue	450,000,000 x (100% - 75%)	=	112,500,000/=
Expenses	400,000,000 x (100% - 75%)	=	100,000,000/=
	Profit		12,500,000/=

Example B

Examples of the event, where the Commissioner may at the time of completion of the long-term contract allow the amount of unrelieved loss for that year.

1. Assumptions

- There is only one contract
- The coy owns depreciable assets
- The coy incurred other business operating expenses
- Contract duration was estimated to be 3 years

Name of T/P	-	X coy
Nature of Business	-	Building contractor
Duration of Contract	-	2016 – 2018

Other Details

Y/1	**2016**	**2017**	**2018**
Project Status	In progress	In progress	Completed
Contract sum	600,000,000	600,000,000	600,000,000

Contract Cost Incurred to date (A)	100,000,000	287,000,000	568,000,000
Contract Cost to Completion	300,000,000	123,000,000	-
Total estimated cost (B)	400,000,000	410,000,000	568,000,000
Expected Gross Profit	200,000,000	190,000,000	32,000,000
Percentage of completion A/B	25%	72%	100%
Gross Profit	50,000,000	133,000,000	32,000,000
Profit for prior		50,000,000	133,000,000
Add back dep.	14,700,000	19,200,000	64,000,000
Allow: wear & tear	20,175,000	17,546875	79,361,378
Administration Expenses	14,525,000	24000,000	99,288,672
NET PROFIT	30,000,000	60,653,125	(215,650,050)
Amount of unrelieved loss carry forward	-	-	(178,650,050)

The assumption here is that, the amount of unrelieved loss to be carried forward does not exceed the amount of education under the contract for that year. That is, the loss to be carried forward shall be limited to the amount of deduction in that year of income.

The meaning of a "long-term contract"

Section 26(6) provides the meaning of the term "long term contract as follows:

(a) means a contract for manufacture, installation, or construction, or, in relation to each the performance of related services, which is not completed within the year of income in which work under the contract commences; but

(b) Excludes a contract estimated to be completed within six months f the date on which work under the contract commenced.

The section provides the types of business for which long term contracts may be entered into and to which the provisions of the section may apply. They are the mentioned types of business or services related to those types of business spreading over a period of more than one year of income but not completed within six months of the date of commencement. However, section 26(7) extends use of percentage of application regulation to other business outside those mentioned in section 27(6). It should be noted that the extension covers only the application of the percentage of completion regulation.

Application of the percentage of completion method to other types of contracts

Section 26(7(provides authority for application of regulation prescribing that the percentage of method may apply to other type of contracts that span more than one year of income where contract may accelerate expenditure in early years or delay income until later years of contact.

Application of regulation 49(3) of the Income Tax Regulations, 2004

Regulation 49(3) of the Income Tax Regulations, 2004 provides that the provisions of section 26 shall apply to contracts entered into by a person after the Income Tax Act, 1973 ceases, that is the provisions of section 26 of the Act will apply to contracts entered into after 1st July, 2004. Prior contracts will not be subjected to section 26 treatments even where they spread over years of income commending after the operationalization of the Income tax Act, 2004. For example a three year long term contract entered into in January, 2003 which ends in December 2006 shall not be subject to the provisions of section 26 of the Act in calculating the income from the contract for years 2004, 2005 and 2006. The provisions of the repealed Income Tax Act, 1973 shall apply with the respect to that contract to the extent of calculation of the gains or profits delivered or loss incurred.

SECTION B

TAXATION OF SPECIALIZED INDUSTRIES

B1

STUDY GUIDE B1: TAXATION OF INSURANCE BUSINESS

Get Through Intro

Income and expenditures of an insurance business are unique to those of other most common business e.g. trading and manufacturing. Moreover, the operations of insurance business are a little bit unique as compare to many other common businesses. Therefore, we need income computation rules that may cater for the unique characteristics of insurance business. This chapter discusses specific rules related with computation of chargeable business income in respect of General Insurance Business and Life Insurance Business.

Learning Outcomes

a) Describe special rules related with computation of taxable of a person running General Insurance Business
b) Describes special rules related with computation of taxable of a person running Life Insurance Business

1. **Describe special rules related with computation of taxable of a person running General Insurance Business. [Learning outcome a]**

1. Special Rules Related With Computation Of Taxable Of A Person Running General Insurance Business

Definitions

'**Insurance business'** means the business of an insurer in effecting, issuing and carrying out insurance
'**General business'** means any insurance that is not life insurance;

Calculation of tax liabilities for general insurance business

When calculating income from general insurance businesses, all premiums derived during the year of income by the person as insurer, including as re-insurer, and proceeds derived during the year of income by the person under any contract of re-insurance should be included in the person's income.
Likewise, the persons should deduct proceeds incurred during the year of income by the person as insurer, including as re-insurer and premiums incurred during the year of income by the person under any contract of re- insurance (Section 58(2)). Furthermore, the insurance company may deduct ordinary business expenses and commissions.

Income from general insurance business (during a year) =

Premiums received by the person as insurer, re-insurer

Add: Proceeds from re-insurance
Less: Proceeds you pay out as insurer or re-insurer
Less: Any premiums paid to re-insurers where you take out re-insurance
Less: Ordinary business expenses and commissions.

Example 1

R Insurance Company Ltd is carrying on general insurance business. The company also re-insures certain risks in Company A outside the United Republic of Tanzania.
The financial statements of R Insurance Company for the year 2017 showed the following:

- Total premium derived Tshs.5,200 million, this amount included Tshs.400 million premium received during a year of income which will cover risks for a period after the end of year 2013 (unexpired risks).
- Outwards reinsurance was Tshs.2,500 million.
- Rental income was Tshs.100 million.
- Interest on deposits with the financial institutions Tshs.100 million.
- Gross claims incurred were Tshs.1,100 million; this included claims that were incurred but not reported of Tshs.600 million.
- Commission payable Tshs.700 million.
- Operating and other expenses incurred in conducting the insurance business Tshs.200 million.
- Reinsurance proceeds received during the year from Company A were Tshs.500 million.

Required:

Calculate the taxable income of R Insurance Company for the year of income 2017

Solution

Note: The income derived or loss incurred from conducting general insurance business shall be calculated separately from the income or loss from any other activities of the person.

Determination of the taxable Income for R Insurance Company Ltd

Include: **(In Million sh.)**

Premiums derived as insurer*(5,200ml=-400ml/=		4,800	
Proceeds derived from reinsurance		500	
Total income		**5,100**	
Less:			
Premiums incurred on reinsurance	2,500	2,500	
Claims paid (Proceeds incurred)		1,100	
Expenses		200	
Total deductions		**3,800**	
Income from insurance activity		1,500	
Commissions Payable		(700)	
Taxable insurance income		**800**	
Interest income		100	
Rental income		100	
Total taxable income		**1,000**	

- Premium paid for un-expired risks are disregarded for this year and will be included in the following year. The outward reinsurance that R Company Ltd. Paid to A Company (non-resident) in subject to withholding tax of 5% as per the requirements of section 83(1)b) read together with the first schedule of the income Tax act para 4(c)(iii).

2. **Describes special rules related with computation of taxable of a person running Life Insurance Business [Learning outcome b]**

2. Special Rules Related With Computation Of Taxable Of A Person Running Life Insurance Business

Definitions

'**Life insurance'** means insurance of any of the following classes:

(a) insurance where the specified event is the death of an individual who is the insured or an associate of the insured;

(b) insurance where:

(i) the specified event is an individual who is the insured or an associate of the insured sustaining personal injury or becoming incapacitated; and

(ii) the insurance agreement is expressed to be in effect for at least five years or without limit of time and is not terminable by the insurer before the expiry of five years except in circumstances prescribed by the regulations;

(iii) insurance under which an amount or series of amounts is to become payable to the insured in the future;and

(iv) re-insurance of insurance referred to under paragraphs (a) to (c).

'**Life insurance business'** means the business of an insurer in effecting, issuing and carrying out life insurance

Calculation of tax liabilities for general insurance business

The calculation of income from life insurance business **should not include** premium derived during the year of income by the person as insurer, including as re-insurer and proceeds derived during the year of income by the person under any contract of re-insurance (Section 59(1)). Likewise, **no deduction** or inclusion in the costs of assets or liability of proceeds incurred during the year of income by the person as insurer, including as re-insurer and premiums incurred during the year of income by the person under any contract of re-insurance is allowed (Section 59(2)). However the insurance company may deduct ordinary business expenses and commissions.

Tip

Income from life insurance business (during a year) should not include the premium received as insurer, re-insurer and proceeds earned under any contract of re-insurance. Ordinary business expenses and commissions can be deducted as expenses. Also do not include expenditure on proceeds you pay out as insurer or re-insurer, or premiums paid to re-insurers where you take out reinsurance.

Example 1

K Insurance Company is conducting a life insurance business. K Company reinsured some of the policy risks with Company M. In addition K. Company has made investments in buildings, which are being rented, and Treasury bills which matured in the year 2017. The financial statements of K. Company for the year of income 2017 showed the following information:

- Total premiums derived for life insurance policies were Tshs 900,000,000
- Total proceeds incurred were Tshs. 400,000,000.
- Total proceeds derived from Company M. were Tshs. 200,000,000 while total premiums incurred under the contract of reinsurance were Tshs. 50,000,000,
- Management expenses were Tshs. 20,000,000.
- Interest derived from Treasury bills were Tshs. 50,000,000 and rental income received was Tshs. 500,000,000 expenses incurred in earning the rental income were Tshs. 50,000,000 and commission paid for obtaining tenants Tshs 50,000,000

Required:

Calculate the taxable income of K Insurance Company for the year 2017.

Solution:

Note: The income derived or loss incurred from conducting life insurance business shall be calculated separately from the income or loss from any other activities of the persons.

The premiums and proceeds derived during the year and proceeds and premiums incurred shall not be used in calculating the income of K. Insurance (as per section 59(2)(a) Company for the year of income 2017 from a life insurance business.

So in this case only income from the Company's investments will be calculated for the year of income 2017 allowing all the management expenses (section 59(2)(b)).

Inclusions		
Interest income	50,000,000	
Rental income	500,000,000	
Total investment income		**550,000,000**
Less: Deductions		
Expenses incurred in earning the rent income	50,000,000	
Commission paid or obtaining tenants	50,000,000	
Management expenses	20,000,000	
Taxable income from life insurance business		**430,000,000**

Self-Examination Questions

Question 1

Best insurance company carries on both general and life insurance. In the last year, the company received Tshs100,000,000 as premium from general insurance and paid Tshs20,000,000 as compensation to general-insured customers.

Also, the company received Tshs50,000,000 as premium from life insurance and paid Tshs20,000,000 as compensation to life insured customers. The management expenses for general and life insurance were Tshs10,000,000 and Tshs7,000,000 respectively. Additionally, the company has taxable income of Tshs10,000,000 from non-insurance business activities.

Required:

Calculate the tax liability of the company if the tax rate was 30%.

Question 2

New insurance Co carries on general insurance. The details of its income and expenses are as follows:

- The company received Tshs240,000,000 as premium from general insurance
- The company paid Tshs50,000,000 towards reinsurance premium
- Tshs 20,000,000 out of premium of Tshs240,000,000 was paid to JM Insurers in the form of proceeds
- Furthermore the company has earned underwriting income of Tshs12,000,000
- The company has incurred administrative expenses of Tshs10,000,000 and discharged insurance claims of Tshs25,000,00
- The company holds assets in the Zambia that have been insured. The premium paid to Professional Insurers, Zambia amounted to Tshs2000,000.

  Required:

  Calculate the tax liability of the company if the tax rate was 30%.

Question 3

IMCA Insurance is a resident corporation dealing with general insurance business. It is an insured corporation and an insurer in some cases depending on the insurance services cycle within its operation. On 31st December, 2017, IMCA reported the following Income Statement.

IMCA Income Statement for the Year Ended 31st December, 2017
(General Insurance – Property, Casualty and Healthy Insurance)

Underwriting Account	**Tshs.**	**Tshs.**
Earned Premiums:		
Accounted premiums	250,000,000	
Ceded re-insurance premium	50,000,000	
Total Premium		**200,000,000**
Add: Investment income for technical account	40,000,000	
Other underwriting income	12,000,000	52,000,000
Total Gross Income		**252,000,000**
Less: Expenses for insurance claims	20,000,000	
Re-insurer’s share	5,000,000	
Total Insurance Claims		**25,000,000**
Operating Expenses:		
Administrative expenses	10,000,000	
Acquisition costs	50,000,000	
Total Operating Expenses		**60,000,000**
Profit on Ordinary Activities		**167,000,000**

During an assessment period, the following additional information were made available:

(i) 1/3 of Tshs. 240,000,000/= of the premium received was paid to IMCA Insurance in the form of proceeds.

(ii) There was no Non-underwriting account during the year.

(iii) IMCA holds assets in the United Kingdom that have to be insured, hence it paid premium to the Diamond Insurance a UK-based corporation amounting to Tshs. 2 million.

(iv) ½ of the total insurance claims above have not been reported in the accounts due to accounting errors of omission.

(v) IMCA paid for its re-insurance to ABC Co. Ltd., another insurance company residing in Ghana where the Corporation owns several assets for Tshs. 1,200,000,000/=.

(vi) For a full period of 5 years, IMCA has been receiving a premium per month from XYZ Ltd. Unfortunately, at the end of the year five, the estate of XYZ Ltd was gutted by fire destroying all insured properties. Under such event, XYZ Ltd was obliged to be compensated.

(vii) IMCA holds 75% shares of the assets in the DIAMOND Insurance Company while during the previous three years it had owned only 50% shareholding. It hence realized a total of Tshs. 35,000,000 from that change.

Required:

Calculate the net taxable income of the IMCA Insurance Corporation in line with the Income Tax Act, 2004

Question 4

NIKO Insurance Limited is a Tanzanian resident company involved in life insurance business. The following financial information is available in respect of NIKO Insurance Limited for the year ended 30th June 2016.

	Tshs
Gross written insurance premiums received	6,520,000
Fees and commissions received	2,265,000
Dividends received	865,000
Interest received from bank accounts	125,000
Rental income received	325,000
Profit on sale of property	69,500
Insurance premiums paid on reinsurance	(3,650,000)
Commissions paid	(425,000)
Staff costs	(2,654,000)
Depreciation	(895,000)
Impairment loss	(759,000)

Required:

Briefly state how each of the items listed above will be treated in the income tax computation of NIKO Insurance Limited.

Question 5

The following income statement relates to Maisha Life Assurance Ltd, a resident company dealing in life insurance business, for the year ended 31st December 2016.

	TZS.'000'	**TZS.'000'**
Gross earned premiums	456,509	
Insurance premium ceded to reinsurer	(128,992)	
Net insurance premium		327,517
Investment income		114,987
Other income		14,723
		457,227
Expenses		
Claims payable	150,405	
Insurance claims recoverable from reinsurer	(42,174)	
Net insurance claims		108,231
General expenses		164,358
Marketing		28,197
Distribution		16,031

Finance costs		22,000
		338,817
Profit before tax		**118,410**

Additional information:

(i) Investment income includes:

	TZS.'000'
Interest from government securities	52,345
Bank deposit interest	27,379
Dividends from resident corporation	10,987
Building lease rentals	24,276
	114,987

(ii) General expenses includes:

	TZS.'000'
Legal costs for income tax appeal	6,270
Legal costs for issue of shares	1,750
Stamp duty on acquisition of new building (used as office for the company)	12,000
Fine on employees' motor vehicles	2,500
Depreciation (computed in accordance with Income Tax Act, CAP 332)	17,832
Partitioning office	31,790
Repairs to premises to increase office space	16,210

(iii) Marketing expenses includes:

	TZS.'000'
Commission paid to insurance agents and brokers	1,211
Promotion gifts	1,800
Advertising on TV	6,000
Neon sign (purchased and installed) to display company name	10,000

(iv) Finance expenses includes:

	TZS '000'
Bank interest	1,100
Bank charges	238
Donation to political party for launching its campaigns	250
Subscription to trade association	1,250
Redundancy payments	11,000
Loan to employee written off	250

(v) Other income includes:

	TZS '000'
Profit on sale of office air conditions (this machine had book value of TZS.1 million)	323
Agency Commission	14,400

Required:

(a) Compute business chargeable income for Maisha Life Assurance Ltd for the year of income 2016 by adjusting the profit before tax.

(b) Differentiate between 'life insurance' and 'general insurance'.

Answers to Self-Examination Questions

Answer to SEQ 1

The income from general insurance, life insurance and other businesses should be computed separately.

(a) Income from general insurance is Tshs70,000,000,000 (Tshs100,000,000 – Tshs20,000,000 - Tshs10,000,000 = Tshs70,000,000)

(b) Loss from life insurance is Tshs7,000,000 (0 - Tshs7,000,000 = Tshs-7,000,000) as premium and payment in life insurance are not included.

(c) Income from other business activities is Tshs10,000,000.

(d) Total income is Tshs73,000,000 (Tshs70,000,000 - Tshs7,000,000 + Tshs10,000,000 = Tshs73,000,000).

(e) Tax liability at 30% is Tshs21,900,000.

Answer to SEQ 2

Income statement of New Insurance Co

Premium	Amount in Tshs	
Premium received (240,000,000 less 20,000,000)	220,000,000	
Reinsurance paid	(50,000,000)	170,000,000
Underwriting income		12,000,000
Total		**182,000,000**
Less: Expenses		
Administrative expenses		
Insurance claims discharged	10,000,000	
Insurance premium paid	25,000,000	
	2,000,000	(37,000,000)
Total taxable income		**145,000,000**

Answer to SEQ 3

INCOME TAX COMPUTATION FOR IMCA GENERAL INSURANCE CO. LTD.

	Tshs.	**Tshs.**
Premium received*	170,000,000	
Less: Ceded premium	50,000,000	120,000,000
Proceeds received		80,000,000
Realization gain of Assets**		35,000,000
Other investment income:		
Investment income for technical account	40,000,000	
	12,000,000	52,000,000
		287,000,000
Less: Expenses		
Insurance claims	25,000,000	
Administrative expenses	10,000,000	
Premium Incurred	2,000,000	
Erroneously omitted insurance claims	12,500,000	49,500,000
TOTAL TAXABLE INCOME		**237,500,000**

*IMCA received 250m as premium. But as per note (i) of the additional information, 1/3 of 240m [i.e. 80m] of the 250m was received in the form of proceeds. Hence only 170m [250m - 80m] is taken as proceeds received.

**Realization out of the change in shareholding is recognised as investment income

Answer to SEQ 4

Income:	
Gross written insurance premium 6,520,000	Not taxable as part of taxable income
Fees and commissions received 2,265,000	Taxable as part of taxable income
Dividends received from non-resident corporation 865,000	Taxable on NIKO
Interest received on bank accounts 125,000	Taxable as part of taxable income – included gross of any withholding tax deducted
Rental income received 325,000	Taxable as part of taxable income – included gross of any withholding tax deducted
Profit on sale of property 69,500	The profit on sale is not taxable, however, capital gains will be calculated and included in NIKO's total income
Expenses:	
Insurance premiums on reinsurance 3,650,000	This is an not allowable expense – deductible from taxable income
Staff costs 2,654,000	This is an allowable expense – deductible from taxable income
Commission paid 425,000	This is an allowable expense – deductible from taxable income's
Depreciation 895,000	This is not an allowable expense, however, capital allowances will be available under ITA Cap 332- 3rd Schedule
Impairments loss 759,000	This is not an allowable expense

Answer to SEQ 5

(a) Calculation of Business Chargeable Income for MLA Ltd for the Year of Income 2016

	TZS	TZS
Profit before tax		118,410
Add: Disallowed expenditure		
Insurance premium coded to reinsurer	128,992	
Insurance claims payable	150,405	
Legal costs – income tax appeal	6,270	
Stamp duty	12,000	
Fine	2,500	
Partitioning office	31,790	
Repairs	16,210	
Neon sign	10,000	
Donations	250	
Loan	250	
		358,667
Less: Disallowed income		
Profit on sale of air condition	323	
Gross earned premium	456,509	
Insurance claims recovered from reinsurer	42,174	
Dividends (FWP)	10,987	
		509,993
Business loss		(32,916)

(b) Life insurance refers to any insurance that promises an obligatory payment of a lump-sum of money or series of payments upon the occurrence of a particular future event.

The payment is obligatory since the event insured will certainly occur in an unknown future timing. For example, any insurance whereby the event insured is death; as death will certainly occur. General insurance business means any insurance that is not a life insurance. In other words, all non-life insurance e.g. motor insurance, health insurance, property and casualty insurance, employees insurance, etc. are general insurances. One of the most important characteristic of general insurances is that it does not involve a compulsory lump-sum or series of future payments. The general insurance only involves a payment of compensations in case an insured event (which may or may not occur) occurs. For example car accident.

SECTION B

TAXATION OF SPECIALIZED INDUSTRIES

B2

STUDY GUIDE B2: TAXATION OF RETIREMENT FUNDS

Get Through Intro

Retirement funds accept individuals' money contributions invest them and promise the individual to receive a sum of money or series of payments upon retirement. Through investments of the individuals' contributions, retirement funds make profits which should be taxed. This guide explains taxation rules of retirement funds.

Learning Outcomes

1. Explain the meaning and types of retirement funds
2. Describe general principles on taxability of retirement funds
3. Describes taxation rules of approved retirement funds in the year they cease to be approved
4. Explain taxation rules relating to transfer of funds among retirement benefits

1. **Explain the meaning and types of retirement funds and ddescribe general principles on taxability of retirement funds [Learning outcome a and b]**

1. Meaning And Types Of Retirement Funds

A retirement fund is any entity established and maintained solely for the purposes of accepting and investing retirement contributions in order to provide retirement payments to individuals who are beneficiaries of the entity. There are 2 categorizes of retirement funds namely as Approved or Unapproved. Approved retirement fund is a resident retirement fund approved by the Commissioner by a notice in writing. Unapproved retirement fund is defined as retirement fund that is not an approved retirement fund.

2. General Principles On Taxability Of Retirement Funds

There are some differences between approved pension funds and other businesses on how they compute their taxable revenues and deductible expenses. In the case of taxable revenue, retirement contributions received by a retirement fund are not taxable (Section 62(2)). On the other hand, retirement payments made by the fund are not deductible, and are not included in the cost of any asset or liability of the fund (Section 62(2)).

Example 1

The following information relates to the financial data of Joseph Pension fund for the year ending 2012. Your duty is to determine the tax liabilities of the company for that year.

	Tshs
Retirement contribution	6,000,000
Investment income	2,000,000
	8,000,000
Less:	
Retirement payments	1,000,000
Management expenses	2,000,000
Depreciation allowance as per ITA Cap 332	1,000,000
Income before tax	**4,000,0000**

Answer

	Tshs
Profit as per account	4,000,000
Add: Non allowable expenses	
Retirement payment	1,000,000
Less: Non-taxable income Retirement contribution	(6,000,000)
Taxable loss	**1,000,0000**

There is no tax liability as the company incurred a loss of Tshs 1,000,000.

2. Describes taxation rules of approved retirement funds in the year they cease to be approved and explain taxation rules relating to transfer of funds among retirement benefits.

[Learning outcome c and d]

3. Taxation Rules Of Approved Retirement Funds In The Year They Cease To Be Approved

When an approved retirement fund ceases to be an approved retirement fund during a year of income, its income tax payable for the year of income should be increased by an amount equal to the income tax rate applicable to corporations; applied to:

- all retirement contributions received by the fund from or on behalf of resident individuals and total income of the fund during the period from its most recent approval as an approved retirement fund to when it ceased to be so approved, less;

- all retirement payments made by the fund from its most recent approval as an approved retirement fund to when it ceased to be so approved in respect of individuals who were resident during that period (Section 62(3)).

Example

Jojo Pension Fund was an unapproved pension fund established in year 2000 and in year 2013 the Fund was approved by the Commissioner as an approved pension fund. In September, Year 05 the Fund ceased to be an approved pension fund.

During year 2015, it received contributions on behalf of resident individuals at the rate of Tshs.200,000,000 per month, and other contributions to the Fund from non-residents were at the rate of Tshs.100,000,000 per month. The retirement payments made before September 2015 were Tshs.200,000,000, but during the year Tshs.450,000,000 retirement payment were made to the resident individuals. Jojo Pension Fund also received rent of Tshs.90,000,000. Minor repairs were made to the rented building of Tshs.2,500,000 and security expenses paid of Tshs.600,000. Administrative expenses were Tshs.35,000,000. The Fund's accounting date is 31st December.

Required:

Calculate the total tax payable in year 2015.

Answer

Income of the fund				
Investment income				
Rent received			90,000,000	
Less: Repairs	2,500,000			
Security	600,000		3,100,000	
Net investment income			86,900,000	(i)
Contributions (October – December 15)				
From resident individuals (200,000,000 x 3)		600,000,000		
Other contributions (100,000,000 x 3)		300,000,000		
Total contributions		900,000,000	(ii)	
Retirement payments				
Total payments			450,000,000	
Made before October 15			200,000,000	
Difference			250,000,000	

Difference in income tax payable (sec.62 (a) and (b))
= 900,000,000 – 250,000,000 = Tshs. 650,000,000
Total income Tshs.86,900,000 + 650,000,000 = sh.736,900,000
Total tax at 30%=221,070,000

4. Taxation Rules Relating to transfer Of Funds Among Retirement Benefits

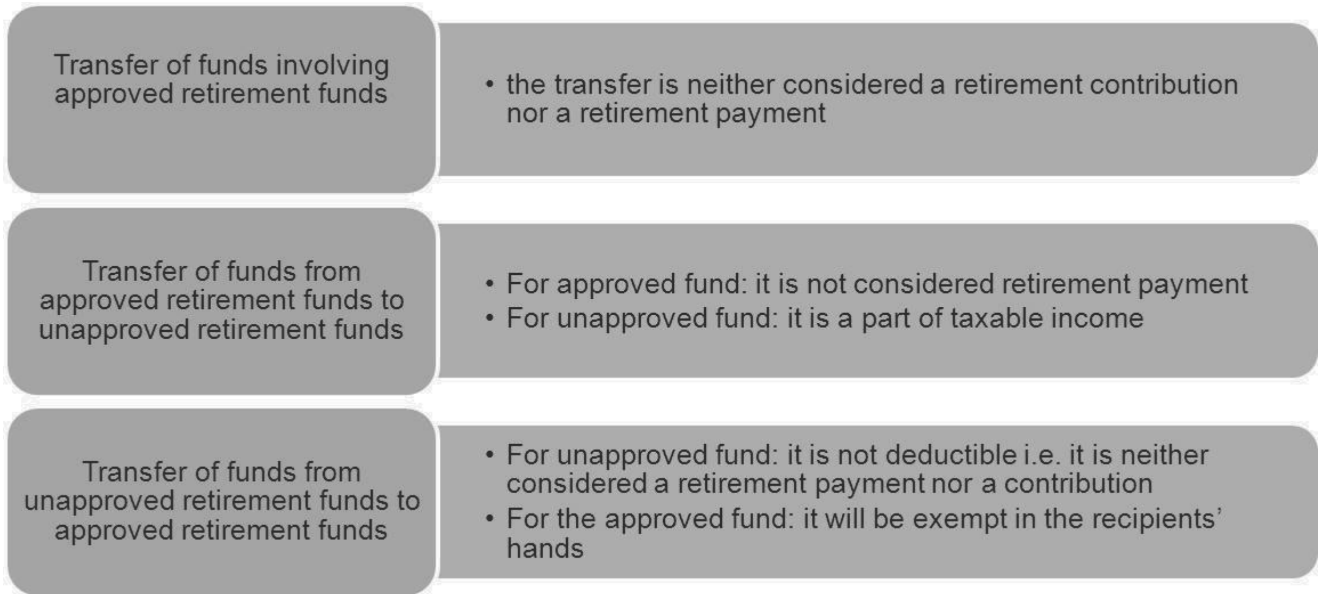
In the case of transfer of funds among retirement funds, the treatment of the transfer depends on whether the retirement funds involved are approved or not.

When the transfer of funds involves approved retirement funds the transfer is neither considered a retirement contribution nor a retirement payment (Income Tax Act 2004, Regulation 11(1)).

But, in the case of a transfer of funds from approved retirement funds to unapproved retirement funds; it is not considered retirement payment from the point of view of the approved retirement funds, but it is a part of taxable income of the unapproved retirement funds (Income Tax Act 2004, Regulation 11(2)).

However, in the case of a transfer of funds from unapproved retirement funds to approved retirement funds; the transfer is not deductible by the unapproved retirement fund and it is neither considered a retirement payment nor a contribution (Income Tax Act 2004, Regulation 11(3)). Yet, when the transfer of funds involves unapproved retirement funds, the transfer is not considered a retirement payment and the transfer will be exempt in the recipients' hands but not deductible by the payers (Income Tax Act 2004, Regulation 11(1)).

Diagram 1: Accounting of pension funds



Example

The following information relates to the financial data of Jack Pension fund, an approved pension fund for the year ending 2017.

	Tshs
Retirement contribution from residents	60,000,000
Investment income	2,000,000
Transfer of funds from approved pension fund	15,000,000
Less:	
Retirement payments	(1,000,000)
Management expenses	(2,000,000)
Transfer of funds to unapproved pension fund	(8,000,000)
Depreciation allowance as per ITA cap 332	
Income before tax	**65,000,0000**

Required:

Calculate the tax liability of the company for the year 2017.

Answer

Tax liability for the year 2017

	Tshs '000'
Income as per account	65,000
Add: Non-allowable expenses	
Transfer of funds to unapproved pension fund	8,000
Retirement payments	1,000
Less: Non-taxable income	
Transfer of funds from approved pension fund	(15,000)
Retirement contribution	(60,000)
	1,000
Taxable loss	**Nil**

Self-Examination Questions

Question 1

The following information have been obtained from the notes to the financial statements of a resident retirement fund for the year ended 31 December 2017

(i) Contributions received on behalf of resident Tshs 200,000,000

(ii) Other contributions to the fund from non-residents Tshs. 100,000,000.

(iii) The retirement payments made were Tshs 200,000,000 to non- resident, and Tshs 450,000,000 retirement payments were made to resident individuals.

(iv) During the year the Pension Fund received Tshs 90,000,000 as rent from Mwanza complex Investment.

(v) It received dividend from TCC Ltd a resident corporation amounting to Tshs 6,000,000

(vi) Pension Fund also received rent of Tshs. 90,000,000 from Mwanza complex Investments.

(vii) Minor repairs were made to the rented Mwanza complex building of Tshs. 2,500,000

(viii) Security expenses paid was Tshs 600,000.

(ix) Administrative expenses were Tshs 3,500,000.

The funds accounting date is 31st December 2017.

Required:

Calculate the total tax payable in year of income 2017

Question 2

The following information relates to the financial data of JIKWAMUE Pension Fund (JPF), an approved pension fund for the year ended 2017.

DETAILS	NOTE	AMOUNT
Retirement contributions	1	85,000,000
Transfer of funds from approved pension fund		15,000,000
Transfer of funds to unapproved pension fund		8,000,000
Retirement payments	2	12,000,000
Investment Income	3	42,000,000
Management expenses		2,000,000
Administrative expenses	4	50,000,000
Security expenses		6,500,000
Depreciation allowances as per ITA Cap 332		1,250,000

Notes

1. During the year of income the Fund received Tshs 55,000,000 from resident individual and Tshs 30,000,000 from non-resident individuals
2. Retirement payments relates to the payments of Tshs 7,000,000 as a lump sum payments, Tshs 3,700,000 as commuted pension and Tshs 1,300,000 as monthly payments to pensioners.
3. Investment income constitutes the rent received during the year of Tshs 32,000,000 from Leonasia Tower and dividend received of Tshs 10,000,000 from TBL a resident corporation
4. Administrative expenses include Tshs 40,000,000 incurred in major repair of one of the Fund's buildings especially Leonasia Tower

Required

Calculate the tax liability of the company for the year 2016

Answers to Self-Examination Questions

Answer to SEQ 1

Profits and gains		
Rent from Mwanza Complex		90,000,000
Dividend from TCC (FWP)		-
		90,000,000
Allowable Deductions		
Minor repairs	2,500,000	
Security expenses	600,000	
Administrative expenses	3,500,000	**(6,600,000)**
Taxable income		**83,400,000**

Tax liability = Tshs 83,400,000×30%=25,020,000

Notes

a. Contributions received contributions are not included in the calculation of the income of a retirement fund-section 62(2)(a)
b. Retirement payments are not deductible in the calculation of the income of a retirement fund-section 62(2)(b)
c. Dividends distributed by a resident corporation to a resident person are taxed in the form of a final withholding tax and therefore final withholding payment are excluded in calculation of taxable income –section 86(1)(a)(i)

Answer to SEQ 2

Calculation of Taxable income and Tax Liability

	Amount
Investment income (Rent)	32,000,000
Deduct:	
Transfer of funds to unapproved pension fund	(8,000,000)
Management expenses	(2,000,000)
Administrative expenses	(12,000,000)
Security expenses	(6,500,000)
Depreciation allowance as per ITA 2004	(1,250,000)
Taxable Income	**2,250,000**
Tax rate	30%
Tax Liability	**675,000**

SECTION B

TAXATION OF SPECIALIZED INDUSTRIES

B3

STUDY GUIDE B3: TAXATION OF CHARITABLE BUSINESS

Get Through Intro

Charitable organizations as well as religious organizations generate income with a primary objective of advancement of public well-being by providing charitable services. However, charitable organizations may be used to avoid tax if they are completely not taxable. A person may transfer income to charitable organizations and then withdraw from them in form of charitable services. To circumvent tax avoidance practices charitable organizations as well as religious are both taxable. This guide introduces discussion on the rules for taxation of charitable and religious organizations

Learning Outcomes

a) Explain the meaning of charitable or religious organization
b) Describes taxation principles of charitable or religious organization
c) Explain taxation rules when charitable Organisation or Religious Organization Ceases to be Charitable

Explain the meaning of charitable or religious organization and describes taxation principles of charitable or religious organization. [Learning outcome a and b]

1. Meaning Of Charitable Or Religious Organization

Charitable organization "means a resident entity of a public character that salutes shall be treated as conducting a business with respect to its functions referred to in section 64(8) as the "charitable business". The following conditions

(a) The entity was established and functions solely as an organization for:

(b) The entity has been issued with a ruling by the Commissioner under section 131 currently in force stating that it is a charitable organization.

Religious organization has been defined under section 3 of the Act as a resident entity of a public character established for the advancement of religion that has been issued with ruling the Commissioner under Section 131 currently in force stating that, it is a religious organization.

2. Taxation Principles Of Charitable Or Religious Organization

For taxation purposes, every charitable or religious organization approved by the Commissioner General, is deemed to be conducting business.

For the purposes of calculating the income of a charitable organisation or religious organisation for any year of income from its charitable business -

(a) there shall be included, together with any other amounts required to be included under other provisions of the Income Tax Act, all gifts and donations received by the organisation or religious organisation; and

(b) there shall be deducted, together with any other amounts deductible under other provisions of the Income Tax Act-

(i) amounts applied in pursuit of the organisation or religious organisation's functions

(ii) 25 percent of the organisation or religious organisation's income from its charitable business (calculated without any deduction under subparagraph (i)) and any investments.

Savings for Implementations of Future Projects

Saving of funds of a charitable organization or religious organization for a project that is detailed in material particulars of the trust income for future application to the charitable functions of the organization is acceptable subject to the approval of the Commissioner General. Where the Commissioner is satisfied and grants an approval the income saved will be treated as an expenditure incurred for charitable purposes – therefore allowed for deduction in computing charitable business income.

1. Explain taxation rules when charitable Organisation or Religious Organization ceases to be Charitable

[Learning outcome c]

3. Taxation Rules When Charitable Organisation Or Religious Organization Ceases To Be Charitable

Where a charitable organization or religious organization carrying on charitable business ceases to be a charitable organization or such religious organization during a year of income the charitable organization or religious organization shall be treated as conducting a business other than its previous charitable business.

The organization after cessation will include in calculating the organization's income for the year of income from business any amount claimed as a deduction when calculating the income from the charitable business that is, the retained 25 percent of the charitable business income and any investment income during that year of income or any prior year of income during which the organization was a charitable or religious organization carrying on charitable business.

Example

M Trust, a charitable organization, was established in Tanzania in the year 2015 had income from a business of Tshs. 15,000,000 of which Tshs. 12,000,000 was applied toward the functions of the organization. Since the balance of the income of Tshs 3,000,000 was less that 25 percent of the total income the amount was not taxed. During the year 02 the organization derived taxable income of Tshs. 25,000,000 of which Tshs. 10,000,000 was applied towards its functions. The organization applied to the Commissioner to be allowed to save Tshs. 9,000,000 to be applied towards its functions in the year 2017. The Commissioner allowed the savings of the amount. The balance of Tshs. 6,000,000 which is, Tshs. 25,000,000 les (Tshs. 10,000,000 + 9,000,000), being 24% of Tshs 25,000,000 were not taxed. The organization ceased to be a charitable organization in the year 17 before applying to its functions the amount of Tshs. 9,000,000 saved from its charitable business in the year 2016.

The taxable income of the organization for the year 2017 when it ceased to be a charitable organization is calculated as follows:

Income from its business in year 2017		Tshs. 16,000,000
Add:		
Exempt amount in year 2015 -	Tshs. 3,000,000	
Exempt amount in year 2016 -	Tshs. 6,000,000	
Exempt amount in year 2017 -	Tshs. 9,000,000	
		18,000,000
Taxable income of the organization for the year of income 17		Tshs. 34,000,000

Self-Examination Questions

Question 1

The income of a trust from a property held for charitable or religious purposes is Tshs. 15,000,000. Besides the trust has received Tshs. 4,000,000 by way of voluntary contributions. It is assumed that the income applied for the purposes of the trust is Tshs. 10,000,000. The trust applied to the Commissioner General to be allowed to save Tshs 1,000,000 to be applied towards its functions in the following year. The Commissioner General approved the saving.

Required

Calculate the tax liability of this organization as per Income Tax Act, Cap 332

Question 2

Define a 'charitable organization' as per section 64 (8) of the Income Tax Act, Cap 332

Answers to Self-Examination Questions

Answer to SEQ 1

Voluntary contributions received	4,000,000
Income from property held for charitable purposes	15,000,000
Total Income	**19,000,000**
Deductions:	
Amount spent in charitable functions	10,000,000
Saving approved	1,000,000
Special Deduction [25%× 19,000,000]	4,750,000
Taxable Income of the charity	**3,250,000**

Tax liability =30%×3,250,000 =975,000

Answer to SEQ 2

Charitable Organization means a resident entity of a public character that satisfies the following conditions:

(i) The entity was established and functions only as an organization for the relief of **poverty** or **distress** of the public or the advancement of **education** or the provision of general public health, education, water or road construction or **maintenance** and

(ii) The entity has been issued with a ruling from the Commissioner stating that it is a charitable organization.

SECTION B

TAXATION OF SPECIALIZED INDUSTRIES

B4

STUDY GUIDE B4: TAXATION OF CLUBS AND TRADE ASSOCIATIONS

Get Through Intro

A club, association or similar institution is formed not for commercial purposes but for social, recreational, sports, arts, science, literature or other leisure pursuits for the interest and benefit of their members. Examples of such club, association or similar institution include an athletic club, an antique car collectors club and a historical society. However, the activities of some clubs, associations or similar institutions are trade dealings which are conducted for a profit that is subject to tax as business profits such as a fitness centre or a professional football club. Where a person carries on a club, association or similar institution which receives from its members not less than seventy five percent of its gross receipts on revenue account (including entrance fees and subscriptions), such person shall be deemed not to carry on a business; but where less than seventy five percent of its gross receipts are received from members, the whole of the income from transactions both with members and others (including entrance fees and subscriptions) shall be deemed to be receipts from a business, and such person shall be chargeable in respect of the profits therefrom. This guide describes taxation principles of clubs and trade associations.

Learning Outcomes

a) Explain the meaning of a club and trade association.
b) Describes taxation principles of clubs and trade associations.

Explain the meaning of a club and trade association and describes taxation principles of clubs and trade associations. [Learning outcome a and b]

1. Meaning Of A Club And Trade Association

Definitions

(i) "**Members club**" means a club or similar institution all the assets of which are owned in common by or held in trust for the members thereof;

(ii) **"Member" means -**

- in the case of a club or similar institution, a person who, while a member, is entitled to an interest in all the assets of the club or institution in the event of its liquidation or who is entitled to vote at a general meeting of the club or institution; and
- in the case of a trade association, a person who is entitled to vote at a general meeting of the association; and

(iii) **"Trade association"** means any association of persons-

(a) That are all separately engaged in a particular type of business; and

(b) Formed with the main object of safeguarding or promoting the business interests of such persons.

2. Taxation Principles Of Clubs And Trade Associations

The activities of a club, trade association or similar institution shall be treated as a business and for the purposes of calculating the club, association or institution's income for a year of income from that business there shall be included, together with any other amounts to be included under other provisions of the Income Tax Act,

(i) entrance fees,
(ii) subscriptions and
(iii) other amounts derived from members during the year of income.

Where three-quarters or more of the amounts to be included in calculating the income of a members club or trade association for a year of income from the business are derived from members of the club or association, the income from that business shall be exempt and shall not constitute chargeable income of the club or association. This means that in case the contributions and amounts derived from the members for a year of income are less than three quarters of the income, the whole of the income will be subjected to taxation at the corporation taxation rate.

Example

XYZ is member's club, which has 150 members. For the year of income 2017, each member subscribed 150,000/= total subscriptions for the year were Tshs 22,500,000.

Out of the 150 members, 50 were new and paid entrance fee of Tshs 20,000 each in year 2017.

Total entrance fees paid were Tshs 1,000,000.

The club was operating a gym which collected fees from non members only, and for that year, Tshs 10,000,000 was paid. The club was running a bar where all types of drinks were sold. The profit obtained from this business was Tshs 15,000,000. Only members were allowed to buy drinks from the bar. At the end of the year the Club organized an end of the year dinner and dance tickets were sold for Tshs 25,000 per couple. All members attended. Some non members were also invited and total collections from tickets were Tshs 5,000,000

During the year some repairs were made to the club assets for a total of Tshs 3,000,000, Salaries paid to club employees were Tshs 9,600,000 and other club expenses were Tshs 600,000

Required

Calculate the income tax payable by XYZ

Answer
Calculation of the income of the club for the year 2017 will be as follows.

Receipts from members	Tshs
Subscriptions	22,500,000
Entrance fees	1,000,000
Profit from the bar club	15,000,000
Dinner and dance tickets	3,750,000
Total	**42,250,000**
Receipts from non-members	Tshs
Gym fees	10,000,000
Dinner and dance tickets	1,250,000
Total	**11,250,000**
Total receipts	**53,500,000**

42,250,000/= of 53,500,000/= = 78.9%

The total contributions from members are more than 75% of the total receipts; therefore the total receipts of the club are exempted from income tax, as provided for under section 65(2) of the Income Tax Act.

Example
Taking the example of XYZ Members' club in example 1 above, assume that the total contributions from, the members was Tshs 12,500,000. Profits from Club bar was contributed by Tshs 12,000,000 by members and Tshs 3,000,000 by non-members. Collected fees from gym Tshs 20,000,000. The contribution of the Club from the members will be as follows:

Receipts from members	Tshs
Subscriptions	12,500,000
Entrance fees	1,000,000
Profit from the bar club	12,000,000
Dinner and dance tickets	3,750,000
Total	29,250,000
Receipts from non-members	Tshs
Gym fees	20,000,000
Dinner and dance tickets	1,250,000
Profit from the bar club	3,000,000
Total	24,250,000
Total receipts	53,500,000

Tshs 29,250,000 of 53,500,000/= is 54.67%. This is less than 75% of the total contributions by members, therefore the total receipts will be taxed at the corporation tax rate after allowing the clubs expenses as follows

Total receipts		53,500,000
Less:		
Repair	3,000,000	
Salaries	9,600,000	
Other club expenses	600,000	13,200,000
Taxable income		40,300,000

Therefore Tax liability = 30%* 40,300,000= 12,090,000

Self-Examination Questions

Question 1

Define a "Trade Association" and explain where the activities of trade association will be treated as business for the purpose of calculating the association's taxable income for a year of income.

Question 2

Simba Sports Club is a Tanzania Club with Head Quarters in Dar es Salaam at Msimbazi Street. It has a lot of Members who contribute and Donate to the Club. For a number of years now, the Club has not paid tax to TRA due to absence of an Accountant to prepare the Financial Statement professionally. Assume you are an employee (Accountant) of the Club and you given the following data collected for the year of Income ended on 31/12/2018.

Subscriptions (Membership Fees)	7,500,000
Competition proceeds-(from non-members)	5,000,000
Sundry Receipts (from non-members)	5,000,000
Donations from Members	20,000,000
Entrance fees during the matches (1/4 from members)	10,000,000
Receipts for hiring the Clubs' football pitch to third parties	2,500,000
Competition expenses	500,000
Fees paid to KK – Security services during the matches	2,000,000
Tournaments (Prizes costs)	500,000
Wages and Salaries	5,000,000
Stationeries postages	200,000
Depreciation of the Club's Assets as per Income Tax Act, Cap 332	250,000
Telephone charges for both International and local	250,000

Bank charges	150,000
Transportation charges	2,500,000
Expenses for up – keeping the football pitch	500,000
Coach hiring expenses	1,500,000
Surgery Dispensary Expenses	1,000,000
Life Insurance Premium paid for players	2,500,000
Utensils and other Culturing expenses during the friend Matches	500,000
Auditing fees	1,500,000

Required: Compute the Taxable Income of Simba Sports /club for the year income ended on 31/12/2018 as per section 65 of the Income Tax Act Cap 332

Answers to Self-Examination Questions

Answer to SEQ 1

A trade association is defined under section 65(3) to mean any association of persons that are all separately engaged in a particular type of business and formed with the main intention/object of safeguarding or promoting the business interests of such persons. The activities of a trade association will be treated as business for income tax purposes where ***less than three quarters*** of the amounts to be included in calculating the income of a member trade association for a year of income from the business (entrance fees, subscriptions other amounts from members etc) are derived from members of the association.

Answer to SEQ 2

Income from Members

Subscriptions (Membership Fees)	7,500,000
Donations from Members	20,000,000
Entrance fees during the matches (1/4 of Tshs 10,000,0000)	2,500,000
Receipts for hiring the Clubs' football pitch to third parties	2,500,000
	32,500,000

Income from Non- Members

Competition proceeds-(from non members)	5,000,000
Sundry Receipts (from non members)	5,000,000
Entrance fees during the matches (3/4 of Tshs 10,000,000)	7,500,000
	17,500,000
Total receipts	**50,000,000**

Tshs 32,500,000 of 50,000,000/= is 65%. This is less than 75% of the total contributions by members, therefore the total receipts will be taxed at the corporation tax rate after allowing the clubs expenses as follows

Total receipts		50,000,000
Less: Expenses		
Competition expenses	500,000	
Fees paid to KK – Security services during the matches	2,000,000	
Tournaments (Prizes costs)	500,000	
Wages and Salaries	5,000,000	
Stationeries postages	200,000	
Depreciation of the Club's Assets as per Income Tax Act, Cap 332	250,000	
Telephone charges for both International and local	250,000	
Bank charges	150,000	
Transportation charges	2,500,000	
Expenses for up – keeping the football pitch	500,000	
Coach hiring expenses	1,500,000	
Surgery Dispensary Expenses	1,000,000	
Life Insurance Premium paid for players	2,500,000	
Utensils and other Culturing expenses during the friend Matches	500,000	
Auditing fees	1,500,000	(17,350,000)
Taxable Income		32,650,000

Tax liability =30%×32,650,000=9,795,000

STUDY GUIDE B5: TAXATION OF PETROLEUM OPERATIONS

Get Through Intro

Tanzania has been involved in extractive industries for years. The exploration of oil and gas in the United Republic of Tanzania has a long history. Initial onshore gas discoveries were made from Songo Songo Island (1974), and Mnazi Bay (1982), located in South East Tanzania in the Ruvuma Basin, Kiliwani North (2008) and Mkuranga made in 2007.

In 2010 forth, there has been significant reported natural gas discoveries from offshore sources confirmed at 43 trillion cubic feet6. The volume of natural gas could be currently more than reported by the *Law Review Journal*, based on appraisal wells drilled lately by E&P companies operating in offshore Tanzania. The current number is said to be 55 trillion cubic feet.7 Based on these discoveries, there has been excitement around the country in general and particularly communities in southern part of Tanzania, (Mtwara, Lindi, and Kilwa) specifically Mtwara where supply base for offshore operation is positioned. People think Tanzania can immediately get out of the poverty trap and move into the middle to high income bracket. This guide discuses taxation principle for petroleum operations

Learning Outcomes

a) Explain the meaning of petroleum and petroleum operations
b) Describe general principles on taxability of petroleum operations
c) Explain calculation rules of depreciation allowances for petroleum operations.
d) Describe taxation rules for midstream and downstream activities

Explain the meaning of petroleum and petroleum operations and describe general principles on taxability of petroleum operations [Learning outcome a and b]

1. Meaning Of Petroleum And Petroleum Operations

(i) **Petroleum**

Petroleum means any naturally occurring hydrocarbon, whether in gaseous, liquid, solid state or any naturally occurring mixture of hydrocarbons, whether in a gaseous, liquids, or solid state or mixture of one or more hydrocarbons whether in a gaseous, liquid or solid state and any other substance and includes petroleum that has been returned to a natural reservoir, but shall not include coal or any substance that may be extracted from coal or other rock;

(ii) **Petroleum operations**

Petroleum operations" means operations and activities in connection with exploration, appraisal, development, and production and includes all abandonment activities;

(iii) **Petroleum products**

Petroleum products" means organic compounds, pure or blended, which are derived from refining or processing of petroleum crude oils, biofuels or synthetic fuels and includes-

a) Asphalts, bitumens, petroleum coke and other residual products;
b) Bunkers or heavy residual fuel oils for combustion engines or industrial heat processes, such as burners for boilers or heating furnaces;
c) Commercial gases , methane, ethane, propane, butane and other similar petroleum gases, biogas or mixtures of these gases, whether in gaseous or liquefied state;
d) Gasoil or automotive diesel, biodiesel, industrial marine diesels or synthetic diesel;
e) gasolines petrol or napths or bioethanal products;
f) kerosenes or other similar oils for illumination or combustion applications;
g) lubricating oils, base oils or refined and blended finished oils
h) turbo fuels for jet propulsion engines; and
i) other products or by-products of petroleum crude processing having a flashing point lower than 120 degrees Celsius, as determined in a Pensky-Martens closed test apparatus;

2. General Principles On Taxability Of Petroleum Operations

For income tax purpose, each separate petroleum operation shall be treated as independent business and the person must prepare accounts for that business separate from any other activity of the person

Income from petroleum operations

In calculating a person's income from separate petroleum rights for a year of income, there shall be included, together with any other amounts to be included under other provisions of the Act

(a) Incoming derived from the disposal of petroleum obtained from the license area
(b) Amounts received in respect of the sale of data or information pertaining to the operations or petroleum reserves
(c) Gains on realisation of assets used in petroleum operations

Deductions for petroleum operations

In calculating a person's income from separate petroleum rights for a year of income, there shall be deducted, together with any other amounts deductable under other provisions of the Act

(a) Royalties and annual fee incurred by the person with respect to the petroleum right under section 113 and 114 of the Petroleum Act
(b) Depreciation allowance granted with respect to the operation and calculated in accordance with paragraph 6 of the Third Schedule; and
(a) Amount deposited in respect of decommissioning fund for the petroleum operations

Non allowable expenses

There shall be no deduction allowed in calculating income from a separate petroleum right –

(a) Under sections

- ✓ 15- Agriculture improvement, research development and environmental expenditure
- ✓ 16 -Gifts to public, charitable and religious institutions,
- ✓ 17- Depreciation allowances for depreciable assets or
- ✓ 26-loss carry back

(b) For an unrelieved loss under section 19, except as permitted by section 65O (Income from the separate petroleum right for any year of income may be reduced by reason of the use of unrelieved losses from that operation, subject to other limitations imposed by section 19 but not below 30 per centum of that income before any reduction for losses.

(c) Any bonus payment

(d) Expenses incurred by the person in implementing the decommissioning plan for the operation in excess of deposits in the decommissioning fund.

Example

The accounts of Goldwell Oil Limited, a petroleum exploration company, for the year ended 31st December 2016 revealed that:

	Tshs'billions'	Tshs'billions'
Sales Revenue (oil exported)		210
Sales Revenue (domestic)		70
Income received from sale of data		10
		290
Exploration costs	160	
Management and administrative expenses	10	
Annual fees paid to National Oil Company in respect of acreage rental and training and research fees	10	
Deposit to decommissioning fund	20	
Donation to charitable institutions	30	
Production bonus paid	10	
Depreciation per accounts	13	
Loss from other mining areas	10	
Loss carried forward from previous year	38	
Royalties on domestic sales	7	
Royalties on export sales	2	310
Net loss		(20)

Note

Approved capital allowances by the Commissioner General were Tshs 31 billion

Required:

Calculate the taxable income and tax liability of for the year of income 2017

Answer

	Tshs'billions'	Tshs'billions'
Net Loss per Accounts		(20)
Add: Non allowable expenses		
Donation to charitable institutions	30	
Production bonus paid	10	
Loss from other mining areas	10	
Depreciation per accounts	13	
Loss carried forward from previous year	38	101
		81
Less: Capital allowances		(31)
Income before unrelieved loss		50
Less: Unrelieved loss	35.0	(35.0)
Adjusted business income		15.0

Tax liability =30%*15 billion =4.5 billion

Note

Unrelieved loss from previous year should not exceeds 70% of the income
(i.e 70% of Tshs 50 million = Tshs 35 million)

Explain calculation rules of depreciation allowances for petroleum operations and describe taxation rules for midstream and downstream activities

[Learning outcome c and d]

3. Computation Of Depreciation Allowances For Petroleum Operations.

The whole of depreciation allowance expenditure incurred in respect of petroleum operations during a year of income shall be placed in a separate pool. Depreciation allowance shall be granted for expenditure pooled for a year of income at the following rates

Year of Income	Depreciation Allowance
First Year	20% of expenditure
Second Year	20% of expenditure
Third Year	20% of expenditure
Fourth Year	20% of expenditure
Fifth year	20% of expenditure

Moreover, the depreciation allowance granted with respect to a particular year of income shall be taken in that year and shall not be deferred to a later year(s) of income

Where an asset for which depreciation allowance have been or may be granted, is treated as realised during a year of income

(a) if the incomings derived from the realisation of an asset(s), exceed the written down value of the pool of depreciable assets, and the excess shall be included in calculating income from the petroleum operations for the year; and

(b) if the written down value of the pool of depreciable assets exceed the incomings derived from the realisation of all assets in the pool, the excess of written down value in the pool of assets may be granted for that year of income and the pool shall be dissolved

Nevertheless, where incomings are derived by a person during a year of income with respect to a depreciable asset employed by the person in petroleum operations but the asset is not realised at that time in whole or in part, the incomings shall be included in calculating income from the petroleum operations for the year.

Definitions

Depreciation allowance expenditure" means-

(a) Additions to the cost of depreciable assets owned and employed by a person wholly and exclusively in petroleum operations; and
(b) Expenditure other than financial costs incurred in respect of mineral operations wholly and exclusively on reconnaissance, appraisal and prospecting or exploration operations or in developing petroleum operations and infrastructure, including as may be prescribed by regulations, where-
    (i) the expenditure is not directly deductible in calculating income from the operations; and
    (ii) does not otherwise fall to be included in the cost of an asset;

Written down value of a pool of depreciable assets at a particular time during a year of income" means-

(a) Written down value of the pool at the end of the previous year of income; plus
(b) expenditure incurred prior to the time, which is added to the depreciation basis of the pool during the year of income or to be added during the following year of income; less
(c) incomings derived during the year of income or to be derived with respect to a realisation occurring prior to the time in respect of assets that are or have been in the pool;

Written down value of an asset" means the cost of the asset less all depreciation allowances granted with respect to expenditure included in that cost."

4. Taxation Rules For Midstream And Downstream Activities

Definitions

(i) **Downstream activities"** means the transportation, distribution, storage, regasification and marketing of gas and petroleum products;
(ii) **Midstream activities"** means activities related to petroleum processing, refining, liquefaction, storage and transportation the point of supply or loading as a commodity;

Taxation principles

A licensee conducting midstream or downstream activities with respect to petroleum shall be subject to income tax with respect to the activities as prescribed by the Income Tax Act,

In calculating a licensee`s income from a business which includes conducting midstream or downstream activities with respect to petroleum, there shall be deducted amounts deposited in and other expenses incurred in respect of the decommissioning fund established for the licence

There shall be no deduction allowed in calculating income from a separate petroleum right –

(a) Under sections
    - ✓ 15- Agriculture improvement, research development and environmental expenditure
    - ✓ 16 -Gifts to public, charitable and religious institutions,
    - ✓ 17- Depreciation allowances for depreciable assets or
    - ✓ 26-loss carry back
(b) For an unrelieved loss under section 19, except as permitted by section 65O (Unrelieved losses of a licensee arising from conducting a business that includes midstream or downstream activities may be

deducted under section 19 so as to reduce total income of the licensee but not below 30 per centum of total income before any deduction for such unrelieved loss.

(c) Expenses incurred by the person in implementing the decommissioning plan for the operation in excess of the amount contributed in the Decommissioning fund.

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Self-Examination Questions

Question 1

Below is the Statement of Comprehensive Income for TET Oil Ltd for the year of income ended on 31st December, 2017:

Item	TZS "000"
Sales revenue	2,000,000
Other operating income	500,000
Profit on disposal of non-current assets	30,000
Subtotal	**2,530,000**
Cost of sales	(450,000)
Impairment charge on oil and gas properties	(42,000)
General and administration costs	(700,000)
Bonus payment	(42,000)
Decommissioning fund deposited	(75,000)
Depreciation allowance	(240,000)
Operating revenue	981,000
Share of profit/loss in associates	(490,000)
Interest revenues	350,000
Profit/loss before tax	**841,000**
Tax	(252,000)
Revenue for the year from continuing operations	589,000
Discontinued operations	(24,000)
Profit/loss after tax	**565,000**
Profit/loss per share	
Basic:	450
Diluted:	300

Additional information:

1. Administration costs include the following:
   - Exploration expenses amounting to TZS.23,000,000
   - Pre-license exploration costs amounting to TZS.37,000,000
   - Royalty expenses of TZS.12,000,000
2. During the year the company acquired an equipment for prospecting and exploration of petroleum for TZS.56,000,000. However, this amount has not been reflected in the depreciation allowance for this year of income.
3. Sales revenue is made up of the following:
   - Incomings derived from disposal of petroleum from the license area amount to TZS.1,650,000,000.
   - Amounts obtained from selling information relating to petroleum reserves amount to TZS.350,000,000.
4. Interest revenue was received from a financial institution.

Required:

Calculate the taxable income for TET Oil Ltd for the year of income 2017 as per the requirements of the Income Tax Act, CAP 332 (Revised 2016).

Question 2

Decommissioning consists of the process (and attendant expenses) through which an project operator closes down, demobilises and removes installations used in oil and gas production, including rigs, topsides, Floating

Production, Storage and Offloading (FPSO) units, pipelines, depleted plugs and abandoned wells. The decommissioning process has an accounting and tax impact.

Required:

(a) Explain the main tax implications and country concerns which relate to the decommissioning expenses of oil and gas installations.

(b) Explain the different solutions which have been identified by governments to mitigate these concerns and tax issues.

Question 3

The principal tax regimes for upstream oil and gas operations are Production Sharing Contracts and Tax/Royalty licence or concession arrangements. The precise fiscal terms for a given field or block are set out in the law and/or in an agreement with the international oil company (IOC). In addition to corporate income tax and production sharing, government take often includes other payments such as petroleum royalties, signature and production bonuses.

Required:

(a) Explain and discuss the concept of petroleum royalties, with examples where possible

(b) Explain and discuss the concepts of signature and production bonuses, with examples where possible

Question 4

When taxing the revenue arising from oil and gas production, some countries include ring fencing provisions in their petroleum laws or in the exploration and production contracts. These ring fencing provisions may have different scopes and objectives. They may also have an impact upon the taxation of oil and gas companies' profits, and upon government tax revenues.

Required:

(a) Explain the concept of ring fencing in oil and gas contracts, and the different scopes of ring fencing. Provide examples of countries which have different ring fencing provisions or regimes in place, and how they apply.

(b) Discuss the impact which ring fencing may have upon the taxation of the oil and gas company concerned, and upon government tax revenues.

Answers to Self-Examination Questions

Answer to SEQ 1

To calculate the taxable income:

Profit before Tax		841,000,000
Add Back: Non-allowable		
Impairment costs	42,000,000	
Bonus payment	42,000,000	
Loss from associates	490,000,000	
Exploration Expenses	23,000,000	
Pre-license exploration costs	37,000,000	634,000,000
		1,475,000,000
Less: Allowable		
Acquisition of equipment (Class 8)	56,000,000	
Profit on disposal of non-current assets	30,000,000	
		86,000,000
TAXABLE INCOME		1,389,000,000

Answer to SEQ 2

(a) Normally, expenses for decommissioning of oil and gas installations and wells are very high, especially in offshore areas. With the proliferation of strict requirements put in place by new environmental laws the costs of decommissioning have been rising. Also, Governments are always concerned with making sure the operator makes the necessary preparations for the decommissioning of the installations and well to avoid environmental disasters. These factors have contributed for the increase in the last decade of the amount of decommissioning costs which are incurred by oil and gas companies. From an accounting perspective companies create a provision for the future liability costs and recognize a deferred tax asset on the future liability but if the provision is not accepted for tax purposes the problem will remain. The tax impact when addressing the decommission process is the recognition of the expenses. Because the decommissioning expenses are made at a point where the oil production is reduced to a very small amount or none at all, the main problem arising is that the profits from the sale of oil may not be enough to deduct the decommissioning expenses leaving the company with unrelieved losses for which it will get no tax benefit. This together with the fact that the tax deduction for the decommissioning expense is only given at the time when the expense is incurred creates possible tax issues for the company. From the Government side the fact that in most cases the tax rules disallow the deduction of accounting provisions or reverses made for decommissioning costs creates uncertainty in this topic and raises concerns that the companies will have profits to be able to pay the decommissioning of the oil and gas installations at the end of the field life.

(b) On the possible solutions to deal with this problem which some countries have been adopting is to create a decommissioning fund. This works by having the companies contributing cash to this fund for future estimated decommissioning expenses early in the project (e.g. when the reserve reaches 50% depletion) to allow for an early tax deduction of the cost when the oil production is still high. This also covers the risk of the Government by linking the deductibility of reserves to the abandonment contribution plan agreed with the oil and gas company and guarantees that the cash for decommissioning will be available when needed. To address cash flow issues this cash may be lent back to the companies in exchange for an interest payment. Examples of this solution include Canada and Ghana. One other solution is to allow the carry back of the expenses against past profits until these costs have been fully tax deducted. In this case losses arising in the year of cessation of trade or losses that arise from decommissioning expenditure can be carried back for a number of periods agreed by the Government. Thus even if the decommission expenses are only deductible when they are effectively incurred the Government guarantees that they will be tax deductible against prior year profits making sure the company is not left with unrelieved losses. An example of this was applicable in the UK. A different solution has been adopted by Norway where if the decommissioning costs are not recovered through the deductions in different field still in production the Government will refund the oil and gas company for the tax value of the decommissioning costs similarly to what happens with the explorations costs incentive.

Answer to SEQ 3

(a) Royalties

Royalties are usually based on production or value of oil and gas produced. Royalties may be based on different values including:

- Fixed percentage;
- Vary with geological features; for example Nigeria offshore royalties decrease with the geological features of greater water depth.
- Sliding scale royalties based on production;
- Sliding scale royalties based on other several factors;
- Sliding scale royalties depending on IRR

(b) Many countries require signature and production bonuses as payments to be made at stages of exploration and production. Bonuses may arise as part of the bidding process for a new exploration and development licence, or be imposed under standard terms such as PSC. Bonuses may include:

- Signature bonuses: payable on signing the oil and gas agreement; for example on signing of the PSC or block exploration and development license.

- Capacity building bonuses: an amount paid to assist in the development of facilities such as project infrastructure, and generally payable at an early stage in the contract.
- Bonuses may be payable on discovery, commercial discovery, licence application, specific levels of production, or levels of cumulative production.

Answer to SEQ 4

(a) Ring fencing imposes a limitation on deductions for tax purposes across different activities or projects undertaken by the same oil and Gas Company. This forces contractors or concessionaries to restrict all cost recovery and or deductions associated with a given license (or sometimes a given field) to that particular cost. This means that all costs associated with a particular block or lisence must be recovered from revenues generated within that block. Ring fencing can be applied on different scopes. Some countries ring-fence their oil and gas activities from other activities performed by the same entity (as downstream operations) in the country whilst others ring fence individual projects from other projects held by the same company. Thus, the ring fence may be individual licenses or on a field-by-field basis. In a ring fencing situation exploration expenses in one non-producing block could not be deducted against income for tax calculations in another block. Under Production Sharing Contracts normally ring-fencing acts in the same way as cost incurred in one ring fenced block cannot be recovered from another block outside the ring fence. As mentioned above some countries ring-fence their oil and gas activities (usually under corporate income tax) whilst others ring-fence individual projects (usually under special petroleum taxes).

(b) The impact of ring fencing in the taxation of oil and gas companies is that it may lead to a higher tax on the projects. If a company operates in several ring-fenced areas it has to calculate profits separately for each of them and cannot consolidate them for tax purposes. However, if all the projects held by the company are economic profitable it would only constitute a timing issue as the costs will still be recovered but this would happen latter on the project in case ring fencing applies. Allowing companies to offset those costs might give an advantage to existing industry players over new entrants with only one license. For governments these rules have impact because the absence of ring fencing can postpone government tax receipts as the company that undertakes a series of projects is able to deduct exploration and development costs from each new project against the income of projects that are already generating taxable income. Thus, by introducing ring fencing the government revenue will be accelerated. If no ring fencing applier this would potentially reduce the (higher) taxes intended to be collected from those operations. Also if there is no ring fencing and different tax regimes apply to different areas, companies could allocate costs disproportionately to higher taxed areas to reduce tax. One other aspect is that where countries impose progressive taxes, area ring-fencing can mean that companies pay high taxes on “excess profits” from one area, even though they have not made excess profits (or have even suffered a loss) in the country as a whole. Ring-fencing adds significant administrative complexity and risk, particularly when license areas or even individual projects are ring-fenced, as is true in many countries. Also, ring-fencing may hamper companies undertaking further exploration and development activities due to the inability to claim deductions for such activities on new projects. It may also encourage tax planning if the ring-fenced tax regime is more onerous than the standard tax regime. For example, locating lower-taxed downstream activities outside the ring fence, including in another jurisdiction, or transfer pricing to shift profits outside the ring fence or costs inside the ring fence. Another concern with ring-fencing is that it can be especially complex where one tax (such as a resource rent tax) is ring-fenced but another tax (such as the CIT) is not.

SECTION B

TAXATION OF SPECIALIZED INDUSTRIES

B6

STUDY GUIDE B6: TAXATION OF MINING OPERATIONS

Get Through Intro

Nature has gifted man with several things, one of them being the minerals of the earth. These minerals of the earth are of limited quantity at any place and are not readily available like stones on the road. They required special efforts to locate them and to win them, otherwise they would have been extracted long before by our forefathers.

Tanzania seems to be well endowed with various mineral deposits but unless these minerals are located and extracted they are virtually useless. Mining is a high risk business. Substantial capital has to be invested in mineral exploration, extraction and testing of samples. Yet, the expenditure does not guarantee a profitable investment because the quality and quality of the minerals ores may be inadequate or of poor grade to make the mining business uneconomical. In view of the high risk involve investors need to be sufficiently encouraged to undertake the mining investment. This guide describes taxation rules of mining operations under the Income Tax Act, Cap 332

Learning Outcomes

a) Explain the meaning of mining and mining operations
b) Describe general principles on taxability of mining operations
c) Explain calculation of rules of depreciation allowances for mining operations.
d) Describe taxation rules for processing, smelting and refining business

Explain the meaning of mining and mining operations and describe general principles on taxability of mining operations. [Learning outcome a and b]

1. Meaning Of Mining And Mining Operations

(i) Mining" means intentionally winning minerals and every method or process by which mineral is won;
(ii) Mining licence" means special mining licence, mining licence or primary mining licence defined as such under the Mining Act;
(iii) Mining operations" means prospecting, mining or operations connected with prospecting or mining carried out pursuant to mineral rights granted under the Mining Act;

2. General Principles On Taxability Of Mining Operations

For income tax purpose, each separate mining operation shall be treated as independent business and the person must prepare accounts for that business separate from any other activity of the person

Income from mining operations

In calculating a person's income from separate mining operations for a year of income, there shall be included, together with any other amounts to be included under other provisions of the Act

(a) Incoming derived from the disposal of minerals produced from the license area
(b) Amounts received in respect of the sale of data or information pertaining to the operations or mineral reserves
(c) Gains on realisation of assets used in mining operations

Deductions for mining operations

In calculating a person's income from separate mining operations for a year of income, there shall be deducted, together with any other amounts deductable under other provisions of the Act

(a) Annual charges and royalties incurred with respect to the mineral rights
(b) Depreciations allowances granted to the mining operation
(c) Contributions to and other expenses incurred in respect of rehabilitation fund for the operation .(i,e expenditure for closure and restoration)

(d) Expenses incurred in respect of acquisition of rehabilitation bond.

Non allowable expenses

There shall be no deduction allowed in calculating income from a separate mining operations –

(a) Under sections
- ✓ 15- **Agriculture improvement, research development and environmental expenditure**
- ✓ 16 **-Gifts to public, charitable and religious institutions**,
- ✓ 17- **Depreciation allowances for depreciable assets** or
- ✓ 26-**loss carry back**

(b) For an unrelieved loss under section 19 of the Income Tax Act, except as permitted by section 65F of the Income Tax Act (i.e Income from the separate mining operation for any year of income may be reduced by reason of the use of unrelieved losses from that operation subject to other limitations imposed by section 19 but not below 30 percent of that income before any reduction for losses .The perpetual loss making cooperation rules do not apply in conducting mining operations under a prospecting licence.
(c) Any bonus payment.
(d) For expenses incurred by the person in implementing an approved mine closure fund in excess of the amount contributed to the approved rehabilitation fund.

Explain calculation of rules of depreciation allowances for mining operations and ddescribe taxation rules for processing, smelting and refining business [Learning outcome c and d]

3. Calculation Of Rules Of Depreciation Allowances For Mining Operations

The whole of depreciation allowance expenditure incurred in respect of mineral operations during a year of income shall be placed in a separate pool. Depreciation allowance shall be granted for expenditure pooled for a year of income at the following rates

Year of Income	Depreciation Allowance
First Year	20% of expenditure
Second Year	20% of expenditure
Third Year	20% of expenditure
Fourth Year	20% of expenditure
Fifth year	20% of expenditure

Moreover, the depreciation allowance granted with respect to a particular year of income shall be taken in that year and shall not be deferred to a later year(s) of income

Where an asset for which depreciation allowance have been or may be granted, is treated as realised during a year of income

(c) if the incomings derived from the realisation of an asset(s), exceed the written down value of the pool of depreciable assets, and the excess shall be included in calculating income from the mineral operations for the year; and

(d) if the written down value of the pool of depreciable assets exceed the incomings derived from the realisation of all assets in the pool, the excess of written down value in the pool of assets may be granted for that year of income and the pool shall be dissolved

Nevertheless, where incomings are derived by a person during a year of income with respect to a depreciable asset employed by the person in mineral operations but the asset is not realised at that time in whole or in part, the incomings shall be included in calculating income from the mineral or petroleum operations for the year.

Definitions

Depreciation allowance expenditure" means-

(c) Additions to the cost of depreciable assets owned and employed by a person wholly and exclusively in mineral or petroleum operations; and

(d) Expenditure other than financial costs incurred in respect of mineral operations wholly and exclusively on reconnaissance, appraisal and prospecting or exploration operations or in developing mineral operations and infrastructure, including as may be prescribed by regulations, where-

(iii) the expenditure is not directly deductible in calculating income from the operations; and

(iv) does not otherwise fall to be included in the cost of an asset;

Written down value of a pool of depreciable assets at a particular time during a year of income" means-

(a) Written down value of the pool at the end of the previous year of income; plus

(b) expenditure incurred prior to the time, which is added to the depreciation basis of the pool during the year of income or to be added during the following year of income; less

(c) incomings derived during the year of income or to be derived with respect to a realisation occurring prior to the time in respect of assets that are or have been in the pool;

Written down value of an asset" means the cost of the asset less all depreciation allowances granted with respect to expenditure included in that cost."

4. Taxation Rules For Processing, Smelting And Refining Business

a. A licensee conducting processing, smelting or refining with respect to minerals shall be subject to income tax with respect to the activities as provided by this Act, and as modified b this is subdivision to the extent that there is no modification, the standard rules in this. Act shall apply.
b. In calculating a licensee's income from a business which includes processing, smelting or refining of minerals, there shall be deducted amounts deposited in respect of rehabilitation fund established for the licence.
c. There shall be no deduction allowed in calculating income from a separate mining operations –

(b) Under sections
- ✓ 15- **Agriculture improvement, research development and environmental expenditure**
- ✓ 16 **-Gifts to public, charitable and religious institutions**,
- ✓ 17- **Depreciation allowances for depreciable assets** or
- ✓ 26-**loss carry back**

(c) For an unrelieved loss under section 19 of the Income Tax Act, except as permitted by section 65F of the Income Tax Act (i.e Income from the separate mining operation for any year of income may be reduced by reason of the use of unrelieved losses from that operation subject to other limitations imposed by section 19 but not below 30 percent of that income before any reduction for losses .The perpetual loss making cooperation rules do not apply in conducting mining operations under a prospecting licence.

(d) For expenses incurred by the person in implementing an approved mine closure fund in excess of the amount contributed to the approved rehabilitation fund.

Question 1

JNJ Mining Limited (JNJM) mines gold in Shinyanga, Tanzania. The company's statement of profit or loss for the year ended 31 June 2017 is as follows:

		Tshs million
Revenue from sale of gold		1,100
Less: Expenses		
Exploration costs	760	
Production bonus paid	11	
Loss carried forward from previous years	44	
Loss from other mining license area	19	
Provision for environmental restoration costs	44	
Royalties	62	
Management and Administration expenses	22	
Depreciation	23	
General provision for doubtful debt	13	
Donation to local Community and charitable institution	12	(1,010)
Profit for year		90

Note

Approved capital allowances by the Commissioner General were Tshs 107 million

Required:

Calculate the taxable income and tax liability of for the year of income 2017

Answer to SEQ 1

Profit per accounts		90
Add: Non allowable expenses		
Production bonus paid	11	
Loss carried forward from previous years	22	
Loss from other mining license area	19	
General provision for doubtful debt	13	
Donation to local Community and charitable institutions	12	77
		167
Less: Capital allowances		(107)
		60
Less: Unrelieved loss of previous year		(42)
Taxable income		18
Tax liability		5.4

Note
Unrelieved loss from previous year should not exceeds 70% of the income
(i.e 70% of Tshs 60 million = Tshs 42 million)

SECTION C

INTERNATIONAL TAXATION

C1

STUDY GUIDE C1: TAXATION OF PERMANENT ESTABLISHMENTS

Get Through Intro

As businesses now operate in a global marketplace, many overseas businesses (incorporated or unincorporated) will have operations in Tanzania. It is therefore important to understand when and how income from such overseas businesses operating in Tanzania may be taxed in Tanzania.

The fundamental principle is that for business income, a person (whether an individual or a company) from one country (Country A) will be taxable in the other country (Country B) only if he has a PE in Country B. If there is a PE, only the income attributable to such PE in Country B will be subject to tax in Country B.

The primary use of the PE concept is to determine the right of a state to tax the profits of an enterprise of another state. As long as an enterprise does not set up a PE in another contracting state, the (worldwide!) profits are taxable only in its home state. This guide discusses the concept of PE and explains taxation principles of PE in Tanzania.

Learning Outcomes

a) Describe the concept of Permanent Establishments
b) Discuss the rationale for permanent establishment concept in income taxation
c) Discuss the methods of attribution of profits to PEs
d) Describe Taxation of a PE under the Tanzanian Income Tax Cap 332, Sections 70-72

Describe the concept of Permanent Establishments and discuss the rationale for permanent establishment concept in income taxation. [Learning outcome a and b]

1. Concept Of Permanent Establishments

Article 5(1) (Permanent Establishment) of the OECD Model Tax Treaty defines a permanent establishment as 'a fixed place of business through which the business of an enterprise is wholly or partly carried on. 'The important elements of a PE are therefore:

- **A place of business:** there must exist a facility such as premises, facilities or installations and, in some instances, machinery or equipment. It may mean a space which is at its constant disposal. The OECD commentary makes it clear that if an employee from a business in one country is purely visiting a client in another country on a short term basis then this will not constitute a place of business.

- **Fixed place**: the place of business must be fixed, ie it is a distinct place with a degree of permanence. Note, however, that there need not be any formal legal right to use a particular place or space

- Through which the business of an enterprise is carried on wholly or partly. This means that persons who are dependent on the enterprise, or persons who represent the enterprise, conduct the business of the enterprise through this fixed place of business.

Examples of PEs

Article 5(2) provides a non-exhaustive list of examples of things which the term 'permanent establishment' may include:

- a place of management
- a branch
- an office
- a factory
- a workshop
- a building site or construction or installation project which lasts for more than six months.

Building site or construction or installation project

Article 5(3) of the OECD model convention states that, a building site, or a construction/installation project constitutes a PE. However, such a site or project must last a certain minimum period before it can be regarded as a PE. The minimum period prescribed may be six months, nine months or 12 months, depending on what is mutually agreed by the two contracting states.

Excluded activities

Article 5(4) of the OECD model DTA itemizes a number of activities that are deemed not to constitute a PE. These are;

(a) The use of facilities solely for storage, display or delivery of goods/merchandise belonging to the enterprise.
(b) The maintenance of a stock of goods/merchandise solely for storage, display or delivery.
(c) The maintenance of a stock of goods/merchandise solely for processing by another enterprise.
(d) Maintaining a fixed place of business solely for purchasing or collection of information for the enterprise.
(e) Maintaining a fixed place of business solely for the carrying out any other activity of preparatory or auxiliary character.
(f) Maintaining a fixed place of business solely for any combination of activities mentioned in (a) to (e), provided that the overall activity resulting from such combination is preparatory or auxiliary in character.

This means that if all an enterprise does in the other country is purchase, store, deliver, or collect information, or any combination of these activities, the enterprise is deemed to have carried out activities that are merely preparatory or auxiliary in character. The enterprise will not establish a PE purely by carrying out such activities.

Agency PE

A dependent agent, Article 5(5)

Where an enterprise has, in the other country, a person:

- who regularly acts on its behalf, and
- who is vested with authority to conclude contracts in the name of the enterprise, and
- who habitually exercises such authority, the enterprise is deemed to have a PE in the other country.

Example

A Malaysian export company has a representative based in Tanzania who would regularly take instructions from Malaysia, reports to Malaysia, and who enters into sales contracts on behalf of the Malaysian company. The representative renders these services exclusively to the Malaysian company and is remunerated by the Malaysian company.

The Malaysian company is deemed to have a PE in Tanzania because of the presence of the representative in Tanzania who regularly transacts on behalf of the Malaysian company.

A dependent agent, Article 5(6)

By contrast, an independent agent will not result in the enterprise being deemed to have a PE, Article 5 (6). It follows, therefore, that an enterprise shall not be deemed to have a PE merely because the enterprise carries on business in the other country through a broker, general commission agent or any other independent agent acting in the ordinary course of their business.

Subsidiaries, Article 5 (7)

A subsidiary does not necessarily constitute a PE of the parent company, et vice versa

Recognizes the separate legal personality of associated companies; parent as such shall not be subject to taxation in the state of its subsidiaries

However, if the activities of the subsidiary on behalf of the parent meet the requirements of Article 5 (1) to (6), the subsidiary can constitute a PE of the parent in the same way as any other company would (e.g. dependent agent of the parent)

2. Rationale For Permanent Establishment Concept In Income Taxation

The relevance of the PE concept in international taxation is twofold; firstly, the existence of a PE is a minimum requirement that must be satisfied for a source country to tax a non-resident's business profits. *Article 5 of the OECD Model Treaty* helps prove existence of a PE. Secondly, once existence of a PE is proved, the PE concept is then used to allocate the right to tax as between the source and resident country. *Article 7 of the OECD Model Treaty* allocates these taxing rights to the source country.

Discuss the methods of attribution of profits to PEs and describe Taxation of a PE under the Tanzanian Income Tax Cap 332, Sections 70-72

[Learning outcome c and d]

3. Methods Of Attribution Of Profits To PES

There are basically two methods of attributing profits to PEs: the direct method (separate-entity approach) and the indirect method. Under the *direct method*, a PE is treated as a separate and independent enterprise from its foreign enterprise, only for purposes of profit attribution, which from a legal point of view is mere fiction. The direct method assumes that the PE is economically independent for tax purposes (although it is legally dependent). The profits attributed to a PE are the profits the PE would earn if it were a separate and independent enterprise from its foreign enterprise. Put the other way, the PE prepares its own books of accounts as if the PE and its foreign enterprise were separate legal entities. *Indirect method* (formula allocation) uses allocation factors to allocate the total profit to an entity's business units. Under the *indirect method*, the firm's total profit is allocated to the PE and its foreign enterprise according to economic factors like capital, wages and sales. The rationale behind such an allocation rule is the idea that economic factors entering the apportionment formula are linked to actually earned profits.For instance, capital and labour are production factors. Taking these factors into account, the enterprise's profit is allocated to the countries where production takes place, i.e. where capital is invested and where wages are paid. The indirect method (formula allocation) has been criticized as unfounded in economics, because it is essentially unclear what amount of profit is "caused" by invested capital and employed workforce or generated revenues. That there is no economic theory of how to allocate a firm's profit fairly according to the input factors involved. The OECD uses the direct method to allocate profits to PEs. Under Article 7(1) of the OECD Model Treaty a source country shall not tax profits of a non-resident enterprise unless that enterprise carries on business in the source country through a PE; and the tax rights of the source country are restricted to profits attributable to the PE. By Article 7(2) of OECD Model Treaty**,** profits attributable to a PE are the profits the PE might be expected to make, in its dealings with other parts of the enterprise, if it were a separate and independent enterprise. In effect, and as recognized by paragraph 16 of the OECD Commentary on Article 7(2) this requirement suggests that the arm's length approach under Article 9 of the OECD Model Treaty should be used, whenever possible, for determining profits attributable to a PE. Under Article 9 of the OECD Model Treaty a tax authority can adjust the accounts of associated enterprises if, because of their special relations, their accounts do not show their true taxable profits.

4. Taxation Of A PE Under The Tanzanian Income Tax Cap 332, Sections 70-72

Meanings of terminologies

The Income Tax Cap 332 defines '**Permanent Establishment'** as a place where a person carries on business and includes

(a) a place where a person is carrying on business through an agent, other than a general agent of independent status acting in the ordinary course of business as such;

(b) a place where a person has used or installed, or is using or installing substantial equipment or substantial machinery; and

(c) a place where a person is engaged in a construction, assembly or installation project for six months or more, including a place where a person is conducting supervisory activities in relation to such a project.

The Act under section 3 provides two type of Permanent establishment as follows

i) Domestic permanent establishment

Means all permanent establishments of a non-resident individual, partnership, trust or corporation situated/operating in the United Republic

ii) Foreign permanent establishment

Means all permanent establishments of an individual, partnership, trust, or corporation that are situated in any one country that is not the country in which the individual, partnership, trust or corporation is resident but excludes a domestic permanent establishment.

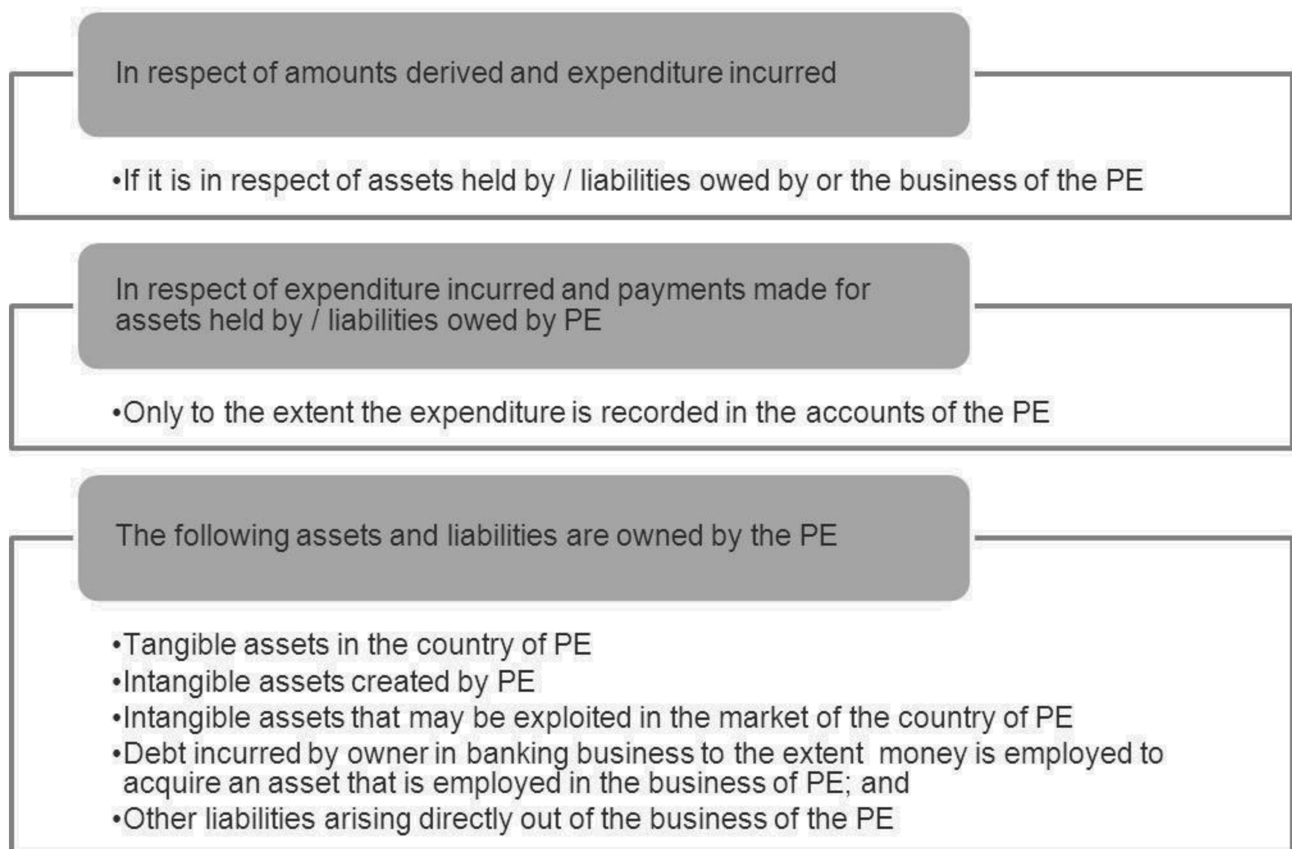
Taxation principles

The owner of permanent establishment and the permanent establishment should be treated as two independent persons **but related** and the residential status of the permanent establishment is determined by the location of its business (Section 70(1)). Therefore, income of domestic or foreign permanent establishment should be calculated distinctly from that of its owner (Section 71(1)).

According to Section 71(2), the following amounts derived and expenditure incurred shall be attributed to the permanent establishment, namely:

- amounts derived and payments received in respect of assets held by, liabilities owed by or the business of the permanent establishment; and
- expenditure incurred and payments made for the purposes of assets held by, liabilities owed by or the business of the permanent establishment, but only to the extent the expenditure is recorded in the accounts of the permanent establishment.

Diagram 1: Amounts attributed to the permanent establishment (PE)



Additionally, the following assets and liabilities are owned by the permanent establishment:

(a) tangible assets situated in the country of the permanent establishment;
(b) intangible assets created by or through the permanent establishment;

(c) intangible assets, to the extent that they may be exploited in the market of the country of the permanent establishment;
(d) debt obligations incurred in borrowing money but not borrowed by the owner who is doing banking business (Section, 71(6)), to the extent that the money is employed in or used to acquire an asset that is employed in the business of the permanent establishment; and
(e) other liabilities arising directly out of the business of the permanent establishment (Section 71(3)). However, in addition to other ways of realizing assets and liabilities, the permanent establishment realizes tangible assets when the asset is no longer situated in the country of the permanent establishment, intangible assets, to the extent the asset is available for exploitation in the country in which the owner is resident or a country in which the owner has another permanent establishment; o liabilities when the money or asset is no longer employed in the business of the permanent establishment (Section 71(4)).

Activities of a PE

All income arising from all sources in a country, where the foreign enterprise maintains a PE is subject to tax in that country irrespective of whether the said income is 'attributable to' the PE or not.

Therefore, profits arising from transaction outside PE are also taxable. As per this rule, not only the profits attributable to the sale of goods by or of the PE but also the profit attributable to the sale of same or similar kind of goods is brought to tax and any other income from sources within that country are also regarded as income attributable to the PE. Under the Income Tax Act, the following activities shall be treated as conducted by the permanent establishment-

(a) employment by the owner of any individual who is resident in the country of the permanent establishment;
(b) sales of trading stock by the owner of the same or a similar kind as those sold through the permanent establishment; and
(c) Other business activities of the owner conducted with residents of the country of the permanent establishment of the same or a similar kind as those effected through the permanent establishment.

PE Allowable Expenses

In the determination of profits of a permanent establishment, deduction shall be allowed for expenses which are incurred wholly and exclusively for the purposes of the business of the permanent establishment. This refers to expenditure incurred and payments made for the purposes of assets held by, liabilities owed by or activities conducted by the business of the permanent establishment. It includes executive and general administrative expenses so incurred, whether in the URT or elsewhere. The ITA, Cap 332, further requires the expenditure to be recorded in the books of accounts of a permanent establishment if it is to be regarded an allowable deduction. Expenditures which have not been recorded in the books of accounts of PE will not be allowable for deduction

Intra group transactions

Only the transfer of an asset or liability between the permanent establishment and the owner or vice versa is recognized, but where the owner carries on a banking business through the permanent establishment, the owner has to receive a written approval from the Commissioner and enter a debt obligation between the owner and the permanent establishment or vice versa; and interest derived or incurred with respect to a debt as instructed by the commissioner (Section 71(6)). This means that apart from the intra-entity interest income and expenses which are recognized as income and expenses, respectively, of a permanent establishment dealing with banking business, other intra-entity income, and expenses are not recognized: This implies that no deduction shall be allowed .in respect of amounts, if any, paid by the permanent establishment to the head office of the enterprise or any of its other offices, by way. of royalties or fees; in return for use of intangible assets or other rights provided by the owner, commission, for services offered by .the owner interest (for money lent by the .owner) and similar other amounts paid to the owner. However, if such expenditure is paid, in respect of reimbursement of actual expenses incurred earlier by head office or--, another office of the owner, on behalf. of the PE's obligation to pay, the .expenditure will be an allowable expense. Similarly, no income shall be included,, in the determination of the profits of a permanent establishment, for amounts charged (otherwise: than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees, commission, interest and any other similar receipts from the owner.

Taxation of Domestic Permanent Establishment

DPE is taxed in two bases

(i) On total income (business and investment income)at 30%
(ii) On repatriated income at 10

According to section 72(1) **the repatriated income = A + B - C**

Where:

A = net cost of assets of the permanent establishment at the start of the year of income + market value of capital contributed to the permanent establishment by the owner during the year.

B = net total income of the permanent establishment for the year of income; and

C = net cost of assets of the permanent establishment at the end of the year of income + any unrelieved loss for the year of income (where the establishment has no total income for the year of income),

Nevertheless, the repatriated income **must not exceed** the net total income of the permanent establishment for the year of income plus the balance of the permanent establishment's accumulated profits account, less where the permanent establishment has no total income for the year of income, any unrelieved loss for the year of income referred to in section 19(4) for the year of income (Section 72(2)). The accumulated profits account is credited with the net total income of the permanent establishment for the year of income and debited with the repatriated income and any unrelieved loss

for the year of income in case of a loss (Section 72(3)).

Definitions

(i) 'Net cost of assets' of a domestic permanent establishment (DPE)

- **'Net cost of assets'** of a domestic permanent establishment (DPE) at the start of a year of income = net cost of assets at the end of the previous year of income
- **'Net cost of assets'** of a DPE at the end of a year of income =

  Written down value of the permanent establishment's pools of depreciable assets at the end of the year of income

Plus: the net cost of other assets of the permanent establishment at the end of the year of income;

Less: the net incomings for liabilities of the permanent establishment at the end of the year of income

(ii) **'Net total income'** of a domestic permanent establishment for a year of income is its total income for the year of income calculated without any deduction of any unrelieved loss brought forward less income tax payable with respect to that income.

(iii) '**Net incomings for a liability to a particular period'** means the amount by which cumulative incomings for the liability exceed cumulative costs for the liability in that period. Basically net incoming for a liability means the outstanding amount of liability at a point in time.

Example 1

Robots and Assembler Design Makers, a domestic permanent establishment of a non-resident entity, has the following information about its financial affairs for year ending 31st December 2018.

(a) Net cost of assets at the start of the year was Tshs20,000,000
(b) During year 2018 it issued 2,000 shares each at Tshs1,000 but the market value of shares has since increased to Tshs1,050.
(c) Written down value of the depreciable assets at the end of the year was Tshs10, 000,000 and the values of other assets were Tshs5,000,000.
(d) The company borrowed 2 years free of interest loan of Tshs3, 000,000 on 1 January 2018 from various lenders, annual repayment of the loan is Tshs1, 500,000.
(e) The company has total income of Tshs40,000,000 during the year before deducting previous unrelieved loss.
(f) Corporate tax rate was 30% and tax rate for repatriated income was 10%.
(g) The balance of accumulated profit account was Tshs10,000,000 on the credit side.

Required:

Calculate the tax liability of the company for the year ending 31st December 2018.

W1: Workings for repatriated income Repatriated income = A + B - C

Where,

A = Tshs20,000,000 plus Tshs1050 x 2, 000 = Tshs22,100,000

B = Tshs40,000,000 less Tshs12,000,000= Tshs28,000,000 and

C = Tshs10,000,000 + Tshs5,000,000 – (Tshs3,000,000 - Tshs1,500,000)= Tshs13,500,000

So repatriated income is equal to Tshs22,100,000 + Tshs28,000,000 - Tshs13,500,000 = Tshs36,600,000. But it should not exceed Tshs28,000,000 + Tshs10,000,000 = Tshs38,000,000. So since it does not exceed Tshs38,000,000 the repatriated income is Tshs36,600,000.

Hence

(a) Tax on total income i.e. 30% of Tshs40,000,000 = Tshs12,000,000
(b) Repatriated income tax i.e. 10% of Tshs 36,600,000 = Tshs3,660,000
(c) Total tax liability is Tshs15,660,000 (Tshs12,000,000 + Tshs3,660,000)

		Tshs'000'
Class	1	160,000
Class	2	30,000
Class	3	20,000
Total		**210,000**

Example 2

DPE LTD is a branch company of ABC LTD a UK based company. Below is extracted information from accounts of DPE LTD (All the values are in Tshs) at the end of the year of income ended 31 December 2018.

1. Tax Written Down Value of Depreciable Asset (TWDV) at 1 January 2018

2. No additions were made to the company's depreciable assets during the year.
3. The extract from the statement of financial position showing the cost of other asset for the year of income 2018 and 2017 is as follows

	2018	**2017**
	Tshs'000'	Tshs'000'
Inventories	40,000	20,000
Trade Receivables	90,000	10,000
Cash and Bank	90,000	40,000
	220,000	**70,000**

4. At 1st January 2015, DPE LTD borrowed Tshs 69,738,000 from CRDB at 10% per annum interest on outstanding amount at start of the year, loan is repayable in 4 equal installments of Tshs 20,000,000 payable in advance.
5. The unrelieved loss of Tshs 5,000,000 was carried forward from previous year.

6. During the year adjusted business income (after deduction of capital allowances and unrelieved loss) is Tshs 70,000,000 and gains from investment were Tshs 25,000,000
7. During the year Tshs 60,000,000 was added as capital by owners
8. Balance in the accumulated profit account Tshs 15,000,000

   Required

   (a) Calculate repatriated income by DPE LTD (if any)

   (b) Calculate the Tax payable DPE LTD for year of income 2018

Answer

Repatriated Income = A+B-C

Where -

A. Is the net cost of assets at the start of the year of income, plus the market value of capital contributed to the permanent establishment by the owner during the year

B. Is net total income of the permanent establishment for the year of income; and

C. Is the net cost of assets of the permanent establishment at the end of the year of income

Calculation of A

(i)	**Net cost of assets at the start of the year of income**	Tshs'000'
	TWDV at start of the year	210,000
	Cost of other business assets	70,000
		280,000
	Less: Net incomings for liability at start (W1)	(20,000)
		260,000
Plus		
(ii)	Capital contributed by owners	60,000
		320,000

	Calculation of B (net total income)	
	Total income for the year of income (70,000+25,000)	95,000
	Add: Unrelieved loss	5,000
		100,000
	Less tax payable at 30%	(30,000)
	Net income for the year	**70,000**
	Calculation of C	
	TWDV at the end of the year **(W2)**	140,000
	Cost of other business assets at the end of the year	220,000
		360,000
	Less: Net incomings for liability at end of the year(W1)	-
		360,000

- So repatriated income is equal to Tshs320,000,000 + Tshs70,000,000 – Tshs360,000,000 = Tshs30,000,000.
- But it should not exceed Tshs30,000,000 + Tshs15,000,000 = Tshs45,000,000. So since it does not exceed Tshs45,000,000 the repatriated income is Tshs30,000,000.

(b) Tax payable by DPE

- On total income =30%×100,000,000= 30,000,000
- On the repatriated income =10%×30,000,000= 3,000,000

TOTAL 33,000,000

(W1)Net incomings of liabilities

Net incoming is the amount of the liability outstanding at any point of time.

Year	Bal/f	Installments	Capital Outstanding at start	Interest at 10%	Bal c/f
	Tshs '000'	Tshs '000'	Tshs '000'	Tshs '000'	Tshs '000'
2013	69,737	(20,000)	49,737	4,974	54,711
2014	54,711	(20,000)	34,711	3,471	38,182
2015	38,182	(20,000)	18,182	1,818	20,000
2016	20,000	(20,000)	0	0	0

(W2) TWDV of Depreciable assets at the year end

Class	1	2	3	**Total**
Rate	37.5%	25%	12.5%	
	Tshs'000'	Tshs'000'	Tshs'000'	Tshs'000'
TWDV at start	160,000	30,000	20,000	**210,000**
Additions	-	-	-	
Realisations	-	-	-	
Depreciation base	**160,000**	**30,000**	**20,000**	
Depreciation Allowances	60,000	7,500	2,500	
TWDV at end	100,000	22,500	17,500	**140,000**

Self-Examination Questions

Question 1

Shika plc is a public limited company resident in Bongo land. It manufactures and sells cryptographic hardware and software. Shika plc is considering trading in Nyanza Land. Tax rates are much higher in Nyanza Land than in Bongo land, however, and Shika plc is concerned about the tax risk that this might entail.
Shika plc is considering a number ways in which it might operate in Nyanza Land:
(i) Increasing production in Bongo land, and either

- selling through independent agents in Nyanza Land, or
- selling through a sales team in Nyanza Land, which would keep a store of the hardware in a warehouse;

(ii) Setting up its own factory in Nyanza Land and selling through its own local sales team; or
(iii) Establishing a subsidiary in Nyanza Land which would manufacture the hardware, obtain the software under licence, and sell both through its own local sales team.

Whichever mode of operation is adopted, Shika plc will need, from time to time, to send some of its technical experts to Nyanza Land. They will visit customers, help with the software integration that represents the front-end of the cryptographic hardware, and advise them on any bespoke adjustments to the software which customers might require to use the hardware optimally. The technical experts will stay in hotels and carry out their work on the customers' premises.
Required:
The Chief Financial Officer of Shika plc would like advice concerning the possible tax consequences of each of the suggested modes of operation.

Question 2
Masala is a company resident in the Republic of Balimi. The company produces packaging for ready-to-eat meals. Masala would like to expand its trading to a second country, Basabi, which has a fast-growing market. A business case for this move is very strong. However, Basabi has a higher corporate tax rate than Balimi, which creates a potential tax risk for Masala. Four possible ways in which the company may operate have been put forward by the legal department, and the Tax Director of Masala has asked you to prepare a memorandum explaining the tax consequences of the four options:
(a) Selling through an office of Masala with its own local sales team in Basabi.

(b) Establishing a local subsidiary in Basabi, which will purchase goods from its foreign parent and will thus take fully responsibility for selling the goods to customers in Basabi (a buy-sell arrangement). Masala will need to send its Quality Director to Basabi on a regular basis to ensure that the subsidiary complies with its obligations under contracts concluded with Masala. The Quality Director will use the local subsidiary's premises.

(c) Setting up a commissionnaire arrangement, under which a vendor will sell products in Basabi in its own name but for the account of (and at the risk of) Masala. Masala will remain the owner of these products prior to their sale. The domestic laws of Basabi provide that contracts concluded by an agency under commissionnaire arrangements are not legally binding on a principal.

(d) Selling Masala's products through several independent agents in Basabi.

You may assume that the double taxation agreement (DTA) between Balimi and Basabi is identical to the OECD Model Tax Convention on Income and on Capital (OECD MTC).

Required:

Write a memorandum, explaining the tax consequences of the suggested modes of operation in Basabi.

Question 3

Powerco, Inc. is a resident of State A. It is engaged in the manufacture and sale of power generating equipment. Powerco is considering whether to start trading in State B. The tax rates in State B are much higher than in State A, and Powerco is concerned about exposing itself to these higher taxes.

The Board of Powerco is considering a number of different ways in which Powerco might operate in State B, namely:

(a) establishing a subsidiary in State B which would manufacture under a licence from State A;
(b) setting up its own factory in State B and selling through its own local sales team;
(c) increasing production in State A, exporting products to State B and only selling through a sales team in State B, which would keep a store of products in a warehouse; and
(d) Increasing production in State A and selling through independent agents in State B.

Whichever model of operation in State B is adopted, Powerco will need to send some of its technicians to State B from time to time, to visit customers and make adjustments and repairs to the power generating turbines supplied to customers. These technicians will stay in hotels and will carry out their work on the customers' premises.

The Double Taxation Agreement (DTA) between State A and State B is identical to the OECD Model.

Required: Write a memorandum, advising Powerco's board on the consequences of the four suggested modes of operation in State B.

Question 4

(a) The following information relates to financial statements of BAMBUCHA (T) LTD a domestic permanent establishment of BAMBUCHA Group Ltd with its Head Quarter in Accra, Ghana.

DETAILS	2015 TZS '000'	2016 TZS '000'
EQUITY AND LIABILITIES		
Ordinary Shares of TZS.200 each	10,000	12,000
Share premium	2,000	3,000
Retained Earnings	4,000	6,000
5% Loan interest	15,000	15,000
Accruals	1,000	2,000
Bank balance	3,000	5,000

Total Equity and Liabilities	35,000	43,000
ASSETS		
TWDV of Depreciable assets	18,000	20,000
Stock	3,000	5,000
Debtors	5,000	6,000
Cash	2,000	3,000
Investment assets	7,000	9,000
Total Assets	**35,000**	**43,000**

Required:

(i) Briefly explain what is meant by 'Repatriated Income'.
(ii) Calculate repatriated income for the year 2016 and tax payable on the repatriated income.

Question 5

Zambia Construction (Tanzania) Limited is a Tanzanian branch of a Zambian incorporated company. The following are the results of its operations for the year ended 31st December 2015:

	TZS '000'	TZS '000'
Turnover		4,910,000
Cost of sales		(2,062,200)
Gross profit		**2,847,800**
Add: Interest received		16,000
Rent received		2,400
		2,866,200
Less: Expenses:		
Depreciation	1,056,000	
Charitable contribution	50,000	
Repair and maintenance	17,500	

Rent	242,000	
Selling expenses	24,000	
Transportation expenses	44,000	
Miscellaneous expenses	150,000	
Interest (Loan from Head Office)	8,000	
Unrelieved loss	8,000	
Salaries and wages	368,000	
Administrative overheads	810,000	
		2,777,500
Profit before tax		88,700 =======

Rent receivable is with respect to a machine leased to the head office. Administrative overheads include the following:

	TZS '000'
Withholding taxes on management fees	1,350
Management fees paid to Head Office	9,000
Employees' benefits	1,480
Directors' fees	1,600
Travel expenses (Head Office directors)	1,300

The following are the details in connection with the non-current assets of the company:

Tax Written Down Value (TWDV) at 1st January 2015

	TZS '000'
Class 1	10,000
Class 2	90,000
Class 6	70,000

During the year, the company bought a new plant for TZS.25 million and two Toyota Prado cars at TZS.80 million each. The plant was fixed in the assembling premises immediately. Class 6 previous years depreciation allowances stand at TZS.40 million.

Other assets were as follows:

	31st December 2014	31st December 2015
Receivables	55,000,000	60,000,000
Cash in hand	45,000,000	55,000,000
Bank	25,000,000	35,000,000

Net incomings for liabilities as at 1st January 2015 was TZS.15,000,000 and accumulated profit account had a credit balance of TZS.339,000,000. It was further informed that during the year the branch had received a total of US$ 20,000 from its head office, half of it being an additional capital and the remaining amount being a working capital loans repayable in ten years.

Assume that the exchange rate is TZS.2,000/US and net incoming for liabilities as at 31st December 2015 was TZS.10,000,000. Ignore withholding taxes.

Required:

Calculate the repatriated income, if any, by Zambia Construction (Tanzania) Limited for the year of income 2015.

Answers to Self-Examination Questions

Answer to SEQ 1

(i) Sales through independent agents in Nyanza Land

If Shika trades through an independent agent, no PE is created and none of Shika plc's profits are taxable in Nyanza Land: However, care should be taken to ensure the agent is independent both legally and economically. This is a question of fact, the principal criteria being:

- the number of other parties represented by the agent;
- the amount of time spent on Shika plc's business; and
- whether the agent bears the economic risks and rewards of working on behalf of Shika plc

Care should also be taken to ensure the agent is acting in the ordinary course of its business in relation to the sale carried out on behalf of Shika plc. This calls for an examination of the other businesses being represented by the agent. For example, if all the agent's other customers were 'non-tech sector', the agent would not be acting in the ordinary course of its business representing a manufacturer of cryptographic hardware/software.

As long as the agent is genuinely independent in relation to the above, Shika plc would not be taxable on sales made through the agent in Nyanza Land and could deduct the sales commission from its profits in Bongo land. Where the agent fails the independence test, the agent would be regarded as dependent in relation to the sales for Shika plc. Shika plc would thus have a dependent agent PE in Nyanza Land and be taxable there in the same way as if it had set up its own sales team.

(ii) ***Export to Nyanza Land, selling through local sales team and warehouse***

The warehouse will not in itself constitute a PE, thus creating a taxable presence in Nyanza Land. It is "a store of goods" specifically exempted under the examples of preparatory or auxiliary activities. However, the sales team would have premises and be contracting in the name of Shika plc as economically dependent agents. This would constitute a PE. The profits on sales in Nyanza Land will be taxable there, hypothesising the sales team as a distinct and separate entity. This would produce lower taxable profits in Nyanza Land than if both manufacture and sales were conducted there.

(iii) ***Own factory and sales team in Nyanza Land***

Shika plc would have a PE. The factory would constitute a fixed place of business of Shika plc in Nyanza Land and the sales team would constitute dependent agents . Neither manufacture nor sales are preparatory or auxiliary activities. The profits generated by the factory and sales team would thus be taxable in Nyanza Land under, for example, the 'Authorised OECD Approach', by hypothesing the factory and sales team as a distinct and separate entity.

This model of operation is therefore not a great strategy from a tax perspective. There is no scope for a licence fee between the head office in Bongo land and branch in Nyanza Land, as they are legally a single entity. Therefore, there is no opportunity to mitigate the tax payable in Nyanza Land to take account of the intellectual property already generated by Shika plc prior to establishing its business in Nyanza Land.

(iv) ***Establish a subsidiary and manufacture under licence***

Shika plc is not taxable on its business profits in Nyanza Land unless it has a PE there. A subsidiary would constitute a separate legal entity. Thus, the subsidiary would be taxable on its profits only in Nyanza Land; and Shika plc would remain taxable only in Bongo land. Care is required to ensure the subsidiary does not become a PE of Shika plc. A subsidiary could constitute a fixed place of business for Shika. If the subsidiary regularly makes premises available for Shika plc's visiting staff, it could constitute a fixed place of business of Shika plc even though no formal legal right exists on the part of Shika plc. Care is also required to prevent the subsidiary constituting a dependent agent of Shika plc. A dependent agent can be a company. This is unlikely though as presumably the subsidiary will not sell Shika plc's hardware or software, as it will be selling its own, which it manufactures/sells under licence. Sales by the subsidiary of its own products manufactured/sold under licence would not be sales on behalf of Shika plc because of the legal separation of parent and subsidiary. But if ever the subsidiary acted as a sales outlet for hardware produced by Shika plc in Bongo land, this would make the subsidiary an

agency PE of Shika plc; merely soliciting and receiving orders without finalising them would be sufficient.

Answer to SEQ 2

The suggested modes of operation may trigger risks of permanent establishment (PE) in Basabi, as explicitly detailed below

a) Selling through an office of Masala with its local sales team in Basabi

A permanent establishment as per article 5 of the model OECD treaty is a permanent place of business through which the business of the enterprise is wholly or partly carried out. The terms makes reference to 3 conditions

- existence of a place of business which must be at the disposal of the enterprise
- the place must be fixed, this entailing a permanence in its nature
- business must be carried through it which usually means that persons who in one way or another are dependent on the enterprise (personnel) conduct the business of the enteprise in the state in which the fixed place is situated.

Since Masala has a fixed office at its disposal (fixed place of business) and it sells through its own sales team (business carried through it) a physical PE arises in this respect in Basabi.

As per provisions of article 7.1 profits attributable to this PE will be therefore taxable in Basabi. Article 7.2 of the treaty also mentions that profits shall be attributed by carrying out an analysis of the functions, risks and assets of the permanent establishment, as it were a separate and distinct entity.

b) Establishing a local Subsidiary

Article 5(7) of the Model OECD treaty states that the existence of a subsidiary does not of its self (i.e. by virtue of control) constitute that subsidiary a permanent establishment of the parent company.

However, a parent company, may be found under the rules of articles 5(1) - 5(5) to have a permanent establishment in a state where its subsidiary has a place of business. Two risks arise in this respect

(i) the parent has premised belonging to the subsidiary at its disposal which may give rise to a physical PE

(j) the subsidiary habitually exercises, in Basabi, an authority to conclude contracts in the name of the parent.

In this scenario, the Director of Masala will visit the subsidiary, use its premises on a regular basis and therefore it is likely that a physical PE will arise in Basabi.

c) Setting up a commissionaire arrangements

The issue to consider here is whether a dependent agency relationship exists with the vendor and whether an agency PE arises in Basabi as per article 5(5) of the model OECD treaty .

For an agency PE to arises, the person should have the authority to conclude contracts. Commentary to article 5(5) specifically states that the phrase "authority to conclude contracts" in the name of the enterprise does not confine the application to agents who enter contracts literally in the name of the enterprise. The paragraph applied equally to an agent who concludes contracts that are equally binding on the enterprise even if those contracts are not actually in the name of the enterprise. Also, lack of active involvement by an enterprise may also be indicative of grant of authority. e.g. an agent may be considered to possess actual authority where he solicits and received (but does not formally finalize) orders

In this case, although the vendor does not conclude contracts on the enterprise, this is not a requirement as per above comments, as he is still involved for and behalf of Masala and assumed the risk of Masala. However, the fact that domestic law of Boronia does not consider the contract binding on the name of Masala, the risk of agency PE in this respect may be mitigated.

d) Independent Agents in Basabi

As per article 5(6) of the model OECD treaty where an enterprise carried on business through a broker, general commission agent, of an independent status, no PE arises and it cannot be taxed in the other state.

However care should be given here because the exemption applies only if the person

(i) is independent of the enterprise both legally and economically
(ii) he acts in the ordinary course of the business when acting on behalf of the enterprise

Determing independence requires examination of whether the person's activities are subject to details instructions or comprehensive control by the enterprise.

Assuming therefore that the agents are truly independent no PE will arise in Boronia and no tax will be due all together.

Answer to SEQ 3

Consequences of the four suggested modes of operation

(i) Establish a subsidiary and manufacture under licence

Powerco is not taxable on its business profits in State B unless it has a PE in that state.

Does the subsidiary constitute a PE? Not in itself. It is a legally separate entity and as such distinguished from a branch. Article 5(7) OECD Model makes this clear. Hence prima facie the subsidiary is separately taxable in State B on its profits and Powerco remains taxable only in State A. However, great care is required to ensure the subsidiary does not become a PE of Powerco. There are two risks:

- The subsidiary has a fixed place of business for Powerco. Does the subsidiary regularly make premises available for visiting staff of Powerco? If so, the subsidiary could constitute a fixed place of business of Powerco even though no formal legal right existed on the part of Powerco). Simply seconding staff for a significant time to monitor the activity of the newly formed subsidiary could constitute the subsidiary a PE of Powerco).
- Does the subsidiary constitute a dependent agent of Powerco under Article 5(5)? Such a dependent agent can be an individual or a company. Does the subsidiary have and regularly exercise the authority to contract on behalf of Powerco? (Article 5(5)). The contracts must relate to the core business of Powerco and not simply a preparatory or auxiliary activity. Hence engaging staff on behalf of Powerco would not constitute it a PE of Powerco . Hence subject to care being taken not to have a PE in State B and State B recognizing the licence fee as a correct arm's length price, the contract manufacturing and licence operation can be effective to reduce tax in State B. The licence fee would reduce profits of the subsidiary and render the fee taxable at the lower rate in State A.

(ii) Own factory and sales team in State B

Here there is no question that Powerco has a permanent establishment under both Articles 5(1) and 5(5). The factory constitutes a fixed place of business of Powerco in State B. The sales team will constitute dependent agents under Article 5(5). Neither manufacture or sales are preparatory or auxiliary activities under Article 5(4). The profits generated by the factory and sales team will

thus be taxable in State B under the 'Authorised OECD Approach' by hypothesing the factory and sales team as a distinct and separate entity. This approach is therefore likely to produce to a higher tax liability. There is no scope for a licence fee between head office in State A and branch in State B, as they are legally a single entity. Therefore no opportunity to mitigate tax in State B to take account of the intellectual property already generated by Powerco prior to establishing its business in State B.

(iii) Export to State B, selling through local sales team and warehouse

The warehouse will not in itself constitute a permanent establishment producing a taxable presence in State B. It is "a store of goods" specifically exempted under the examples of preparatory or auxiliary activities in Article 5(4). However the sales team will have premises and be contracting in the name of Powerco as economically dependent agents. This will therefore constitute a PE under both Articles 5(1) and 5(5). Once again, the profits on sales in State B will be taxable there, this time hypothesizing the sales team as a distinct and separate entity. This will necessarily produce lower taxable profits in State B than if both manufacture and sales are conducted in State B.

(iv) Sales through independent agents in State B

In principle, where Powerco is dealing through an independent agent, no permanent establishment is created and no profits of Powerco are taxable in State B (Articles 7(1) and 5(6)). However, there are two risks in relation to the independent agent:

- Is the agent independent both legally and economically? This is a question of fact, principal criteria being the number of other parties represented by the agent; the amount of time spent on the business of Powerco; and whether the agent bears the economic risks and rewards of working on behalf of Powerco (Commentary Article 5(6), paragraph 38.6)
- Is the agent acting in the ordinary course of his business in relation to the sale carried out on behalf of Powerco?

This calls for an examination of the other businesses being represented by the agent. For example, if all the agent's other customers were wine manufacturers, he would not be acting in the ordinary course of his business in representing a manufacturer of power plants.

So long as the agent is genuinely independent in relation to the above tests, Powerco would not be taxable on sales made through the agent in State B and could deduct the sales commission from its profits in State A. Where the agent fails the test of independence on either above criterion, the agent would still be regarded as dependent in relation to the sales for Powerco. Powerco would thus have a dependent agent PE in State B and be taxable there in the same way as if it had set up its own sales team.

Answer to SEQ 4

(i) ***The term 'repatriated** income' **is not define under the Income Tax Act** but*

according to the provisions of section 72 subsection (2), the repatriated income of a domestic permanent establishment of a non-resident person for a year of income shall be calculated according to the following formula;

(A + B - C)

Where:

A is the net cost of assets of the permanent establishment at the start of the year of income plus the market value of capital contributed to the permanent establishment by the owner during the year.

B is net total income of the permanent establishment for the year of income; and

C is the net cost of assets of the permanent establishment at the end of the year of income plus, where the establishment has no total income for the year of income, any unrelieved loss for the year of income.

(ii) Net of Assets at start = 35,000,000 –19,000,000= 16,000,000

Market value of capital introduced in the year = 15,000,000-12,000,000 = 3,000,000

Then, A = 16,000,000 + 3,000,000= 19,000,000

B = 6,000,000 – 4,000,000= 2,000,000

C = 43,000,000 – 21,000,000= 21,000,000

Therefore,

Repatriated income = A + B – C = 19,000,000 + 2,000,000 – 21,000,000 = 0

Since the result is zero the company has no income liable for tax

Answer to SEQ 5

Taxpayer: Zambia Construction (Tanzania) Limited		
YOI: 2015		
Residential Status: Resident corporation		
Source of Income: Business		
Profit before tax		88,700,000
Add: Disallowed expenditure:		
Depreciation	1,056,000,000	
Interest	8,000,000	
Unrelieved loss	8,000,000	
Charitable contributions	50,000,000	
Withholding taxes	1,350,000	

Management fees	9,000,000	
Travel expenses	1,300,000	1,133,650,000
Less: allowable Expenditure		
Depreciation(Note 1)		60,500,000
Less: disallowed income		
Rent Receivable		2,400,000
Business chargeable income before charity		1,159,450,000
Less: Charitable contributions		23,189,000
Total Income		**1,136,261,000**

Calculation of Repatriated income

Repatriated Income	
	TZS
Additional Capital	20,000,000
Opening cost of Assets (Note 2)	295,000,000
Net Income for Liabilities	15,000,000
A	300,000,000
Total income	1,136,261,000
Tax payable on Total Income	340,878,300
B	795,394,800
Closing cost of assets	289,500,000
Net incomings for liabilities	10,000,000
C	279,500,000

Repatriated income (A + B – C)	815,894,800

Repatriated of income if TZS.815,894,800 as it does not exceed the balance in the accumulated profit in account below:

Accumulated Profit Account			
RI	815,894,800	Balance b/f	339,000,000
Balance c/f	318,500,000	Net total income	795,394,800
	1,134,394,800		1,134,394,800

Note 1

Depreciation allowance schedule

	Class 1	**Class 2**	**Class 6**	**Total**
	37.5%	25.0%	5.0%	
TWDV – opening	10,000,000	90,000,000	70,000,000	170,000,000
Additions				
2 Toyota Prado	60,000,000**			
	70,000,000	90,000,000	70,000,000	
Depreciation allowance:				
Annual Allowance	26,250,000	22,500,000	5,500,000*	54,250,000
TWDV – closing	25,000,000	50,000,000	64,500,000	139,500,000

* Depreciation allowance =5 %× (70m+40m)

**The cost of each car is restricted to TZS 30m

Then

Total depreciation allowance is TZS 54,250,000+(50%×25,000,000×1/2)- 1st portion of initial allowance

= Tshs 60,500,000

Note 2: Calculation of cost of assets

	31st December 2014	31st December 2015
	TZS	**TZS**
Receivables	35,000,000	60,000,000
Cash in Hand	45,000,000	55,000,000
Bank	25,000,000	35,000,000
TWDV	170,000,000	139,500,000
	295,000,000	289,500,000

STUDY GUIDE C2: TAXATION OF CONTROLLED FOREIGN CORPORATIONS AND TRUSTS

Get Through Intro

In order to counter the use of tax havens/low tax centers, a number of countries have introduced CFCs provisions which attribute current income or profits earned by a foreign corporation or trust to a domestic taxpayer. This guide discusses the meaning of the controlled foreign trusts and corporations and the rationale behind the taxation of controlled foreign trusts and corporations. Furthermore the guide explains the taxation principles of members of controlled foreign trusts and corporations in Tanzania.

Learning Outcomes

a) Discuss the meaning and rationale behind taxation rules for controlled foreign trusts and corporations

b) Describe the principles of taxation of controlled foreign trusts and corporations and its members

Discuss the meaning and rationale behind taxation rules for controlled foreign trusts and corporations [Learning outcome a]

1. Meaning And Rationale Behind Taxation Rules For Controlled Foreign Corporations And Trusts

1.1 Meaning of Controlled Foreign Corporations and Trusts

According to Section (3) of the INCOME TAX ACT CAP 332 a controlled foreign trust or corporation means a non resident trust or corporation in which a resident person owns a membership interest, whether directly or indirectly through one or more interposed non-resident entities and where (a) the person is associated with the trust or corporation; or (b) there exist between one and four other resident persons which, if associated with the person, would cause the person to be associated with the trust or corporation. Associate can be classified as controlled foreign corporation if resident entity controls 50% or more of right to income or capital contributed or voting power. Direct or indirect control means ability of influencing affairs example voting power where resident entity can influence the controlled foreign corporation not to declare dividend so that fund can be used for other purpose. Each country has its own Controlled foreign corporation and Trusts laws, but most are similar in that they tend to target individuals over multinational corporations when it comes to how they are taxed.

1.2 Rationale behind taxation rules for Controlled Foreign Corporations and Trusts(CFCs rules)

Controlled foreign corporation or trusts regimes are used in many countries as a means to prevent erosion of the domestic tax base and to discourage residents from shifting income to jurisdictions that do not impose tax or that impose tax at low rates. While the rules applicable to CFCs and the attributes of a CFC differ from country to country, the hallmark of CFC regimes in general is that they eliminate the deferral of income earned by a CFC and tax residents currently on their proportionate share of a CFC's income. Typical conditions for the application of such regimes are that a domestic taxpayer "control" the CFC; that the CFC be located in a "low tax" jurisdiction or a jurisdiction that imposes a tax rate lower than the rate (as specifically defined) in the shareholder's country, or, alternatively that the CFC be located in a "black" or "grey" list jurisdiction (as opposed to a favored "white" list jurisdiction);and that the CFC derive specific types of income (e.g. passive income in some regimes, but all types of income in others).

Definitions

(a) **Corporation"** means any company or body corporate established, incorporated or registered under any law in force in the United Republic or elsewhere, an unincorporated association or other body of persons, a government, a political subdivision of a government, a public authority, public institution, a public international organisation and a unit trust but does not include partnership.

(b) **Trust"** means an arrangement under which a trustee holds assets but excludes a partnership and a corporation;

(c) **Trustee"** means an individual or body corporate holding assets in a fiduciary capacity for the benefit of identifiable persons or for some object permitted by law and whether or not the assets are held alone or jointly with other persons or the individual or body corporate

is appointed or constituted trustee by personal acts, by will, by order or declaration of a court or by other operation of the law; and includes –

(i) any executor, administrator, tutor or curator;
(ii) any liquidator, receiver, trustee in bankruptcy or judicial manager;
(iii) any person having the administration or control of assets subject to a usufruct, *fideicommissum* or other limited interest;
(iv) any person who manages the assets of an incapacitated individual; and
(v) any person who manages assets under a private foundation or other similar arrangements;

Describe the principles of taxation of controlled foreign trusts and corporations and its members
[Learning outcome b]

2. Principles Of Taxation Of Controlled Foreign Trusts And Corporations And Its Members

2.1 Taxation of trusts

Section 52(1) provides that a trust or unit trust shall be liable to tax separately from its beneficiaries and separate calculations of total income shall be made for separate trusts regardless of whether they have the same trustee. Section 52(6) provides that arrangements between a trust and its trustees or beneficiaries are recognized as transactions between distinct persons.

2.2 Taxation of corporations

A corporation shall be liable to tax separately from its shareholders. Furthermore, amounts derived and expenditure incurred jointly or in common by the managers or shareholders for the purposes of a corporation that lacks legal capacity, shall be treated as derived or incurred by the corporation and not any other person. Moreover, assets owned and liabilities owed jointly or in common by the managers or shareholders for the purposes of a corporation that lacks legal capacity shall be treated as owned or owed by the corporation and not any other person.

2.3 Taxation of members of a controlled foreign trust or corporation.

It is the **share** of the **member's unallocated income** of a controlled foreign trust or corporation for a year of income which is taxable. That share of the unallocated income of the **controlled foreign trust or corporation** is then included in the income of the member. The unallocated income is treated as part of total income of the member and retains its character.

2.3.1 Calculations of unallocated income

The unallocated income of a controlled foreign corporation for a year of income is -

(a) The attributable income of the trust or corporation for the year of income;
Less:-
(b) Any distributions made by the trust or corporation during the year of income to the taxpayer.

Section 73(2) the "attributable income" of a controlled foreign trusts or corporation for a year of income shall be its total income for the year of income calculated as if the trust or corporation were resident.

Self-Examination Questions

Question 1
Briefly explain the rationale for taxing controlled foreign corporations.

Question 2
Munira Ltd (a resident) holds 60% shares in a in subsidiary company named ZZ(B) Company Ltd. ZZ(B) carries on business in Zambia .During the year of income 2015,ZZ(B) Company Ltd financial statements showed the following transaction.

(i) Gross Business Income Tshs 3,600,000,000
(ii) Business Expenses Tshs 1,700,000,000
(iii) Rental from lease of a building Tshs 360,000,000
(iv) Dividends distribution of 15% of after tax profits during the year
(v) Corparate tax rate in Uganda is 25%

Addition information

- Dividends in Zambia are subject to a 5%withholding tax on gross dividends.
- Domestic income of Munira Ltd during year 2015 is Tshs2,000,000,000
- Investment income is assessed separately in Zambia.

Answers to Self-Examination Questions

Answer to SEQ 1
The rationale for taxing controlled foreign corporations is to ensure that subsidiaries most of foreign corporations are not accomplishing foreign tax avoidance through non-payment of dividend to their parent companies. So the most objective of this tax is to increase tax revenues through prevention of tax avoidance.

Answer to SEQ 2

1. Calculate actual dividend paid to Munira Ltd

Total Income (3,600m-1,700m)+360m	2,260,000,000
Corporate tax (Zambia) at 25%	(565,000,000)
Income net of Tax	1,695,000,000
Dividend paid at 15% of net income	**254,250,000**

2. Calculate deemed dividend

Total Income	2,260,000,000
Less: Actual distribution	(254,250,000)

Un-alloacated income	**2,005,750,000**
% of shareholding	**60%**
Deemed dividend	**1,203,450,000**

3. Total taxable income

Total Income		
Domestic income		2,000,000,000
Foreign Income	Actual dividend (60%*254,250,000)	152,550,000
	Deemed dividend	1,203,450,000
		3,356,000,000

4. Calculate total tax liablity and net tax liability

(i) **Total tax liability**

Total income	3,356,000,000
Tax rate	30%
Tax liability	1,006,800,000

(ii) Net tax liability

Total tax liability	1,006,800,000
Less: Foreign tax relief under section 77-	
• Corporate tax -60%*565,000,000or 25%*1,356,000,000	(339,000,000)
• Withholding tax -5%*254,250,000*60%	(7,627,500)
	660,172,500

SECTION C

INTERNATIONAL TAXATION

C3

STUDY GUIDE C3: INTERNATIONAL DOUBLE TAXATION OF INCOME

Get Through Intro

Many countries tax their taxpayers (citizens and non-citizens) in their territories when the taxpayers' income originates from within the countries. Also, even when income is earned in foreign countries, many countries tax foreign income on residence basis. This in turn can cause double taxation.

With a view to encourage trade and development, double taxation treaties are entered into by various nations. They are largely designed to reduce the impact of international double taxation.

This Study Guide discusses the problem of double taxation, the nature of double taxation treaties as well as the functions of double taxation treaties. The guide also discuses in details the methods for eliminating double taxation and Model Tax Conventions

Knowledge of this Study Guide will help you in your career as a tax consultant as well as in your role in the tax department of a corporate.

Learning Outcomes

a) Explain the meaning and effects of international double taxation of income and forms of double taxation of income (juridical vs economic)
b) Explain causes of juridical double taxation of income,
c) Explain the approaches for double taxation relief and the nature and purpose of bilateral double taxation treaties
d) Explain main Model Tax Conventions on Double Tax Agreement
e) Explain the general approach to interpretation of a DTA
f) Outline the standard chapters and articles of a model DTA
g) Explain the Stages in the life of a double tax treaty and procedures for incorporation of the treaty into domestic law
h) Explain the relationship between tax treaties to domestic law and discuss the concept of treaty overrides
i) Explain limitations on the use of double tax treaties by tax authorities
j) Describe methods of eliminating Double Taxation (deduction method, exemption method, credit method)

Explain the meaning and effects of international double taxation of income and forms of double taxation of income; explain causes of juridical double taxation of income, and Explain the approaches for double taxation relief and the nature and purpose of bilateral double taxation treaties [Learning outcome a, b, and c]

1. Meaning of international double taxation of income and forms of double taxation of income (juridical vs economic)

International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods & services and movements of capital, technology and persons, are so well known that it is hardly needed to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries. Elimination of double taxation thus becomes essential for international trade to flourish. Though tax structures does not drive business decisions, it definitely poses significant influence over investment decisions in any jurisdiction.

Economic double taxation happens when the same transaction, item of income or capital is taxed in two or more states but in hands of different assesses (because of lack of subject identity). Eg. When one state attributes an income/capital to its legal owner whereas the tax law of other state attributes it in the hands of the person in possession or having economic control over the income. Yet another classic example is tax on distributed surplus by a company which is taxed in the hands of the company distributing such surplus, while the other jurisdiction taxes the said income from distribution in the hands of the shareholder.

2. Causes of juridical double taxation of income.

International Juridical double taxation mainly arises because of various states, in addition to levying taxes on income sourced in its jurisdiction *(source rule),* also seek to levy tax on incomes / capital arising from transaction carried in other countries by its resident taxpayers (*residence rule*). Eg.: If an US entity lends money to Tanzanian Company, then interest income earned by the US entity will be chargeable to tax in Tanzania since income is sourced in Tanzania. Similarly the US entity, would be subject to tax on its world-wide income in the US based on it being resident of USA. This gives rise to double taxation. Specifically double taxation arises on the following circumstances

i) Resident-resident conflict: Two states may tax a person (individual or company) on his world-wide income or capital because they have inconsistent definitions for determining residence.

ii) Source-resident conflict: One state may tax income derived by a person by application of the residence or nationality principle, where as another state may tax that same income by application of the source principle.

iii) Source-source conflict: Two states may invoke the source principle to tax the same item of income, due to conflict in the way the source of income is determined under their domestic legislation.

- When a person is considered as Resident in two or more states simultaneously, double taxation of same income may arise. E.g. In cases where one person is deemed to be resident by virtue of POEM situated in Country X, while naturally he is also resident in Country Y.
- When source rules overlap, double taxation may arise. i.e. where two or more countries as per their domestic laws conclude that in respect of the same transaction, income arises or is deemed to arise in both their respective jurisdictions.

3. Approaches For Double Taxation Relief And The Nature And Purpose Of Bilateral Double Taxation Treaties

International double taxation may be eliminated either by concession by one state that **is unilaterally** (on the basis of domestic law), **or bilaterally** (on the basis of tax treaties) in several ways:

Double taxation treaties are international contracts among nations or states. The contracts have four main characteristics:

First, they allow contracting parties to use their domestic tax laws but the contract may restrict the application of the domestic tax laws in agreed areas. For instance, restrictions of domestic tax laws may include exemption of income or provision of foreign tax credit for tax paid in contracting countries.

Second, **the contracts allocate tax claims among contracting parties** to escape international double taxation. For example, the contracting parties may agree to tax their taxpayers based on sources of income, rather on both sources and residence status.

Third, the **contracts normally do not expand contracting nationals' right to tax nor invent new taxing rights**. Finally, the contracts do not divide tax jurisdictions among contracting parties but the parties remain with their tax jurisdictions; yet **the contracts signify agreements among contracting parties over their mutual (reciprocals) restrictions of tax jurisdictions either through exemption, tax credit or both exemption and tax credit**.

Double taxation treaties have five main functions.

(i) They **reduce or eliminate international double taxation impact on taxpayers with foreign income**. This function can be achieved through either exemption of foreign income, provision of foreign tax credit or both exemption of foreign income and provision of foreign tax credit.

(ii) Second, double taxation treaties **enable investors to know the income earned in a foreign country**, and in fact it facilitates or encourages foreign trade, labour or international capital flows by eliminating or reducing foreign tax burden.

(iii) Third, double taxation treaties **help in avoiding unfair tax liabilities in foreign countries**, and discrimination against foreign investments.

(iv) Fourth, double taxation treaties **may help to prevent tax avoidance or evasion** as, in main cases, the double taxation treaties may include provisions for the exchange of information among contracting countries. This information may help tax authorities during tax audits to verify taxpayers' foreign income and taxes. Also, the provisions for the exchange of information among contracting countries are important in enforcing domestic tax laws as tax laws based on residential status of taxpayers may include income earned in foreign countries. In this case, exchange or request of information from foreign countries is paramount in ensuring that foreign income is taxed accordingly.

(v) Finally, double taxation treaties **defend countries' right to tax economic transactions or income earned in their tax jurisdictions** or by resident taxpayers in foreign countries through contracts.

Explain main Model Tax Conventions on Double Tax Agreement; explain the general approach to interpretation of a DTA; cutline the standard chapters and articles of a model DTA; and explain the Stages in the life of a double tax treaty and procedures for incorporation of the treaty into domestic law

[Learning outcome d, e, f and g]

4. Main Models of Tax Conventions on Double Tax Avoidance

Model Conventions are the agreements that serve as a template and starting point in tax treaty negotiations. They do serves as a guideline for establishing tax agreements. They are used in negotiations and drafting of DTTs between countries.

There are three generally used Models of the DTAA:

(i) OECD Model Tax Convention

The OECD Model Tax Convention is the basis on which all tax treaties are negotiated and implemented by the OECD countries. It is a model agreement to which an accompanying Commentary is provided as an aid to interpretation. The draft Model DTAA was first published by the OECD in 1963 and is updated periodically. The OECD model is generally regarded as favouring the developed countries, as it gives priority of taxation to the residence state over that of the state of source. OECD Model is the base on which other Models are built. It has also been used as a Model for negotiating Treaties between OECD Members and non-member countries. A major advantage of using the OECD Model is the existence of the well-established and well-respected Commentary. This provides a valuable tool of interpretation which has widespread international acceptance amongst states which are not OECD members.

(ii) UN Model Double Taxation Convention

Since the OECD Model was regarded as furthering the interests of the developed countries, the developing countries prepared their own model in 1979, which is known as the 1979 UN Model Tax Convention. This was developed / modified further in 1980, 2001 and 2011 incorporating the changes gained out of the experience. As the OECD model was the source, both the drafts are largely similar and in fact most Tanzanian DTAAs are a mix of both the models.

(iii) US Model Income Tax Convention

US Model serves as a model to negotiate Treaty with the USA. Like UK Model Convention, the US Model Convention is also based on the OECD Model. It adapts to the conditions peculiar to the US. The US Model convention was first published in 1976 and revised in 1977, 1981, 1996, 2006 and recently in 2016. USA has also published a Technical Explanation to explain / clarify the provisions in the Articles of the US Model Convention.

5. Standard Chapters And Articles Of A Model DTA

The standard chapters and articles of a model DTA are as follows:

(i) Chapter I - Scope of the Convention - This Chapter generally specifies whom the convention applies to and the taxes it covers (Article 1 - Persons covered; Article 2 - Taxes covered).

Example

- Article 1 of the UN Model Convention reads as under (this is similar to Article 1 of the OECD Model Convention): "*This Convention shall apply to persons who are residents of one or both of the Contracting States.*"
- Article 2 deals with the taxes which are covered under the DTAA. The UN Model Commentary Clause on Article 2 reads as under (this is similar to **Article 2 of the OECD Model Convention** except for Paragraph 4 which uses the word 'taxation law' in place of 'tax law'): *"1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.*

(ii) Chapter II - It defines the concepts of the DTAA and the terms used (Article 3 – General Definitions; Article 4 - Resident; Article 5 – Permanent Establishment). Terms like `resident' and 'PE' which require detailed explanation are defined in separate Articles

(iii) Chapter III - Taxation of Income - This is the body of the DTAA. This Chapter deals with categorization of the income under various heads and the method of taxation of such income. (Article 6 - Income from Immovable Property; Article 7 - Business Profits; Article 8 – Shipping, Inland waterways transport and Air transport; Article 9 – Associated enterprises; Article 10 - Dividends; Article 11 - Interest; Article 12 - Royalties and Fees for Technical Services (FTS); Article 13 – Capital Gains; Article 14 - Independent Personal Services (absent in OECD); Article 15 - Dependent Personal Services; Article 16 - Directors' Fees and remuneration of top-level managerial officials; Article 17 – Artistes and Sportspersons; Article 18 – Pensions and social security payments; Article 19 - Government Service; Article 20 - Students; Article 21 - Other Income).

Chapter III is also called the Distributive Rules as regards the computation of income, as it specifies how much revenue a State will receive from a particular source of income/activity. That determination is made by using expressions such as "shall be taxed only in" which means only one of the States has a right to tax that income or by using the expression "may be taxed in the State of Source but at a rate not exceeding.." which means that the income can be taxed by the source State at a limited rate

(iv) Chapter IV - Normally deals with Norms for Taxation of Capital [Article 22 – Capital (absent in U.S. Model)].

(v) Chapter V - Contains special provisions to ensure elimination of double taxation (Article 23 - Elimination of Double Taxation). The U.S. Model convention also contains an additional article (Article 22 - Limitation of Benefits) which provides for conditions for claiming the benefits under the DTAA. The relief in respect of double taxation can be given by two ways. One is universal relief i.e. given under domestic law of that country, while bilateral relief is given under DTAA.

(vi) Chapter VI – Contains special provisions dealing with procedural recourse for grievances against unfair application / interpretation of the DTAA [Article 24 - Non Discrimination; Article 25 – Mutual Agreement Procedure; Article 26 - Exchange of Information; Article 27 – Assistance in the collection of taxes; Article 28 – Members of diplomatic missions and consular posts; Article 29 – Territorial Extension (present in OECD)]. The U.S. Model convention covers an additional article (Article 28 – Subsequent changes in law).

(vii) Chapter VII – This provides for the date when the DTAA would come into force and when it would be terminated (Article 29 - Entry into Force; Article 30 - Termination).

(viii) Protocol – Every DTAA would also have a protocol which is a part of the DTAA and explains in detail the provision of the Articles of the DTAA. The Protocol puts in the clarification arrived at by the Contracting States after exchange of letters on issues which need to be ironed out. The Tanzania-USA DTAA also has a long list of illustrations explaining the provisions of the DTAA. Exchange of notes and Protocol which are acted upon by the parties are also recognized in international law as a valid and binding agreement and do not need to be formalized.

Students are advised to read in details articles of the OECD and UN model DTA.

6. General Approach To Interpretation Of A DTA

DTAAs not being different from other international agreements are to be interpreted using the same principles accepted in the International law. Therefore, the principles set out in the Vienna Convention on the Law of Treaties will be applicable in interpreting the DTAAs in the case of conflict. The Vienna Convention on the Law of Treaties provides guidelines to the countries in legal interpretation of the treaties which are parties to this Convention. Even though India is not a party to the Vienna Convention, nonetheless, one may rely on this convention for the purpose of interpretation in case of ambiguity. The Delhi bench of Tribunal in the case of *British Airways Plc. (2002)(80 ITD 90)(Del. Trib.)* has taken recourse to the Vienna Convention for the purpose of interpretation of double taxation treaties.

The General Rule of interpretation as provided in Article 31 of the Vienna Convention are as follows:

- A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
- The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
  - (a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
  - (b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
- There shall be taken into account, together with the context:
  - (a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
  - (b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
  - (c) Any relevant rules of international law applicable in the relations between the parties.

- A special meaning shall be given to a term if it is established that the parties so intended. The U.S. Court in the case of *Scotland West Life Insurance Co. Canada v. CIR (1996) (107 TC US 363)* has cited the following principles of precedence for the guidelines in interpretation of the DTAAs:

(i) The meaning should be consistent with genuine shared expectation of the contracting parties;

(ii) It should give effect to the purpose of the treaty. Where interpretations, both restricted and liberal are possible, the liberal interpretation should be preferred;

(iii) Words should be understood in its ordinary meaning unless it is specifically given a special or restricted meaning. As far as possible, the language in the law and the DTAA should be both effective;

(iv) Ambiguities could be resolved by making reference to the materials used during the process of negotiations, which can be given due weight age, though, it may not be conclusive.

7. Stages in the life of a double tax treaty and procedures for incorporation of the treaty into domestic law

7.1 Stages in the life of a double tax treaty

It may take many years from the start of negotiations between two states to the date when a tax treaty into which they enter starts to be used. Sometimes treaties progress to the final stages but are never brought into use, perhaps because in the time it has taken to negotiate the treaty, the domestic tax laws of the two states have changed significantly and the states are forced to 'go back to the drawing board'. However, the key stages are as follows.

(i) **Negotiation and Authentication**

The initial negotiation of a DTC tends to be carried out by representatives of the ministries of finance, treasuries and/or revenue authorities of the contracting states (Holmes, 2015). Authentication requires the text of the relevant DTC to be "established as authentic and definitive" (Article 10 VCLT).

(ii) **Date of Signature**

Date when the representatives of each contracting state (CS) sign the treaty. Article 18(a) Vienna Convention on the Law of Treaties (VCLT) attaches some importance to the signature of the treaty in that it requires a CS to refrain from acts that would defeat the object and purpose of the treaty where that CS has signed the treaty (or exchanged instruments constituting the treaty subject to ratification). The date of signature is the date to which a DTC will generally be referred.

The signing of a DTC has been described as expressing:

- an indication that the negotiators of the two CSs are satisfied with the wording of the DTC (Miller and Oats 2016); and
- a commitment to present the treaty for ratification as opposed to a commitment to conclude the treaty. Furthermore, the signature of the treaty does not in and of itself provide taxpayers with any rights arising under the treaty terms .Accordingly, a DTC that has been signed will still need to be ratified.

(iii) **Entry into force**

A treaty will normally enter into force when each of the states has 'ratified' it. This means that the state has adopted the provisions of the treaty into its domestic law. This can be done directly, whereby a state's constitution provides that a treaty will automatically become part of domestic law once it has been approved by the appropriate officials. Alternatively, a new treaty may need specific approval from the government or the monarch. When the appropriate procedures have been completed in each contracting state, the states exchange 'instruments of ratification'. This triggers the 'entry into force' of a treaty, making it legally binding on both states. Frequently one state will pass on to the other state its instrument of ratification well before it receives one back from this other state. Completing the exchange brings the provisions of the treaty into effect for taxpayers, but only in accordance with a formula laid out in the treaty, not immediately. The US operates rather differently: a treaty will become operative as if it were domestic law once it has been approved by the Senate and instruments of ratification exchanged.

(iv) **Effective date**

Arguably, the most important date for taxpayers and administrations (Sassevillle, 2010).

OECD MTC leaves it to CSs to decide what that date will be and some treaties include extensive provisions on this issue. Provisions of a DTC can become effective, before, with or after entry into force of a DTC.

7.2 Incorporation of Treaties Into Domestic Law

Once a treaty is agreed it may need to be incorporated into domestic law, in some states the process is automatic. Countries can be classed into two groups in this respect:

(i) **Direct effect** countries – those where treaties automatically become part of the domestic law – this **monistic** principle means such treaties are enforceable without the need for further legislation.

(ii) **Indirect effect** countries – those where treaties need to be enacted into domestic law and require special legislative steps, in order for them to be enforceable within that jurisdiction. This **dualistic** approach means treaties are “transformed” into domestic law and usually it is the statute and not the treaty which has legal authority.

As a general rule, a treaty supersedes domestic law. However, this will depend on the state in question, and also how the treaty became part of domestic law. In states which apply the monistic approach, where no further legislation is needed, it is often the case that the treaty itself is seen as superior law to other domestic legislation, and therefore it will automatically take priority over such legislation. By contrast, other states, more often those that apply the dualist approach and therefore require further legislation for a treaty to be ‘in force’, may consider that the treaty (as enacted domestically) is no different to any other domestic provision.

Explain the relationship between tax treaties to domestic law and discuss the concept of treaty overrides; explain limitations on the use of double tax treaties by tax authorities; and describe methods of eliminating Double Taxation (deduction method, exemption method, credit method.

[Learning outcome h, i, and j]

8. Relationship Between Tax Treaties To Domestic Law And Discuss The Concept Of Treaty Overrides

Treaties are governed by international law rather than by domestic laws, usually under the Vienna Convention on the Law of Treaties (1980). This Convention lays down rules for matters such as the territorial scope of treaties, general rules of interpretation, breaching of treaties and for dealing with a fundamental change in the circumstances of one of the states.

The general rule is that the provisions contained within treaties override those of domestic tax law. Where domestic law overrules treaty provisions this is known as 'treaty override' and is a controversial area. It may be intentional, which if it takes the form of newly enacted domestic law is frowned upon, or unintentional, such as a domestic court decision which fails to use the treaty definitions or departs in some other way from the Vienna Convention rules for interpretation of treaties. This may be by mistake, through ignorance or deliberate if there is too much tax revenue at stake.

It should be noted that some states specifically provide that subsequent changes in domestic law will, if they contradict the treaty, override the treaty. This is clearly unsatisfactory from the point of view of that

state's treaty partners. The central tenet of the Vienna Convention is that treaties are concluded 'in good faith' and there is a presumption that a state will not want to override its treaties.

How easily treaty provisions can be overridden by domestic law is a function of the way that a state's constitution incorporates treaties into its lexis. Generally, if, as in the UK, a parliamentary statute is required to give effect to a treaty then subsequent domestic law may override the treaty.

If a state does override the provisions of one or more of its treaties, then it is open to the treaty partner(s) to terminate the treaty. However, this is rather extreme and the Vienna Convention only allows this where the override relates to a provision so material that it is unlikely that the other state would have entered into the treaty if the override had been anticipated. It is more likely that the 'mutual agreement' provisions will be used or that there will be a corresponding override by the other state.

9. Limitations on the use of double tax treaties by tax authorities

The purpose of double tax treaties is to allocate the right to tax the same source of income between the two contracting states. They cannot therefore increase a state's right to tax. For instance, if a double tax treaty states that the source state may tax dividends and so may the residence state, then if one of them does not routinely levy taxes on dividends, or if one of them allows special domestic tax reliefs against dividend income such that no domestic tax is payable, then the treaty does not authorize that state to start charging tax

10. Methods Of Eliminating Double Taxation (Deduction Method, Exemption Method, Credit Method)

In situations related to taxpayers with foreign sourced income; the income might be taxed twice: first taxed in the foreign country and then in the country of residence i.e. international double taxation.

There **two methods that a nation can use to relieve foreign income tax of their taxpayers**. These methods can be provided unilaterally or in a bilateral treaty.

The methods are:

(i) Exemption method

The first method is through exemption. The exemption method can be implemented either unilaterally or bilaterally by contracting countries:

Exemption method can be divided into full exemption and exemption with progression. In the full exemption method, the country of residence omits the foreign income from its own tax system and taxes only domestic income. On the other hand the exemption with progression method includes the exempted income when determining the tax rate to apply to domestic income in case of progressive tax rate systems.

Merits Of The Method

- This is the simplest method to administer for both the taxpayer and the tax authorities.
- The method encourages companies to invest in jurisdictions with lower taxation rates.
- It may attract holding companies.
- The exemptions method is advocated by the economists who support the capital import neutrality (CIN) theory.

Demerits Of The Method

- It may only be available if at the source country a minimum taxation rate was imposed to that income
- The tax authorities don´t have the visibility of where the resident company gets the income from.

Example

A resident taxpayer earned Tshs 8,000 from Tanzania and Tshs 2,000 from Kenya, so the worldwide income was Tshs 10,000. The tax rate in Kenya was 20% flat rate, while in Tanzania there were two tax rates one for income above Tshs 8,000 which was 30% and another for income not above Tshs 8,000 which was 25%.

Required

(b) Determine the tax burden of the person without foreign tax relief

(c) Determine the tax relief if full exemption method is used

(d) Determine the tax relief if exemption with progression approach is used

Answer

(a) The tax burden without foreign tax relief will be Tshs3,400

Items	Tshs
Tax paid in Tanzania 30% of Tshs10,000	3,000
Tax paid in Kenya 20% of Tshs2,000	400
Total taxes	**3,400**

(b) Tax burden if full exemption method is used is Tshs 2,400.

Items	Tshs
Tax paid in Tanzania 25% of Tshs8,000	2,000
Tax paid in Kenya 20% of Tshs2,000	400
Total taxes	**2,400**

(c) Tax burden if exemption with progression method is used is Tshs 2,800.

Items	Tshs
Tax paid in Tanzania 30% of Tshs8,000	2,400
Tax paid in Kenya 20% of Tshs2,000	400
Total taxes	**2,800**

(ii) Tax credit method

The second approach to foreign income tax relief is the tax credit method. The credit method **does** not exempt the income earned in foreign countries but it taxes it and provides for foreign tax credit for any foreign tax paid in the foreign countries.

Under this method the country of residence has the subsidiary right to tax the income when the tax rates in the sourced countries is lower than the tax rates in the residence countries. So in that case, the country of residence may collect some taxes from the foreign income when the worldwide income is computed.

Likewise credit method is divided into full credit, ordinary credit and tax sparing.

- **Full Credit method**
  In the full credit method, the countries of residence allow deduction of the total amount of foreign tax when computing the tax liability of resident taxpayers.

- **Ordinary credit method**
  In the ordinary credit method the deduction of foreign tax is restricted i.e. maximum deduction to the proportional of taxes that could have been paid on the foreign income if the income were earned in the residence country.
- ***Tax Sparing:***
  This happens when in the source country there are tax holidays for certain type of activities to attract foreign investment, but the resident country credits the taxes that it should have been paid at source anyway.

Merits Of The Method

- The credit relief is the recommended method under the capital export neutrality theory (CEN).
- When the source country has higher taxation rates, then the resident country may allow to carry forward/back credits.
- It allows to include tax losses in the resident companies' tax base
- The tax authorities can see where companies get the profits from. Good to allocate auditing resources.

Demerits

- It requires more administration work

Example

A resident taxpayer earned Tshs8,000 from Tanzania and Tshs2,000 from Kenya, so the worldwide income was Tshs10,000. The tax rate in Kenya was 20% flat rate, while in Tanzania there were two tax rates one for income above Tshs8,000 which was 30% and another for income not above Tshs8,000 which was 25%.

Required:

(a) Determine the tax burden of the person without foreign tax relief
(b) Determine the tax burden if full credit method is used
(c) Determine the tax burden if ordinary credit approach is used
(d) Determine the tax burden if tax sparing approach is used assuming Kenya has 10 years tax holiday incentive.

Answer:

(a) The tax burden without foreign tax relief will be Tshs3,400

Items	Tshs
Tax paid in Tanzania 30% of Tshs10,000	3,000
Tax paid in Kenya 20% of Tshs2,000	400
Total taxes	3,400

(b) Tax burden if full credit method is used will be Tshs 3,000.

Items	Tshs
Tax in Tanzania 30% of Tshs10,000	3,000
Less: Tax paid in Kenya 20% of Tshs2,000	(400)
Total taxes paid in Tanzania	2,600
Plus tax paid in Kenya	400
Total tax paid by the person	3,000

(c) Tax burden if ordinary credit method is used is Tshs 3,000.

Items	Tshs
Tax in Tanzania 30% of Tshs10,000	3,000
Less: Tax paid in Kenya 20% of Tshs2,000	(400)
Total taxes paid in Tanzania	2,600
Plus tax paid in Kenya	400
Total tax paid by the person	3,000

Note: The maximum deduction is 30% of Tshs2,000 which is Tshs600 below the tax paid in Kenya.

(d) The tax burden under tax sparing method will be Tshs 2,600

Items	Tshs
Tax in Tanzania 30% of Tshs10,000	3,000
Less: Tax that would have been paid in Kenya 20% of Tshs2,000	(400)
Total taxes paid in Tanzania	2,600
Plus tax paid in Kenya	0
Total tax paid by the person	2,600

(iii) Deduction method:

Under this method the residence country allows its taxpayers to claim a deduction for taxes, including income taxes, paid to a foreign government in respect of foreign sourced income.

Example

A resident taxpayer earned Tshs 8,000 from Tanzania and Tshs2,000 from Kenya, so the worldwide income was Tshs10,000. The tax rate in Kenya was 20% flat rate, while in Tanzania there were two tax rates one for income above Tshs8,000 which was 30% and another for income not above Tshs8,000 which was 25%.

(e) Tax burden if deduction method is used is Tshs 3,280.

Items	Tshs
Tax paid in Tanzania 30% of Tshs(10,000-400)	2,880
Tax paid in Kenya 20% of Tshs2,000	400
Total taxes	3,280

ARTICLES OF THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

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Chapter I
SCOPE OF THE CONVENTION
***Article* 1**
PERSONS COVERED

1. This Convention shall apply to persons who are residents of one or both of the Contracting States.
2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.
3. This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under [paragraph 3 of Article 7], paragraph 2 of Article 9 and Articles 19, 20, 23 A [23 B], 24 and 25 A [25 B] and 28.

***Article* 2**
TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
3. The existing taxes to which the Convention shall apply are in particular:
   (a) (in State A): ....
   (b) (in State B): ....
4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of significant changes made to their tax law.

Chapter II
DEFINITIONS
***Article* 3**
GENERAL DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires:
   (a) The term "person" includes an individual, a company and any other body of persons;
   (b) The term "company" means anybody corporate or any entity that is treated as a body corporate for tax purposes;
   (c) The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
   (d) The term "international traffic" means any transport by a ship or aircraft, except when the ship or aircraft is operated solely between places in a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State;
   (e) The term "competent authority" means:
      (i) (In State A): ....
      (ii) (In State B): ....
   (f) The term "national" means:
   (i) any individual possessing the nationality of a Contracting State
   (ii) any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.
2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

***Article* 4**
RESIDENT

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
(a) He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
(b) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
(c) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
(d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.
3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

***Article* 5**
PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term "permanent establishment" includes especially:
   (a) A place of management;
   (b) A branch;
   (c) An office;
   (d) A factory;
   (e) A workshop;
   (f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. The term "permanent establishment" also encompasses:
   (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;
   (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.
4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
   (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;
   (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
   (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
   (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;

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

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

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

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

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

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

(i) in the name of the enterprise, or

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

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

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

6. Notwithstanding the preceding provisions of this Article but subject to the provisions of paragraph 7, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person..

7. Paragraphs 5 and 6 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

9. For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.

Chapter III
TAXATION OF INCOME
***Article* 6**
INCOME FROM IMMOVABLE PROPERTY

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.
2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.
3. The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.
4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

***Article* 7**
BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (*a*) that permanent establishment; (*b*) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (*c*) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.
2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.
3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment

including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.
5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.
6. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article. (NOTE: The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)

***Article* 8**

INTERNATIONAL SHIPPING AND AIR TRANSPORT

Article 8 (alternative A)

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.
2. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 8 (alternative B)

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

3. The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

***Article* 9**
ASSOCIATED ENTERPRISES

1. Where:
   (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
   (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.
3. The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

***Article* 10**
DIVIDENDS

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
   (a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);
   (b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.
3. The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt claims,

participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.
5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

***Article* 11**
INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
3. The term "interest" as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (*a*) such permanent establishment or fixed base, or with (*b*) business activities referred to in (*c*) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.
5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.
6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the

beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

***Article* 12**
ROYALTIES

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
3. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (*a*) such permanent establishment or fixed base, or with (*b*) business activities referred to in (*c*) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.
5. Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.
6. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

***Article* 12A**
FEES FOR TECHNICAL SERVICES

1. Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, notwithstanding the provisions of Article 14 and subject to the provisions of Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees

is a resident of the other Contracting State, the tax so charged shall not exceed ___ percent of the gross amount of the fees [the percentage to be established through bilateral negotiations].

3. The term "fees for technical services" as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made:
   (a) to an employee of the person making the payment;
   (b) for teaching in an educational institution or for teaching by an educational institution; or
   (c) by an individual for services for the personal use of an individual.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with:
   (a) such permanent establishment or fixed base, or
   (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.
5. For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or fixed base.
6. For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State through a permanent establishment situated in that other State or performs independent personal services through a fixed base situated in that other State and such fees are borne by that permanent establishment or fixed base.
7. Where, by reason of a special relationship between the payer and the beneficial owner of the fees for technical services or between both of them and some other person, the amount of the fees, having regard to the services for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the fees shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

***Article* 13**
CAPITAL GAINS

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.
3. Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.
4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at

any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

5. Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company, or comparable interests, such as interests in a partnership or trust, which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 365 days preceding such alienation, held directly or indirectly at least ___ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.
6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

***Article* 14**
INDEPENDENT PERSONAL SERVICES

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:
   (a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or
   (b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.
2. The term “professional services” includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

***Article* 15**
DEPENDENT PERSONAL SERVICES

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.
2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
   (a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and
   (b) The remuneration is paid by, or on behalf of, an employer whois not a resident of the other State; and
   (c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.
3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic, other than aboard a ship or aircraft operated solely within the other Contracting State, shall be taxable only in the first-mentioned State.

Article **16**

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS

1. Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other State.
2. Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

Article **17**

ARTISTES AND SPORTSPERSONS

1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.
2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.

Article **18**

PENSIONS AND SOCIAL SECURITY PAYMENTS

Article 18 (alternative A)

1. Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.
2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 18 (alternative B)

1. Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.
2. However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is madeby a resident of that other State or a permanent establishment situated therein.
3. Notwithstanding the provisions of paragraphs 1 and 2, pensionspaid and other payments made under a public scheme which is part ofthe social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article **19**

GOVERNMENT SERVICE

1\.

   (a) Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that State who:
   (i) is a national of that State; or
   (ii) did not become a resident of that State solely for the purpose of rendering the services.

2.
(a) Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.
(b) However, such pensions and other similar remuneration shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.

3. The provisions of Articles 15, 16, 17 and 18 shall apply to salaries, wages, pensions, and other similar remuneration in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

***Article* 20**
STUDENTS

Payments which a student or business trainee or apprentice who is orwas immediately before visiting a Contracting State a resident of theother Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

***Article* 21**
OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
2. The provisions of paragraph 1 shall not apply to income, otherthan income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situatedtherein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment orfixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.
3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

Chapter IV
TAXATION OF CAPITAL
***Article* 22**
CAPITAL

1. Capital represented by immovable property referred to inArticle 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.
2. Capital represented by movable property forming part of thebusiness property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by

movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services may be taxed in that other State.

3. Capital of an enterprise of a Contracting State that operates ships or aircraft in international traffic represented by such ships or aircraft, and by movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.
4. [All other elements of capital of a resident of a Contracting State shall be taxable only in that State.] (The question of the taxation of all other elements of capital of a resident of a Contracting State is left to bilateral negotiations. Should the negotiating parties decide to include in the Convention an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.)

Chapter V
METHODS FOR THE ELIMINATION OF
DOUBLE TAXATION
***Article* 23 A**
EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State, in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.
2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10, 11 12, and 12A may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income which may be taxed in that other State.
3. Where in accordance with any provision of this Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.
4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10, 11, 12 or 12A to such income; in the latter case, the first-mentioned State shall allow the deduction of tax provided for by paragraph 2.

***Article* 23 B**
CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State, in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first-mentioned State shall allow:
   (a) as a deduction from the tax on the income of that resident an amount equal to the income tax paid in that other State;

(b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

2. Where, in accordance with any provision of this Convention, income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Chapter VI
SPECIAL PROVISIONS
***Article* 24**
NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.
2. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.
3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, paragraph 6 of Article 12, or paragraph 6 of Article 12A apply, interest, royalties, fees for technical services, andother disbursements paid by an enterprise of a Contracting Stateto a resident of the other Contracting State shall, for the purposeof determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident ofthe first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.
5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
6. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

***Article* 25**

MUTUAL AGREEMENT PROCEDURE

Article 25 (alternative A)

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.
2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.
3. The competent authorities of the Contracting States shallendeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.
4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article.

Article 25 (alternative B)

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.
2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.
3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.
4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article.
5. Where,

(a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and

(b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within three years from the presentation of the case to the competent authority of the other Contracting State, any unresolved issues arising from the case shall be submitted to arbitration if either competent authority so requests. The person who has presented the case shall be notified of the request. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. The arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic laws of these States unless both competent authorities agree on a different solution within six months after the decision has been communicated to them or unless a person directly affected bythe case does not accept the mutual agreement that implements the arbitration decision. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.

***Article* 26**
EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws of the Contracting States concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation there under is not contrary to the Convention. In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes. The exchange of information is not restricted by Articles 1 and 2.
2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and it shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorizes such use.
3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:
   (a) To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
   (b) To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
   (c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (*ordre public*).
4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall

such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.
6. The competent authorities shall, through consultation, develop appropriate methods and techniques concerning the matters in respect of which exchanges of information under paragraph 1 shall be made.

***Article* 27**

ASSISTANCE IN THE COLLECTION OF TAXES

1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Articles 1 and 2. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.
2. The term "revenue claim" as used in this Article means an amount owed in respect of taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to this Convention or any other instrument to which the Contracting States are parties, as well as interest, administrative penalties and costs of collection or conservancy related to such amount.
3. When a revenue claim of a Contracting State is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State.
4. When a revenue claim of a Contracting State is a claim in respect of which that State may, under its law, take measures of conservancy with a view to ensure its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of taking measures of conservancy by the competent authority of the other Contracting State. That other State shall take measures of conservancy in respect of that revenue claim in accordance with the provisions of its laws as if the revenue claim were a revenue claim of that other State even if, at the time when such measures are applied, the revenue claim is not enforceable in the first-mentioned State or is owed by a person who has a right to prevent its collection.
5. Notwithstanding the provisions of paragraphs 3 and 4, a revenue claim accepted by a Contracting State for purposes of paragraph 3 or 4 shall not, in that State, be subject to the time limits or accorded any priority applicable to a revenue claim under the laws of that State by reason of its nature as such. In addition, a revenue claim accepted by a Contracting State for the purposes of paragraph 3 or 4 shall not, in that State, have any priority applicable to that revenue claim under the laws of the other Contracting State.
6. Proceedings with respect to the existence, validity or the amount of a revenue claim of a Contracting State shall not be brought before the courts or administrative bodies of the other Contracting State.
7. Where, at any time after a request has been made by a Contracting State under paragraph 3 or 4 and before the other Contracting State has collected and remitted the relevant revenue claim to the first-mentioned State, the relevant revenue claim ceases to be:
   (a) in the case of a request under paragraph 3, a revenue claim of the first-mentioned State that is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, or

(b) in the case of a request under paragraph 4, a revenue claim of the first-mentioned State in respect of which that State may, under its laws, take measures of conservancy with a view to ensure its collection, the competent authority of the first-mentioned State shall promptly notify the competent authority of the other State of that fact and, at the option of the other State, the first-mentioned State shall either suspend or withdraw its request.

8. In no case shall the provisions of this Article be construed so as to impose on a Contracting State the obligation:
   (a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
   (b) to carry out measures which would be contrary to public policy (*ordre public*);
   (c) to provide assistance if the other Contracting State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice;
   (d) to provide assistance in those cases where the administrative burden for that State is clearly disproportionate to the benefit to be derived by the other Contracting State.

***Article* 28**
MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

***Article* 29**
ENTITLEMENT TO BENEFITS

1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would other wise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25) unless such resident is a “qualified person”, as defined in paragraph 2, at the time that the benefit would be accorded.
2. A resident of a Contracting State shall be a qualified person at a time when a benefit would otherwise be accorded by the Convention if, at that time, the resident is:
   (i) an individual;
   (ii) that Contracting State, or a political subdivision or local authority thereof, or an agency or instrumentality of that State, political subdivision or local authority;
   (iii) a company or other entity, if, throughout the taxable period that includes that time, the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:
      (i) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or
      (ii) the company's or entity's primary place of management and control is in the Contracting State of which it is a resident;
   (iv) a company, if:
   (i) throughout the taxable period that includes that time, at least 50 per cent of the aggregate vote and value of the shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subparagraph c) of this paragraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought or is a qualifying intermediate owner; and
   (ii) with respect to benefits under this Convention other than under Article 10, less than 50 per cent of the company's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly,

in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e);

(v) a person, other than an individual, that

(i) is a [agreed description of the relevant non-profit organizations found in each Contracting State],

(ii) is a recognised pension fund to which subdivision (i) of the definition of recognised pension fund in paragraph 1 of Article 3 applies, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident of either Contracting State, or more than [__ per cent] of the beneficial interests in that person are owned by individuals resident of either Contracting State or of any other State with respect to which the following conditions are met

(A) individuals who are residents of that other State are entitled to the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed, and

(B) with respect to income referred to in Articles 10 and 11 of this Convention, if the person were a resident of that other State entitled to all the benefits of that other convention, the person would be entitled, under such convention, to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention; or

(iii) is a recognised pension fund to which subdivision (ii) of the definition of recognised pension fund in paragraph 1 of Article 3 applies, provided that it is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in the preceding subdivision;

(vi) a person other than an individual, if

(i) at that time and on at least half the days of a twelve-month period that includes that time, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), b), c) or e) own, directly or indirectly, shares representing at least 50 per cent of the aggregate vote and value (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) of the shares in the person, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and

(ii) less than 50 per cent of the person's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions), to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e) of this paragraph; or

(vii) [possible provision on collective investment vehicles];

3.

(a) A resident of a Contracting State shall be entitled to benefits under this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in the first-mentioned State (other than the business of making or managing investments for the resident's

own account, unless these activities are banking, insurance or securities activities carried on by a bank or [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer respectively), and the income derived from the other State emanates from, or is incidental to, that business. For purposes of this Article, the term "active conduct of a business" shall not include the following activities or any combination thereof:

(i) operating as a holding company;
(ii) providing overall supervision or administration of a group of companies;
(iii) providing group financing (including cash pooling); or
(iv) making or managing investments, unless these activities are carried on by a bank [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer in the ordinary course of its business as such.

(b) If a resident of a Contracting State derives an item of income from a business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other State from a connected person, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item only if the business activity carried on by the resident in the first-mentioned State to which the item is related is substantial in relation to the same or complementary business activity carried on by the resident or such connected person in the other Contracting State. Whether a business activity is substantial for the purposes of this paragraph shall be determined based on all the facts and circumstances.

(c) For purposes of applying this paragraph, activities conducted by connected persons with respect to a resident of a Contracting State shall be deemed to be conducted by such resident.

4. [A rule providing so-called derivative benefits. The question of how the derivative benefits paragraph should be drafted in a convention that follows the detailed version is discussed in the Commentary.]
5. A company that is a resident of a Contracting State that functions as a headquarters company for a multinational corporate group consisting of such company and its direct and indirect subsidiaries shall be entitled to benefits under this Convention with respect to dividends and interest paid by members of its multinational corporate group, regardless of whether the resident is a qualified person. A company shall be considered a headquarters company for this purpose only if:

(a) such company's primary place of management and control is in the Contracting State of which it is a resident;

(b) the multinational corporate group consists of companies resident of, and engaged in the active conduct of a business in, at least four States, and the businesses carried on in each of the four States (or four groupings of States) generate at least 10 per cent of the gross income of the group;

(c) the businesses of the multinational corporate group that are carried on in any one State other than the Contracting State of residence of such company generate less than 50 per cent of the gross income of the group;

(d) no more than 25 per cent of such company's gross income is derived from the other Contracting State;

(e) such company is subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3 of this Article; and

(f) less than 50 per cent of such company's gross income, and less than 50 per cent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including

intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e) of paragraph 2. If the requirements of subparagraph b), c) or d) of this paragraph are not fulfilled for the relevant taxable period, they shall be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four taxable periods.

6. If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 of this Article, nor entitled to benefits under paragraph 3, 4 or 5, the competent authority of the Contracting State in which benefits are denied under the previous provisions of this Article may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income or capital, taking into account the object and purpose of this Convention, but only if such resident demonstrates to the satisfaction of such competent authority that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the Contracting State to which a request has been made, under this paragraph, by a resident of the other State, shall consult with the competent authority of that other State before either granting or denying the request.

7. For the purposes of this and the previous paragraphs of this Article:

(a) the term “recognised stock exchange” means:
   (i) [list of stock exchanges agreed to at the time of signature]; and
   (ii) any other stock exchange agreed upon by the competent authorities of the Contracting States;

(b) with respect to entities that are not companies, the term “shares” means interests that are comparable to shares;

(c) The term “principal class of shares” means the ordinary or common shares of the company or entity, provided that such class of shares represents the majority of the aggregate vote and value of the company or entity. If no single class of ordinary or common shares represents the majority of the aggregate vote and value of the company or entity, the “principal class of shares” are those classes that in the aggregate represent a majority of the aggregate vote and value;

(d) two persons shall be “connected persons” if one owns, directly or indirectly, at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company’s shares) or another person owns, directly or indirectly, at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company’s shares) in each person. In any case, a person shall be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

(e) the term “equivalent beneficiary” means:
   (i) a resident of any State, provided that:
      (A) the resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that State and the Contracting State from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph a), b), c) or e) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident’s multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article in such convention, provided that, if such convention does not contain a detailed limitation on benefits article, such convention shall be applied as if the provisions of subparagraphs a), b), c) and e) of paragraph 2 (including the definitions relevant to the application of the tests in such subparagraphs) were contained in such convention; and
      (B) *(1)* with respect to income referred to in Article 10, 11, 12 or 12A if the resident had received such income directly, the resident would be entitled under such Convention, a provision of domestic law or any international agreement, to a rate of tax with respect to such income for which benefits are being sought under this Convention that is less than or

equal to the rate applicable under this Convention. Regarding a company seeking, under paragraph 4, the benefits of Article 10 with respect to dividends, for purposes of this sub clause:

(I) if the resident is an individual, and the company is engaged in the active conduct of a business in its Contracting State of residence that is substantial in relation, and similar or complementary, to the business that generated the earnings from which the dividend is paid, such individual shall be treated as if he or she were a company. Activities conducted by a person that is a connected person with respect to the company seeking benefits shall be deemed to be conducted by such company. Whether a business activity is substantial shall be determined based on all the facts and circumstances; and

(II) if the resident is a company (including an individual treated as a company), to determine whether the resident is entitled to a rate of tax that is less than or equal to the rate applicable under this Convention, the resident's indirect holding of the capital of the company paying the dividends shall be treated as a direct holding; or

(2) with respect to an item of income referred to in Article 7, 13 or 21 of this Convention, the resident is entitled to benefits under such Convention that are at least as favourable as the benefits that are being sought under this Convention; and

(C) notwithstanding that a resident may satisfy the requirements of clauses A) and B) of this subdivision, where the item of income has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of residence of the company seeking benefits, if the item of income would not be treated as the income of the resident under a provision analogous to paragraph 2 of Article 1 had the resident, and not the company seeking benefits under paragraph 4 of this Article, itself owned the entity through which the income was derived by the company, such resident shall not be considered an equivalent beneficiary with respect to the item of income;

(ii) a resident of the same Contracting State as the company seeking benefits under paragraph 4 of this Article that is entitled to all the benefits of this Convention by reason of subparagraph a), b), c) or e) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under paragraph 5, provided that, in the case of a resident described in paragraph 5, if the resident had received such interest or dividends directly, the resident would be entitled to a rate of tax with respect to such income that is less than or equal to the rate applicable under this Convention to the company seeking benefits under paragraph 4; or

(iii) a resident of the Contracting State from which the benefits of this Convention are sought that is entitled to all the benefits of this Convention by reason of subparagraph a), b), c) or e) of paragraph 2, provided that all such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares) of the company seeking benefits under paragraph 4 does not exceed 25 per cent of the total vote and value of the shares (and any disproportionate class of shares) of the company;

(f) the term "disproportionate class of shares" means any class of shares of a company or entity resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State by particular assets or activities of the company;

(g) a company's or entity's "primary place of management and control" is in the Contracting State of which it is a resident only if:

(i) the executive officers and senior management employees of the company or entity exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, in that Contracting State than in any other State; and

(ii) such executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to day activities necessary for preparing and making those decisions, than the officers or employees of any other company or entity;

(h) the term “qualifying intermediate owner” means an intermediate owner that is either:

(i) a resident of a State that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation; or

(ii) a resident of the same Contracting State as the company applying the test under subparagraph d) or f) of paragraph 2 or paragraph 4 to determine whether it is eligible for benefits under the Convention;

(i) the term “tested group” means the resident of a Contracting State that is applying the test under subparagraph d) or f) of paragraph 2 or under paragraph 4 or 5 to determine whether it is eligible for benefits under the Convention (the “tested resident”), and any company or permanent establishment that:

(i) participates as a member with the tested resident in a tax consolidation, fiscal unity or similar regime that requires members of the group to share profits or losses; or

(ii) shares losses with the tested resident pursuant to a group relief or other loss sharing regime in the relevant taxable period; [and]

(j) the term “gross income” means gross receipts as determined in the person’s Contracting State of residence for the taxable period that includes the time when the benefit would be accorded, except that where a person is engaged in a business that includes the manufacture, production or sale of goods, “gross income” means such gross receipts reduced by the cost of goods sold, and where a person is engaged in a business of providing non-financial services, “gross income” means such gross receipts reduced by the direct costs of generating such receipts, provided that:

(i) except when relevant for determining benefits under Article 10 of this Convention, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person’s Contracting State of residence, whether through deductions or otherwise; and

(ii) except with respect to the portion of any dividend that is taxable, a tested group’s gross income shall not take into account transactions between companies within the tested group; [and]

8. *(a)* Where

(i) an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats such income as attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and

(ii) the profits attributable to that permanent establishment are exempt from tax in the first-mentioned State, the benefits of this Convention shall not apply to any item of income on which the tax in the third jurisdiction is less than the lower of [rate to be determined bilaterally] of the amount of that item of income and 60 per cent of the tax that would be imposed in the first-mentioned State on that item of income if that permanent establishment were situated in the first-mentioned State. In such a case any income to which the provisions of this paragraph apply shall remain taxable according to the

domestic law of the other State, notwithstanding any other provisions of the Convention.

(b) The preceding provisions of this paragraph shall not apply if the income derived from the other State emanates from, or is incidental to, the active conduct of a business carried on through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively).

(c) If benefits under this Convention are denied pursuant to the preceding provisions of this paragraph with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request.

9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

Chapter VII

FINAL PROVISIONS

***Article* 30**

ENTRY INTO FORCE

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at ______________________ as soon as possible.
2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:
   (a) (In State A): ....
   (b) (In State B): ....

***Article* 31**

TERMINATION

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year ____. In such event, the Convention shall cease to have effect:

(a) (In State A): ....
(b) (In State B): ....

TERMINAL CLAUSE

NOTE: The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

OECD -MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL

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Chapter I

SCOPE OF THE CONVENTION

ARTICLE 1

PERSONS COVERED

1. This Convention shall apply to persons who are residents of one or both of the contracting States.
2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.
3. This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.

ARTICLE 2

TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
3. The existing taxes to which the Convention shall apply are in particular:
   a) (in State A): ....
   b) (in State B): ....
4. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

Chapter II

DEFINITIONS

ARTICLE 3

GENERAL DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires:
   a) the term “person” includes an individual, a company and any other body of persons;
   b) the term “company” means any body corporate or any entity that is treated as a body corporate for tax purposes;
   c) the term “enterprise” applies to the carrying on of any business;

- *d)* the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
- *e)* the term “international traffic” means any transport by a ship or aircraft except when the ship or aircraft is operated solely between places in a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State;
- *f)* the term “competent authority” means:
  - *(i)* (in State A): ....
  - *(ii)* (in State B): ....
- *g)* the term “national”, in relation to a Contracting State, means:
  - *(i)* any individual possessing the nationality or citizenship of that Contracting. State; and
  - *(ii)* any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State;
- *h)* the term “business” includes the performance of professional services and of other activities of an independent character.
- *i)* the term “recognised pension fund” of a State means an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and:
  - *(i)* that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities; or
  - *(ii)* that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in subdivision (*i*).

2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

ARTICLE 4
RESIDENT

1. For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof as well as a recognised pension fund of that State. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
   - *a)* he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
   - *b)* if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
   - *c)* if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

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

ARTICLE 5
PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term "permanent establishment" includes especially:
   a) a place of management;
   b) a branch;
   c) an office;
   d) a factory;
   e) a workshop, and
   f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.
4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:
   a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
   b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
   c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
   d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
   e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity;
   f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs *a)* to *e),* provided that such activity or, in the case of subparagraph *f*), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

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

   a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or
   b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely

related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are
   a) in the name of the enterprise, or
   b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
   c) for the provision of services by that enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.
6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.
7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.
8. For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in theother (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent ofthe beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company’s shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.

Chapter III

TAXATION OF INCOME

ARTICLE 6

INCOME FROM IMMOVABLE PROPERTY

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.
2. The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships and aircraft shall not be regarded as immovable property.
3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.
4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise.

ARTICLE 7

BUSINESS PROFITS

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.
2. For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.
4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

ARTICLE 8

INTERNATIONAL SHIPPING AND AIR TRANSPORT

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.
2. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

ARTICLE 9
ASSOCIATED ENTERPRISES

1. Where
   a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
   b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

ARTICLE 10
DIVIDENDS

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
   a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);
   b) 15 per cent of the gross amount of the dividends in all other cases. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.
3. The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

ARTICLE 11
INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, interest arising in a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
3. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.
5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.
6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

ARTICLE 12
ROYALTIES

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.
2. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.
3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.
4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

ARTICLE 13
CAPITAL GAINS

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.
3. Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.
4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.
5. Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident.

[ARTICLE 14 - INDEPENDENT PERSONAL SERVICES]
[DELETED]

ARTICLE 15
INCOME FROM EMPLOYMENT

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that

State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:
   a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
   b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
   c) the remuneration is not borne by a permanent establishment which the employer has in the other State.
3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic, other than aboard a ship or aircraft operated solely within the other Contracting State, shall be taxable only in the first-mentioned State.

ARTICLE 16
DIRECTORS' FEES

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

ARTICLE 17
ENTERTAINERS AND SPORTSPERSONS

1. Notwithstanding the provisions of Article 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from that resident's personal activities as such exercised in the other Contracting State, may be taxed in that other State.
2. Where income in respect of personal activities exercised by an entertainer or a sportsperson acting as such accrues not to the entertainer or sportsperson but to another person, that income may, notwithstanding the provisions of Article 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.

ARTICLE 18
PENSIONS

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

ARTICLE 19
GOVERNMENT SERVICE

1.
   a) Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

- *b)* However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:
  - *(i)* is a national of that State; or
  - *(ii)* did not become a resident of that State solely for the purpose of rendering the services.

2.
   - *a)* Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.
   - *b)* However, such pensions and other similar remuneration shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.
3. The provisions of Articles 15, 16, 17, and 18 shall apply to salaries, wages, pensions, and other similar remuneration in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

ARTICLE 20
STUDENTS

Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

ARTICLE 21
OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

Chapter IV
TAXATION OF CAPITAL
ARTICLE 22
CAPITAL

1. Capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.
2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State may be taxed in that other State.
3. Capital of an enterprise of a Contracting State that operates ships or aircraft in international traffic represented by such ships or aircraft, and by movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.

4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.

Chapter V

METHODS FOR ELIMINATION OF DOUBLE TAXATION

ARTICLE 23 A

EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.
2. Where a resident of a Contracting State derives items of income which may be taxed in the other Contracting State in accordance with the provisions of Articles 10 and 11 (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State), the first mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.
3. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.
4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

ARTICLE 23 B

CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State), the first mentioned State shall allow:
   a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
   b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.
2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Chapter VI

SPECIAL PROVISIONS

ARTICLE 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.
2. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.
3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.
5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the firstmentioned State are or may be subjected.
6. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

ARTICLE 25

MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of either Contracting State. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.
2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.
4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.
5. Where,
   a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
   b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities, any unresolved issues arising from the case shall be submitted to arbitration if the person so requests in writing. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.

ARTICLE 26
EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2.
2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use.
3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:
   a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
   b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

   c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy (*ordre public*).
4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.
5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

ARTICLE 27
ASSISTANCE IN THE COLLECTION OF TAXES

1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Articles 1 and 2. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.
2. The term “revenue claim” as used in this Article means an amount owed in respect of taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to this Convention or any other instrument to which the Contracting States are parties, as well as interest, administrative penalties and costs of collection or conservancy related to such amount.
3. When a revenue claim of a Contracting State is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State.
4. When a revenue claim of a Contracting State is a claim in respect of which that State may, under its law, take measures of conservancy with a view to ensure its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of taking measures of conservancy by the competent authority of the other Contracting State. That other State shall take measures of conservancy in respect of that revenue claim in accordance with the provisions of its laws as if the revenue claim were a revenue claim of that other State even if, at the time when such measures are applied, the revenue claim is not enforceable in the firstmentioned State or is owed by a person who has a right to prevent its collection.
5. Notwithstanding the provisions of paragraphs 3 and 4, a revenue claim accepted by a Contracting State for purposes of paragraph 3 or 4 shall not, in that State, be subject to the time limits or accorded any priority applicable to a revenue claim under the laws of that State by reason of its nature as such. In addition, a revenue claim accepted by a Contracting State for the purposes of paragraph 3 or 4 shall not, in that State, have any priority applicable to that revenue claim under the laws of the other Contracting State.
6. Proceedings with respect to the existence, validity or the amount of a revenue claim of a Contracting State shall not be brought before the courts or administrative bodies of the other Contracting State.

7. Where, at any time after a request has been made by a Contracting State under paragraph 3 or 4 and before the other Contracting State has collected and remitted the relevant revenue claim to the first-mentioned State, the relevant revenue claim ceases to be
   a) in the case of a request under paragraph 3, a revenue claim of the first mentioned State that is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, or
   b) in the case of a request under paragraph 4, a revenue claim of the firstmentioned State in respect of which that State may, under its laws, take measures of conservancy with a view to ensure its collection the competent authority of the first-mentioned State shall promptly notify the competent authority of the other State of that fact and, at the option of the other State, the first-mentioned State shall either suspend or withdraw its request.
8. In no case shall the provisions of this Article be construed so as to impose on a Contracting State the obligation:
   a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
   b) to carry out measures which would be contrary to public policy (*ordre public*);
   c) to provide assistance if the other Contracting State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice;
   d) to provide assistance in those cases where the administrative burden for that State is clearly disproportionate to the benefit to be derived by the other Contracting State.

ARTICLE 28
MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

ARTICLE 29
ENTITLEMENT TO BENEFITS1

1. [Provision that, subject to paragraphs 3 to 5, restricts treaty benefits to a resident of a Contracting State who is a “qualified person” as defined in paragraph 2].
2. [Definition of situations where a resident is a qualified person, which covers
   — an individual;
   — a Contracting State, its political subdivisions and their agencies and instrumentalities;
   — certain publicly-traded companies and entities;
   — certain affiliates of publicly-listed companies and entities;
   — certain non-profit organisations and recognised pension funds;
   — other entities that meet certain ownership and base erosion requirements;
   — certain collective investment vehicles.]
3. [Provision that provides treaty benefits to certain income derived by a person that is not a qualified person if the person is engaged in the active conduct of a business in its State of residence and the income emanates from, or is incidental to, that business].
4. [Provision that provides treaty benefits to a person that is not a qualified person if at least more than an agreed proportion of that entity is owned by certain persons entitled to equivalent benefits].
5. [Provision that provides treaty benefits to a person that qualifies as a “headquarters company”].
6. [Provision that allows the competent authority of a Contracting State to grant certain treaty benefits to a person where benefits would otherwise be denied under paragraph 1].

7. [Definitions applicable for the purposes of paragraphs 1 to 7].
8.
a) Where
   (i) an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats such income as attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and
   (ii) the profits attributable to that permanent establishment are exempt from tax in the first-mentioned State, the benefits of this Convention shall not apply to any item of income on which the tax in the third jurisdiction is less than the lower of [rate to be determined bilaterally] of the amount of that item of income and 60 per cent of the tax that would be imposed in the first-mentioned State on that item of income if that permanent establishment were situated in the first-mentioned State. In such a case any income to which the provisions of this paragraph apply shall remain taxable according to the domestic law of the other State, notwithstanding any other provisions of the Convention.

b) The preceding provisions of this paragraph shall not apply if the income derived from the other State emanates from, or is incidental to, the active conduct of a business carried on through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively).

c) If benefits under this Convention are denied pursuant to the preceding provisions of this paragraph with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request

9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

ARTICLE 30
TERRITORIAL EXTENSION1

1. This Convention may be extended, either in its entirety or with any necessary modifications [to any part of the territory of (State A) or of (State B) which is specifically excluded from the application of the Convention or], to any State or territory for whose international relations (State A) or (State B) is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.
2. Unless otherwise agreed by both Contracting States, the termination of the Convention by one of them under Article 32 shall also terminate, in the manner provided for in that Article, the application of the Convention [to any part of the territory of (State A) or of (State B) or] to any State or territory to which it has been extended under this Article.

Chapter VII
FINAL PROVISIONS
ARTICLE 31
ENTRY INTO FORCE

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at .... as soon as possible.
2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:
   a) (in State A): ....
   b) (in State B): ....

ARTICLE 32
TERMINATION

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year ...... In such event, the Convention shall cease to have effect:

a) (in State A): ....
b) (in State B): ....

Self-Examination Questions

Question 1
Describe the main methods of relief from international double taxation.

Question 2
What are the objectives of a modern double tax agreement, and how do these objectives differ from the past?

Question 3
Acceptable international practice, grants countries a primary right to tax income with a source in that country. The taxpayer's "home" country would then provide relief for foreign tax paid.

Required:

a. Explain the common methods that countries use to grant relief on foreign income tax paid.

b. Explain the Tanzania's response to the double taxation problem.

Question 4
Outline five benefits that Tanzania may get from Double Taxation Treaties

Question 5
'The term "International Double Taxation" is used in so many different contexts that precise definition of the term will not be appropriate in all contexts. Various models of international tax treaties identify their main objectives as "the avoidance of double taxation with respect to taxes on income and capital'.

Required:

(i) Briefly explain what is meant by the term "International Double Taxation".

(ii) List and briefly explain any three conflicts that may lead to international double taxation.

(iii) Name and briefly explain three common methods used to grant relief from international double taxation.

Question 6

Describe the concept of "tax sparing" as sometimes included in Double Taxation Agreements. Include a definition of the term together with an explanation of how it operates in practice and the rationale for the concept.

Question 7

The credit method of double taxation relief is common in both unilateral and bilateral double taxation relief systems. Under this method, a tax credit is typically provided against tax payable in the residence country in respect of foreign tax paid in the country of source of an item of income. Although conceptually very simple, there are a number of practical issues which commonly arise, and are required to be dealt with, under the credit method. Give examples of such difficulties and how they might be resolved.

Question 8

Explain the role of Double Taxation Treaties.

Question 9

Assume you have been appointed by the Tanzania Revenue Authority (TRA) as a tax consultant to evaluate double taxation treaties in Tanzania.

Required:

(b) Evaluate the current Tanzania's double taxation treaties.

(c) Prepare a report on the appropriate recommendations to Tanzanian policy makers.

Question 10

The concept of double taxation is associated to a taxation principle referring to income taxes that are paid twice on the same source of earned income asset or financial transaction.

Required:

(i) State the main reason why international double taxation arises.

Briefly describe any two types of payment which may result into a double liability.

Question 11

Explain the five conditions which a taxpayer must fulfil to qualify for getting foreign tax relief.

Answers to Self-Examination Questions

Answer to SEQ 1

1. **Exemption Method**

   The residence state does not tax the income, which according to the DTA may be taxed in the source state or the state in which a PE is established. There are two main methods of exemption:

- ***Full Exemption**:* the income that may be taxed in the other CS is not taken into account by the residence state in determining its tax; and
- ***Exemption with Progression:*** the income that may be taxed in the source state is not taxed the by the residence state but it retains the right to take that income into account when determining the tax to be imposed on other income.

2. **Credit Method**

   Under the principle of credit, the residence state calculates its tax on the basis of the taxpayer's total income. This amount includes the income from the state, which according to the Convention, may be taxed in that other state. It then allows a deduction from its own tax for the tax paid in the other state. However, the extent to which the residence state deducts the tax paid in the other state varies across countries.

- ***Full Credit**:* resident state may allow a full credit for the whole amount of tax paid in the source country on its' resident's foreign income.
- ***Ordinary credit:*** only relevant where the source state rate of tax is higher than that of the residence state – the residence state will only credit the tax that relates to the higher of the two country rates which is said to achieve Capital Export Neutrality (CEN).
- ***Tax Sparing:*** This arises where a source country offers tax incentives to foreign investors that result in reduced or no taxation in the country of source on the investor's income. The investor receives no benefit in terms of their tax liability in the residence state as they have only paid very little or no tax and so cannot be credited. There are no tax sparing provisions in the OECD or UN MTC. However, tax sparing is discussed in the commentaries of both MTCs.

3. **Deduction Method**

   The residence state taxes foreign source income (as well as domestic source) however, the residents of the residence state are allowed a deduction from their assessable income in the residence state.

Answer to SEQ 2

The two main purposes of a double taxation agreement (DTA) are the allocation of taxing rights in order to eliminate (or at least minimise) double taxation, and the prevention of tax evasion.

It also has a dual purpose in another sense, that it is both an instrument of domestic and international law. Any company that operates in more than jurisdiction has the potential to be subject to tax by more than one country.

Countries tends to tax residents on their worldwide income and assets, as well as claiming the rights to apply source taxation to income, which arises in their jurisdiction. Therefore, if a company is operating cross border it may be subject to source tax from the state it receives its income from, and residence tax in its home state.

Types of double tax agreement

There are various models, which are used to form the basis of a double tax agreement negotiation.

The most widely globally used is the OECD model tax convention (MTC), which we shall use as the model for our discussion below. There are other models though, which are very similar including the
UN model, which encourages broader source taxation and tends to be used between developing and developed nations, and the US model, which the US use as their template in all negotiations, which includes the concept of citizenship, and has limitation of benefit clauses.

The problems of Double Taxation

Juridical double taxation is where the same income is taxed in the hands of the same taxpayer by two different tax authorities. This could occur where a company in state A receives an interest payment from state B. State B may apply an interest WHT on the interest payment, and state A may tax the interest income as profits arising in A. This is the main kind of double taxation, which the DTA seeks
to minimise.

Economic double taxation is where the same income is taxed by two different tax authorities in the hands of two different taxpayer. This might happen if one country requires a transfer pricing adjustment, and that income has already been taxed elsewhere (assuming a compensating adjustment has not been claimed)
Double tax is considered to be a bad thing. If a company is taxed on the same income more than once they can end up suffering a very high rate of taxation. This cost might mean they are unable to compete with a local company which is not subject to the same level of taxation on similar levels of income. The tax cost could become so crippling high as to prevent the company from being able to survive.

How the DTA reduces double taxation

The DTA minimises double taxation, firstly by allocating taxing rights. Certain types of income (such as royalties in the MTC model) or employment income (assuming <183 days spent in the other state), are only taxable in the state of residence. The source state is denied any taxing rights

And where the source state is permitted to levy tax on certain types of income, the DTA also restricts the amount of tax which source states may apply in some circumstances, such as in Article 10 the MTC sets a cap of 5% on dividend income (where 25% share capital is owned) or 15% otherwise. Likewise,
Article 11 restricts the level of source tax on interest payments to 10%.

Where source tax is permitted, it has priority over residence tax. To the extent that both source and residence taxation is permitted, article 23 A & B prescribe a means for the residence state to give relief for the overseas tax suffered.

The credit method gives relief for the foreign tax suffered by way of a deduction from the total tax due in the residence state.

The alternative method is the exemption method, whereby profits which have already been subject to taxation at source are excluded from the tax calculation in the state of residence.

The MTC also allows a mechanism for the tax authority to make a transfer pricing adjustment under Article 9. Here if a multi-national enterprise has priced a transaction at a price other than that which would be expected to be concluded between independent parties, then the tax authority can request an adjustment to make it an arms length price.

Article 9 also offers the taxpayer the opportunity to claim for a compensating adjustment in the other corresponding country so that they do not suffer double economic taxation as a result of the income adjustment.

Prevention of Evasion

The second purpose of the double tax treaty is to prevent evasion. It has several clauses in which it achieves this to some extent.

The reference to "beneficial owner" in the interest, dividend and royalties articles (10, 11 & 12) means that treaty benefits can be denied if a conduit has been used. i.e. where a company in a specific territory has been inserted in the transaction chain in order to obtain specific treaty benefits ("treaty shopping"). The

beneficial ownership clause means double tax treaty benefit can be denied if the conduit entity doesn't have the rights to enjoy the income itself (i.e. the entity might be contractual
or legally obliged to pass the income on - though not necessarily a requirement)
In addition the OECD commentary to article 1 states that the MTC does not have to grant benefits where an arrangement has been undertaken with the main purpose of securing a favourable tax position (9.4)
There is also at present an optional limitation of benefits (LOB) clause in the commentary. This denies treaty benefits to people/companies not meeting the fit and proper requirements.
There are changes coming in to the next version of the MTC following the BEPS Action Plan 6 – treaty abuse (Base Erosion and Profit Shifting), which means in future treaties either the LOB clause plus and anti-conduit rules will be introduced into the main body, or a principle purpose test with LOB. These will therefore be gradually adopted as countries refresh their old treaties or enter into new ones.

The Mutual Agreement Procedure

A really useful tool within the double taxation agreement is the mutual agreement procedure (MAP).
This is a process whereby if there is a disagreement between two tax authorities on the treatment of income, leading to double taxation, then the taxpayer can apply for MAP in order to request that the parties involved endeavour to reach an agreement. If no agreement is reached, it is now possible
(since 2008 if the clause is included in the relevant DTA) for the taxpayer to apply for arbitration, whereby an independent panel
MAP is used even more widely, that is can be used to approve an Advance Pricing Agreements (APA) between two contracting states. This way a taxpayer can obtain some certainty in advance of undertaking a transaction on how to price it in order for it to be acceptable to both contracting states.
Article 24 is also used to ensure nationals of one state are not treated in a manner more burdensome than nationals of another.

How do the objectives differ from the past?

The reliefs from double taxation methods have changed very little. Though there is a trend globally towards increased use of the exemption method.
There is an increasing emphasis on preventing evasion, as this is a global problem which the tax authorities are increasingly determined to work together in order to clamp down on taxpayers evading paying the taxes that are due. This is seen in the introduction of the principal purpose test and other measures.

Answer to SEQ 3

(a) Methods of granting relief for double taxation.

- Exemption:
  Where the foreign income is excluded in the tax base of the taxpayer
- Deduction:
  This treats the foreign tax paid as an allowable deduction
- Credit:
  Which reduces the amount of tax payable by the amount of foreign tax paid.

(b) Tanzania's response to the double taxation has been through:

- Granting relief for foreign income tax paid (section 77 of the Income Tax Act Cap 332)
- Entering into Double Taxation Treaties with its trade and investment partners

Answer to SEQ 4

To mention the benefits for the Double Taxation Treaties:

(i) Allow for the exchange of information between countries and hence providing a country with means of accessing information otherwise not available.
(ii) Minimizes the negative impact of loss of revenues to the government
(iii) Reduces distortions to investment flows, by providing good governance and transparency.
(iv) Enhances the competitiveness of domestic businesses
(v) Promotes domestic compliance with respect to income arising outside the country.

Answer to SEQ 5

(i) International double taxation refers to imposition of comparable taxes by two or more sovereign countries on the same item of income (including capital) of the same taxable person for the same period.

(ii) Three conflicts that may lead to international double taxation

- **Source –source conflicts:** Two or more countries assert the right to tax the same income of the taxpayer because they all claim the income sourced in their country.
- **Residence –residence conflicts:** Two or more countries may assert the right to tax the same income of the taxpayer because they all claim the taxpayer is a resident of their country. In this case a taxpayer ends up being a resident of more than country and referred to as **"dual resident taxpayer"**.
- **Residence –source conflicts:** One country asserts the right to tax foreign sourced income of a taxpayer because taxpayer is a resident of that country, and another asserts the right to tax the same income because the source of the income is in that country.

(iii) Three common methods used to grant relief from international double taxation

(iv) Deduction method: The residence country allows its taxpayers to claim a deduction for taxes, including income taxes, paid to a foreign government in respect of foreign sourced income.
(v) Exemption method: The residence country provides its taxpayers with a exemption of foreign sourced income.
(vi) Credit method: The residence country provides its taxpayers with a credit against taxpayers with a credit against taxes otherwise payable for income taxes paid to foreign country.

Answer to SEQ 6

Tax sparing relates to the practice provided for in some DTAs where one country agrees to grant a credit for tax which was not actually paid in the other country, but would normally have been payable under the general tax provisions. It can broadly be defined as the practice of granting foreign tax credits in respect of notional tax. Tax sparing is usually only found in DTAs between developed economies and emerging economies. The rationale for the practice is that many developed economies tax their residents on a worldwide basis and allow double tax relief by means of the credit method. At the same time, many emerging economies grant nonresidents tax concessions in an effort to encourage foreign direct investment. Where, however, an emerging economy grants a foreign investor who is taxed on worldwide

income a tax concession, the tax foregone in the investee country typically becomes payable in the jurisdiction of the investor as a result of the reduced tax credit available. The effect of this is to eliminate the benefit of the tax concession offered by the investee country and to shift tax revenues from an emerging economy to a developed economy.

Accordingly, tax sparing was introduced as a means of countering these problems and preserving the benefit of tax concessions offered by emerging countries. It works by deeming, in the country of residence of the investor, tax to have been paid in the investee country at normal corporate tax rates notwithstanding that because of a tax concession no tax was actually paid.

Answer to SEQ 7

There are various practical difficulties with the credit method of double taxation relief which are generally required to be dealt with under clearly defined rules. Examples include:

- How to deal with the position where the tax is assessed in respect of different accounting periods in the residence and source jurisdictions.
- Where income is derived in multiple source jurisdictions, should foreign income and foreign tax be aggregated, or dealt with on an income by income basis? Should there be total aggregation of foreign income and tax, or should such aggregation be on the basis of territory, type of income, etc.
- How to deal with the position where foreign tax is imposed on a gross basis (i.e. interest withholding tax) in the source jurisdiction, but on a net of expenses basis in the residence jurisdiction. In these circumstances there may be excess foreign tax credits (foreign tax which cannot be relieved) due to the fact that the residence country recognises a much small amount of foreign income than was used to impose tax in the source country.
- How to deal with the position where there is an overall loss in the residence jurisdiction but tax is still payable in the source jurisdiction.
- How to deal with the position where several sources of income are derived in a single source country, but they are taxed at different rates or some items are exempt. i.e. should all of the source country income and tax be aggregated for the purpose of calculating the maximum credit allowable in the residence country, or should each item of income be dealt with separately?

Answer to SEQ 8

Double Taxation Treaties are agreements between two states which are designed to:

(1) Protect against the risk of double taxation where the same income is taxed in two states. This could encourage both inward and outward investments. These can have a positive impact on the economy.

(2) Provide certainty of treatment for cross border trade and investment. Certainty can significantly reduce instances of bribery and corruption.

(3) Prevent excessive foreign taxation and other forms of discrimination against business interests abroad. One of the canons of taxation is equity. All countries strive for quality tax regimes.

(4) Protect the government’s taxing rights and protect against attempts to avoid or evade tax. Tax evasion is a criminal offence in most countries. It denies countries the much needed funds for development.

(5) They also contain provisions for the exchange of information between national taxation authorities. The tax authorities can use the information to capture more taxpayers and increase the tax revenues.

(6) Seek to encourage and maintain an international consensus on cross-border economic activity and to promote international trade and investment. This is very important since the world is almost a global village.

Answer to SEQ 9

(a)

- Tanzania has signed DTAs with nine countries. These are Sweden, Canada, Denmark, Finland, Norway, India, Italy, Zambia and South Africa. Most of the treaties are old and signed in the 1960s, 1970s and 1980s.
- These have remained in force despite the changing economic conditions in Tanzania and globally, including the rapid developments in e-commerce. Their substantive economic value is difficult to measure.
- International treaties signed between and other countries enjoy a special status in Tanzania's legal jurisprudence. International treaties are treated as 'superior' to Tanzanian laws and therefore have significant influence on how Tanzania's laws are drafted and exercised.
- Currently, Tanzania is negotiating nine new DTAs with the Netherlands, Mauritius, United Kingdom, United Arab Emirates, Kuwait, Iran and China. A treaty with Oman has been concluded in 2011 but not yet signed and one with Vietnam was concluded in 2014 but negotiations were re-opened before signing due to changes in Vietnam's income tax legislation.
- So far there are no publicly known DTAs lined up for re-negotiation or cancellation. Publicly available information shows that the last tax treaty to be terminated by Tanzania was with Switzerland. It seems that the reason for termination was that the treaty was applicable to Tanzania as an extension of a tax treaty signed between Switzerland, the United Kingdom and Ireland in 1954.

(b)

- Review the tax rates and taxation rights of current DTAs and cancel all harmful DTAs.
- Impose a moratorium on signing new DTAs and develop a new policy directive for DTA negotiations.
- Ensure parliamentary approval and oversight of all DTAs.
- Invest in capacity building and greater understanding of DTAs within the public administration.
- Adopt a model DTA which favours the taxing rights of source countries.
- Join or form coalitions on common concerns regarding DTA negotiations. These could strengthen Tanzania's bargaining position.
- Invest more in other measures to attract FDI. These measures could include non-tax preferences like government participation in investments.
- Leverage on the current momentum as a popular FDI destination in East Africa to negotiate new DTAs.

Answer to SEQ 10

(a) **Double taxation**

(i) Reason why international double taxation arise.

- International double taxation is a result of overlapping tax jurisdictions due to conflicting source rules among nations.
- Discretion of the country to tax her citizens in whatever manner.In URT, for example, resident person is chargeable on is income accruing or derived worldwide, in which case, double taxation is inevitable. Specifically double taxation arises on the following circumstances

iv) *Resident-resident conflict: Two states may tax a person (individual or company) on his world-wide income or capital because they have inconsistent definitions for determining residence.*

v) *Source-resident conflict: One state may tax income derived by a person by application of the residence or nationality principle, where as another state may tax that same income by application of the source principle.*

vi) *Source-source conflict: Two states may invoke the source principle to tax the same item of income, due to conflict in the way the source of income is determined under their domestic legislation.*

vii) *Triangular Cases: In some cases, a state may have a source-residence conflict with one state and a source-source conflict with another state.*

(ii) Types of payment (or transactions) which may give rise to double taxation/double liability:

- Dividend payment - distribution by non- resident trust
- Dividend income
- Repatriated Income

Answer to SEQ 11

- Double taxation of the same income
  The income of the taxpayer must be subjected to similar tax in Tanzania and a foreign country.

- The foreign income must be part of the total income of the resident person and then the inclusion of foreign income might be causing international double taxation.
- Actual payment of income tax or comparable tax. The taxpayer might show that he/she has paid or will the income tax or comparable tax in a foreign country.
- Only resident person may claim foreign tax relief. The taxpayer must be a resident person in Tanzania for tax purpose to be able to claim the foreign tax relief.
- The foreign income tax paid/payable must be in the same year of claiming the foreign income tax relief.
- Double taxation of the same income. The foreign income tax relief can only granted if it is provided that there was double taxation of the same income.

SECTION C

INTERNATIONAL TAXATION

C4

STUDY GUIDE C4: INTERNATIONAL TAX PLANNING AND AVOIDANCE

Get Through Intro

The amount of taxes that multinational companies pay and the ways in which these taxes are managed across the world are under the most scrutiny in recent memory. The main argument focuses on whether companies are paying their “fair share of tax”.

This Study Guide covers specific issues related to taxation of multinational companies including the instruments used in tax planning. Moreover, anti avoidance measures employed by Courts and Tax Authorities will be discussed.
Knowledge of this Study Guide will not just enable you to pass this exam, but also in your career as a tax consultant.

Learning Outcomes

a) Explain international tax planning and the need for international tax planning
b) Describe tax planning and avoidance techniques employed by multinational firms
c) Describe general anti-avoidance provisions and specific anti-avoidance provisions (anti-thin capitalization, anti-treaty shopping, CFCs rules, transfer pricing etc)
d) Describe judicial anti-avoidance doctrines (Business purpose rule, substance over form principle, sham transaction, step transaction doctrine etc)

Explain international tax planning and the need for international tax planning and describe tax planning and avoidance techniques employed by multinational firms.

[Learning outcome a and b]

1. Explain International Tax Planning And The Need For International Tax Planning

International tax planning is the art of arranging cross-border transactions with the knowledge of international tax principles to achieve a tax effective and lawful routing of business activities and capital flows. The planning process follows the money flows in cross- border transactions, as they pass from the host country where they arise to the home country where they eventually end. Tax planning helps to reduce the cumulative impact of taxation, as compared to the separate tax incidence in the countries through which the transaction flows. Its prime objective is to receive the after-tax flows of overseas income lawfully at minimal cost and risk. Domestic tax planning is concerned primarily with the national rules of tax deductions, allowances and exemptions, and the different tax rates levied on various sources of income in a single jurisdiction. International tax planning examines the interrelationship of two or more tax systems, the impact of juridical and economic double taxation, and the tax compliance rules in more than one country. It also involves additional considerations, such as tax incentives and exemptions for foreign income, availability of foreign tax credits, use of tax treaties and anti-avoidance measures. International tax planning has been defined as a tax-driven proactive arrangement of a person’s affairs to minimize his tax results. It would normally be optimized when the after-tax profit is maximized. Besides reduction in the overall effective tax rate, it may also lead to tax deferral and reduction in tax compliance costs. It not only looks at legal tax-saving opportunities but also at tax risks such as double taxation and prospects of counteracting tax legislation.

1.1 Need for international tax planning

Tax is not usually a primary or overriding factor in the decisions to engage in overseas business activities or to invest abroad. These decisions are generally made on factors, such as business viability, availability of resources, market access and market potential. Other persuasive factors include political and economic stability, government grants and incentives, geographical location, business infrastructure, availability of a skilled and low cost workforce, strong currency, etc. The decisions are (and should be) rightfully based on commercial, economic, and even social and political considerations. However, once the initial decision has been made, tax often becomes an important business consideration. A survey conducted by the Ruding Committee revealed that almost half the multinationals in the European Union considered the tax rate on business profits as a decisive factor in deciding the country to locate their operations. Other key considerations mentioned in the survey were the availability of treaties and the quality of the tax administration. These factors influence the long-term financial viability of the business and the ultimate return on the investment. Generally, cross-border activities suffer a higher tax liability on a worldwide basis than just domestic or single-country transactions. They are subject to tax in more than one tax jurisdiction. Moreover, the taxpayer may have to cope with inconsistent tax laws, erratic tax authorities and high taxes in various jurisdictions. Proper tax planning is, therefore, essential in an international business

to reduce the distortions that arise due to the lack of harmonization in domestic tax systems. Without tax planning, it would suffer from excess tax payments and additional tax compliance costs.

2. Opportunities For International Tax Planning:

There are three levels of tax impact on cross-border transactions, as follows:

(i) Source or host country, i.e. taxes payable on the income earned through overseas subsidiaries or branches, and the withholding tax on the payments made by them;

(ii) Intermediary country (if used), i.e. taxes payable on the overseas income and the withholding taxes on the repatriation of profits or capital to the home country; and

(iii) Residence or home country, i.e. taxes payable on the profits and capital received at home, and sometimes even if not received, from entities in the other countries.

The opportunities for tax planning exist at each level. For example:

(a) The Taxation in the Source Country may be Reduced Through:

i. Local tax planning that optimizes the use of tax deductions, incentives, tax losses and special tax concessions available under the domestic law and tax treaties.

ii. Tax exemptions from the break or “fracture” of the connecting tax factors with either the source or the Residence State (or both).

iii. The use of various planning techniques to ensure that the taxable profits arise outside the country.

iv. The use of tax treaties and innovative planning techniques to reduce the withholding taxes or to obtain a tax-exemption.

v. The selection of the appropriate legal entity (e.g. branch or subsidiary) and the form of financing (debt or equity).

(b) The Intermediary Country Taxation on Remitted Income Flows may be Reduced Through:

i. The use of tax treaties to reduce the withholding taxes in the host country.

ii. The proper selection of offshore financial centres to minimize or avoid the corporate and withholding taxes.

iii. Tax arbitrage through a change in the nature or character of the payments made to the home country.

iv. The use of various tax concessions, such as the participation exemption and EC Directives.

v. The retention of funds offshore for reinvestment abroad or to achieve a tax deferral on remittances made to the home country.

(c) The Taxation on Profits Repatriated to the Home Country may be Reduced Through:

i. The use of appropriate global corporate structures that avoid, reduce or defer the tax liability.

ii. The optimal use of available foreign tax credits and exemptions to reduce domestic tax liabilities.

Describe general anti-avoidance provisions and specific anti-avoidance provisions (anti-thin capitalization, anti-treaty shopping, CFCs rules, transfer pricing etc) and describe judicial anti-avoidance doctrines (Business purpose rule, substance over form principle, sham transaction, step transaction doctrine etc) [Learning outcome c and d]

3. Tax Planning Techniques Employed By Multinational Firms

As the amount of the tax liability is determined by the taxable income multiplied by the tax rate, the reduction in either of the two factors leads to a reduction in the tax payable.

Most planning techniques used **today rely on the following principles:**

i. Exemption from the tax.
ii. Reduction in the tax rate.
iii. Reduction in the tax base.
iv. Deferral of the tax payment.
v. Credit or exemption for foreign taxes paid.
vi. Treaty shopping.
vii. Use of hybrids.

Example:

(a) A State may decide to exempt (i.e. not tax) an income or tax it at a reduced rate for certain tax policy reasons (e.g., tax incentive). The ability to claim tax exemptions normally constitutes the best method of tax planning. The related expenses are generally not deductible, ("tax exemption").

(b) A reduction of the tax rate may be either a reduced domestic rate or a reduced withholding tax. To benefit from a reduced tax rate, the taxpayer may re-characterize the income to a lower rate category, or apply a tax incentive. The lower withholding tax may be achieved again by re-characterization of the income or capital or under a tax treaty. A tax rate reduction is a tax incentive. Tax incentives are offered by probably every country with a tax system, ("rate reduction").

(c) Profits within a multinational organization may be shifted from a high tax to a low tax jurisdiction through appropriate business restructuring or profit extraction techniques. These techniques reduce profits in high-tax countries and increase profits in lower- taxed countries through legitimate shifting of activities within a multinational group. Generally, it is easier to plan for a new income flow to be outside the jurisdiction's tax net than to divert it once it has already been included in the taxable income, and has a tax history, ("base reduction").

(d) A deferral of taxes is useful in so far as it provides for a benefit through a reduction in the time-value of money. Certain income (e.g. dividends) is taxable at home only when it is received. Such income flows may be deferred unless they are required. Some countries regard such deferral as improper and have complex rules to tax them currently if their payment can be controlled by the receiving company, ("tax deferral").

(e) Most countries provide relief for foreign taxes paid on income received at home to avoid double taxation. The amount and the timing of these reliefs vary widely under domestic tax laws of countries. They represent tax benefits that reduce tax at home and often require planning to optimize their use. ("Tax credits and exemptions").

(f) Cross-border payments of passive income are often subject to a withholding tax at source. This withholding tax may be reduced to nil or a low rate of tax under double tax treaties. Prior planning

may ensure that the payment is received in an intermediary jurisdiction where the tax burden is lowest, as "flow-through income". Treaty shopping techniques are widely used with the help of intermediary entities e.g., holding companies, ("treaty shopping").

(g) In recent years, new tax planning techniques have emerged that rely on hybrid situations where the same transaction, instrument or entity is taxed differently in two countries. Their use in tax planning may enable both avoidance of double taxation and also tax arbitrage through double dipping or non-taxation. ("Use of hybrids").

Some common tax planning techniques using these principles are listed below:

(i) The Review of Tax Provisions and Compliance Rules under the Domestic Law ("Domestic Law"):

The starting point for any international tax planning is the knowledge of the tax rules and practices in the various jurisdictions involved in the transaction. Each country has the right to legislate its own tax laws and how they should be enforced. The domestic law and practices alone decide who should be taxed, what should be taxed and how it should be taxed (as well as what is acceptable planning). Tax treaties cannot expand the tax base or generally determine how it should be computed.

(ii) The Reduction of the Pre-tax Profits through Deductible Expenses ("Tax Deductions"):

Several countries give additional tax deductions and allowances under the domestic law to encourage investment, stimulate savings and for other social and political considerations. The effective use of these "tax breaks" can reduce the tax liability.

(iii) The Use of Special Tax Concessions for Foreign Capital, Technology, etc. ("Tax Incentives"):

Many countries grant special tax concessions for foreign capital and technology. The host countries may give incentives to attract them, such as tax holidays or the use of tax-free zones for exports or employment generation. Many of these tax concessions may be given to nonresidents only ("ring fenced").

(iv) The Optimal use of the Tax Loss Carry-overs ("Use of Tax Losses"):

Tax losses represent deferred tax benefits, and tax planning can help to optimize their use. Most countries allow carry-forward of past losses for specified (or unlimited) periods for set-off against future profits. Some of them permit carry-back of losses. Several jurisdictions allow a group of companies to net their taxable profits and losses under "tax consolidation" rules.

(v) The Provision of Special Deductions or Exemptions to Qualifying Dividends ("Economic Double Taxation"):

Many countries give relief under dividend-deduction or participation exemption rules to partly or fully exempt foreign dividends (and sometimes capital gains). Relief may also be given on the dividends through indirect credit for the foreign underlying taxes paid by the subsidiaries, or under the imputation system for domestic dividends.

(vi) The Split of Pre-tax Profits among the Various Tax-beneficial Jurisdictions through Source Allocation ("Profit Diversion"):

The tax base of a multinational organization may be split lawfully by appropriate structuring of the worldwide business activities. For example, the manufacturing unit may be set up in one country, while sales and marketing activities could be conducted through separate overseas entities. The manufacturing activity itself may be split globally. For example, the taxpayer could use a low-tax base for the manufacture of value-adding (and profitable) components or semi-finished goods, and complete the low-profit processing and assembly in a high-tax location, or vice versa. Similarly, construction or assembly projects can be unbundled with separate contracts for each scope of work. A turnkey project may be split into procurement, preparatory studies, technical drawings, engineering and consultancy services, technical support, and supervision activities. Separate agreements may be signed for on-site and off-site work and for the provision of personnel, assembly, installation and testing activities. Separate offshore entities may be formed to hold or manage various assets or to provide group management services. Different group companies in more than one country may handle these contracts.

(vii)The Extraction of Pre-tax Profits from High-tax Countries through Legitimate Tax-deductible Charges or Expenses ("Base Erosion"): International tax planning encourages a shift of taxable profits from high-taxed countries to low-taxed countries through tax- deductible expenses, such as interest, royalties or management fees. The tax base is reduced through a transfer of pre-tax profits under acceptable transfer pricing and commercial substance rules within the group. It may have a licensing company, a research and development company, a regional management or "overseas headquarters company," a service company, a financial holding, etc. Each of these entities may be set up in a commercially appropriate and tax-beneficial jurisdiction. Such tax planning usually requires evidence that the expenses were incurred wholly and exclusively for the business purposes of the paying entity, and on an arm's-length basis. To avoid the transfer pricing issue, it is preferable to ensure that at least one or more group entities in the value chain are unrelated. The expense deductibility may also depend on factors, such as the payment of withholding taxes, reasonableness tests, and full disclosures to the tax authorities.

(viii) The Tax Deferral of Foreign Profits ("Tax Deferral"):

Tax deferral provides a tax saving in terms of the time cost of money. The deferral may be achieved through the setup of intermediary companies, changes in the accounting periods, the use of different legal entities, etc.

The extent of the benefit from the deferral normally depends on four factors:

(a) The amount of foreign income,
(b) The difference between the effective domestic and foreign tax rates,
(c) The length of deferral, and
(d) The interest rate.

The use of an offshore company may allow the retention of undistributed profits abroad to defer the taxation in the home country. The profits may be timed for remittance tax-free when the offshore profits are needed. The deferral of income remittances may not be tax beneficial in all cases. For example, if the effective home tax rate is lower than the tax paid abroad, or if the foreign source income is tax-exempt in the Residence State, the funds may be brought home without tax costs.

(ix) The Optimal use of Foreign Tax Credits ("Tax Credits"):

Many countries provide double tax relief through the credit method. They could be direct credits for withholding tax only, or may include indirect credits on dividends for the tax paid on the underlying income. Some countries give additional tax sparing or matching credits for the taxes that are waived due to incentives. These tax credits are usually given under various limitations and their method of calculation varies widely. Unused tax credits often result in the deferral or loss of these tax benefits. Tax planning can optimise the availability and the use of foreign tax credits.

(x) The Review of Exchange Gains and Losses in Cross-border Transactions ("Exchange Risks"):

Cross-border transactions invariably lead to considerations of foreign exchange gains and losses, and their tax consequences. While many countries treat foreign exchange gains and losses as ordinary income, several countries differentiate them between revenue and capital gains and losses. The tax treatment of the unrealized gains and losses also varies widely. Tax planning can help to ensure that the exchange losses are tax-deductible currently while the gains are tax-deferred.

(xi) The Exemption of Taxable Income due to the Lack of a Connecting Factor with a Tax Jurisdiction ("Connecting Factors"):

Tax authorities cannot impose a tax under domestic law, unless there is a factor connecting the tax subject ("taxpayer") or the tax object ("taxable event") with the tax jurisdiction. Tax planning involves a break or "fracture" of the connecting factors with either the home or host country, or both.

(xii)The use of Appropriate Legal Structure to Achieve the Business and Tax Objectives ("Legal Form"):

Foreign operations may be conducted through varying legal forms of business entities. These legal forms include companies, branches, agencies, licensing or franchise operations, joint ventures, consortiums, etc. Each form has advantages and disadvantages for tax planning. For example, a company is a separate legal entity and its profits may not be taxed on shareholders until they are distributed as dividends. A branch operation is an integral part of the enterprise and is usually taxable in both the host and home jurisdictions. A branch may, therefore, be used to claim tax deductions at home during the start-up loss period, and converted into a subsidiary when the operations are profitable. International tax planning may also take the form of hybrid entities that take advantage of differing entity characterization in various jurisdictions. For example, an entity may be taxable as a company in one country and as a fiscally transparent partnership in another country.

(xiii) The use of the Optimal form of Financing to Minimize Taxation ("Debt or Equity"):

Although the form and mix of financing is based on commercial considerations, the choice impacts the tax liability. Generally, loan capital is both more flexible and tax advantageous, while equity may be preferred commercially. Dividends are usually subject to a higher tax than interest.

Dividends are paid out of post-tax income while interest is a tax-deductible expense. The form of financing may also involve hybrid instruments, which combine the benefits of debt and equity. Tax planning should also consider the form and currency of the equity and debt instrument and where the funds are lent or borrowed.

(xiv) The use of Tax Treaties to Avoid or Reduce Taxation ("Treaty Planning"):

Active business income is not taxed in the source State unless there is a permanent establishment. If it exists, only the income attributable to it is taxed. It is possible to avoid taxation if the place of business does not constitute a permanent establishment under a treaty. Moreover, withholding taxes on various passive forms of income may be reduced under tax treaties. A reduction in the foreign withholding taxes decreases the total tax liability if the income received is tax-exempt at home. Under the credit relief method it avoids excess foreign tax credits.

(xv)The use of "Third Country" Tax Treaties to reduce Taxes ("Treaty Shopping"):

Treaty shopping can help:

(a) To reduce withholding taxes,
(b) To avoid or defer remittances of taxable income to the home country,
(c) To help maximize foreign tax credits through dividend mixer companies,
(d) To avoid or defer capital gains tax on the sale of investments abroad, etc.

The use of intermediary treaty havens can help to reduce or eliminate the withholding or other taxes in the source country with little or no additional tax costs. They may reduce the tax through either "direct conduits" or "stepping-stone conduits". The essential difference between the two methods is that the direct conduit method makes use of an exemption from tax in the intermediary country, while the stepping-stone method reduces the tax liability in that country through a counterbalancing expense.

i. **The availability and use of Advance Tax Rulings ("Tax Rulings"):** International tax planning is not risk-free. It is subject to changes in tax rules and practices, as well as differing interpretations by tax authorities and judicial decisions in various countries. Several jurisdictions give advance tax rulings on the tax treatment of cross-border transactions. They vary from the formal and comprehensive guidance under specific legislation to informal advice given by tax authorities without statutory obligation. These advance provide tax certainty to tax planning.
ii. **The Selection of Tax-beneficial form of Transaction or Re-characterization of Transactions ("Tax Arbitrage"):**

The income from the same transactions can often be structured differently for tax purposes (e.g., as sales, royalties, commissions, interest or service fees, etc.) by the taxpayer. Thus, it may be possible to select a tax-beneficial income type or to re-characterize the income subsequently through tax planning. The re-characterization can alter the applicable tax provisions for calculating the tax, credits or refunds.

iii. **The Review of the Cross-border Transactions from Host to Home Jurisdiction ("Holistic Planning"):**

The tax planning should follow the cash flow of the transaction from the host country where it arises to the home country where it ends (including intermediary jurisdictions, if used). Generally, cross-border transactions suffer a higher overall tax than just domestic transactions. The objective should be to reduce the aggregate tax liability to at least the domestic level, or less, and thereby maximise the net-of-tax return.

iv. **The Compliance with Domestic Tax Law and Anti-avoidance Measures in Various Jurisdictions ("Anti-avoidance Measures"):**

Most countries have enacted complex tax rules to protect their domestic tax base. These anti-avoidance rules include transfer-pricing norms, anti-deferral or controlled foreign corporation rules, anti-treaty shopping rules, thin capitalization rules and various general and specific anti-abuse provisions.

v. **The Effective use of Advisors on Tax Laws and Practices in Various Jurisdictions ("Tax Advisors"):**

International tax planners often face problems due to lack of reliable and up-to-date tax information on various jurisdictions. Tax planning usually requires specialist knowledge of the tax laws and practices in various countries, and the related tax treaties.

Tax laws, treaties and practices are constantly changing, and are difficult to monitor. Moreover, they may be changed in future, either prospectively or retrospectively. A timely review of the plan with tax advisors in the various jurisdictions involved in the transaction is an essential tax planning measure.

3.2 International tax planning- a methodology

Any person engaged in international tax planning must comply with the important things as follows:

Step One: Analysis of existing database

- Determine the facts, and applicable tax and non- tax
- Determine fully the host-to-home transaction
- Review the domestic law and the tax treaties in each jurisdiction
- Compute the tax liability and other costs
- Perform cost-benefit analysis

Step Two: Design of tax planning options

- Introduce multilateral or global tax planning
- Identify suitable foreign intermediary countries
- Select the form of transaction, operation, or relationship
- Examine relevant non-tax factors
- Check the availability of advance rulings
- List all tax planning options

Step Three: Evaluate the plan

- Determine the tax savings and non-tax costs if
  - (i) The plan is not adopted,
  - (ii) The plan is adopted and succeeds, and

(iii) The plan is adopted and fails.

- Compute the total costs from host-to-home
- Select the best tax option

Step Four: Debug the plan

- Get local advice on tax laws and practice
- Obtain advance rulings, wherever possible
- Check the applicability of treaties and protocols
- Determine validity of entities in the jurisdictions
- Check compliance with anti-avoidance rules
- Evaluate any significant risks or disadvantages
- Review the long term benefits and costs

Step Five: Update the plan

- Review regularly changes in tax laws, treaties and tax practices
- Amend the plan accordingly

4. General Anti-Avoidance Provisions And Specific Anti-Avoidance Provisions

Anti-avoidance rules are rules that allow the tax administrators to re-characterise any transaction that have been entered into mainly for the purpose of obtaining an undue tax benefit. These rules can either be specific or general rules, or as well as judicial doctrines and principles adopted in the statutes.

4.1 *General Anti-Avoidance rules (GAAR)*

Many countries have what is known as the general anti-avoidance rule in their tax statutes. This is a rule that is used to regulate any transaction, or arrangement that the tax administration feels is a tax avoidance arrangement. This rule tries to capture all foreseeable tax avoidance arrangements. A GAAR is typically a statutory rule that empowers a revenue authority to deny taxpayers the benefit of an arrangement that they have entered into for an impermissible tax-related purpose.

This rule also incorporates the judicial anti-avoidance concepts of developed over many years. For example, in examining tax avoidance arrangements, tax administrators should consider the business purpose rule of the transaction.

The form and substance law also implies that the administration can overlook the form, or legal contracts and instead consider the substance of the transaction. For example, management contracts provided by a parent company, that then receives some services from the recipients of the management service can have its contract over looked, because the aim of such a contract could be a sharing or transfer of expenses and profits and not service provision.

The doctrine of the label has also been incorporated in the GAAR in some countries. This doctrine is used to re-characterise transactions that the tax administrator feels were wrongly characterized. This may happen when upon provision of a service, the parties characterize a service, for example as provision of management service while it should be a technical service which attracts a technical fee for withholding tax.

4.2 Specific anti-avoidance rules (SAAR)

Most countries have enacted in their tax statutes some so specific anti-avoidance rules to aim at certain specific transactions that are considered to be used for tax avoidance. In terms of management contracts, these transactions are not specified but the scheme through which they are provided for are specified. Some of the rules include the following:

a) **Transfer pricing rules**

These are rules put in place to counteract intercompany transfers of prices for tax benefits. This is done to prevent taxpayers from carrying out transactions that are not at arms length. This concept has already been discussed above. For example, Tanzania has enacted a specific transfer pricing rule as shown in Section 33 of the Income Tax.

b) **Controlled foreign corporation**

Some countries use the CFC rules to counteract the use of management contracts in an tax avoidance measure. This happens to prevent the diversion of passive and certain income to, and accumulation of such income, in a controlled corporation established in a tax haven. If a management company is incorporated in a tax haven, it is possible for shareholders to earn income passively from its management fees it receives from other entities in other countries, and hence CFC rules can be used to counteract that. In Tanzania, these rules are provided for in Part VI, division III of the Income Tax Act, from Sections 73 to 76.

c) **Anti-thin capitalization**

Thin capitalisation rules often operate by limiting, for the purposes of calculating taxable profit, the amount of debt that can give rise to deductible interest expenses. The interest on any amount of debt above that limit (excessive debt) will not be deductible for tax purposes

d) **Anti-haven rules**

Several jurisdiction have incorporated in their domestic law's provisions that prevent the use of tax havens and that cost and expenses are not deductible if they arise from transaction with entities that are located in tax havens, however the deduction can only be allowed if resident company can prove the non-resident company actually and mostly carries on business and it has in fact been conducted.

(e) **Anti-treaty shopping**

These rules are called limitation on benefits provision where a third party that's not subject to treaty cannot benefit from that particular treaty in many countries this concept is included in tax treaty agreements with other countries it limits benefits under treaty in certain circumstances.

5. Judicial Anti-Avoidance Doctrines

Courts have stated certain principles intended to curb tax avoidance. They have stated doctrines or General Anti-Avoidance Rules (GAAR). Three main guiding principles are:-

(a) *The Business purpose Rule*.
(b) The substance or form rule.

(a) The Business Purpose Rule:

The business purpose rule attacks tax avoidance schemes that do not have a business purpose and those artificially designed merely to avoid tax. Under the business purpose doctrine, a transaction must have a main or predominant business purpose (i.e. commercial justification) other than tax avoidance. The mere tax advantage cannot be an acceptable business purpose; it must show a business or non-tax purposes. Thus, it must have a valid business or economic purpose other than reduction of tax liability. If the primary purpose is something other than tax avoidance, the transaction represents acceptable tax planning. On the other hand, if the primary purpose is to obtain tax benefits and the transaction would not be carried out without those benefits, the transaction is treated as unacceptable tax avoidance.

(b) Substance over Form Rule:

Under the substance over form principle, the acts must be assessed according to bona fide economic and commercial substance and not the formal content. It requires establishment of the underlying economic reality. Under the substance over Form Principle there are 4 doctrines.

(i) **Lack of Economic Substance.**

It applies where due to the legal form used for the transaction a taxpayer has the real economic power over the taxable income without the tax liability.

(ii) **Sham Transactions:**

Sham transactions refer to transactions where the parties say one thing while intending another. In a Sham Transaction, they give effect to a transaction, which they do not carry out, or do not intend to carry out. The transactions are said to have happened that have not really happened, or are a cover up for another transaction. In short, they do not crate the legal rights and obligations, which they give the appearance of creating, since the relationships that are alleged to exist do not exist. A sham transaction hides the economic reality of a transaction that exists only in form.

For example, an entity may be legally set up as a partnership but it is not intended to operate as a partnership. Similarly, an employee may be deemed as an independent contractor. In a sale and lease back transaction; the transfer of the related rights and obligations of ownership may not accompany the sale of assets. Where the court holds that a transaction is a sham, they normally apply the tax rules based on the true economic position. The form of the transaction is disregarded when compared with the underlying substance.

(iii) **Doctrine of Label**

The parties use an incorrect "label" or description to classify the nature of the actual rights and liabilities in a transaction. Unlike a sham, the transactions do create rights and liabilities which do exist or which are not different from those that actually do exist. They are not artificial or fraudulent. For example, a loan may have a non-arm's length rate of interest and no repayment terms. The label may describe the transaction as a loan when it should be treated as equity. In Ridge Securities vs IRC 44 TC 373, the court rejected a loan with interest at over 400% per annum as a loan transaction. In Council of India vs. Scobie 4TC 618, the court rejected a purchase consideration described as an annuity payable over a period of 47 years. The doctrine has also been involved to decide the price allocations in composite transaction. In Vestey vs. ITC [1949] 40 TC 112, the taxpayer had agreed to sell his shares at a consideration payable over 125 yearly installment, and treated the entire price as a capital receipt. The court held that a proportion should be treated as an interest payment. The label that the parties chose to attach to their payments was not conclusive of their character for tax purposes.

(iv) **The Step Transaction Doctrine:**

A step-transaction-doctrine has evolved which regards a series of connected transactions as a single transaction under the 'substance-over-form" principle. In a step transaction, the intermediate steps in a chain of pre-ordained, even if bona fide, transactions may be disregarded and several related transactions treated as a single composition transaction. Alternatively the transaction may be broken into its distinct steps to determine their acceptance for tax purposes. The step transaction doctrine maintains that "purely formal distinctions cannot obscure the substance of a transaction."

Self-Examination Questions

Question 1

(a) Explain why some jurisdictions consider it appropriate to enact "thin capitalisation" provisions or publish administrative guidance to address the issue of "thin capitalisation".

(b) Give examples of different means by which "thin capitalisation" provisions or guidance might determine the amount of excessive interest expenses.

(c) Some "thin capitalisation" provisions are concerned only with limiting the deductibility of interest on debt between related parties. Is such a limitation logical, particularly when applied in the circumstances of a corporate group carrying on substantial business activities in a large number of jurisdictions? Explain your answer.

Question 2

(a) Describe what is meant by the term "transfer pricing" and explain why it is a major issue in international taxation.

(b) Give two examples of how a transfer pricing arrangement might work.

(c) Do you agree with the statement that "*the principal means of countering transfer pricing arrangements is through the entering into of double taxation agreements based on the OECD Model Agreement*"? Explain your answer.

Question 3

Describe how a Tanzanian resident subsidiary of a Multinational Foreign Corporation can use each one of the practices outlined below to reduce its liability to Tanzanian income tax and hence the tax liability of the group as a whole and discuss how the arm's length principle is applied to prevent such practices:

(i) Obtaining excessive debt finance from foreign members of the group.
(ii) Making low interest loans to foreign members of the group.
(iii) Transfer pricing policies for transfers of goods within the group.

Question 4

Thin capitalisation rules in a host state's domestic legislation can represent an obstacle which companies need to carefully consider before setting up their funding strategy for a new project. However, the complex variety of funding alternatives can be seen as an opportunity to plan a company's funding operations in order to preserve the tax utilisation of paid interest expenses.

Required:

(a) Explain what is meant by 'thin capitalisation rules', and discuss the different ways in which thin capitalisation rules may introduce limitations for companies, and their tax effects.

(b) Discuss possible planning alternatives which may be used to bypass thin capitalisation restrictions.

Question 5

At a dinner party, the chairman of a group whose trading activities are solely in the Tanzania says to you that "it is not fair that multinational groups can plan their way out of a tax charge in the Tanzania whereas Tanzanian domestic groups have to pay all their taxes. It's not an even playing field".

Required

Using examples of anti-avoidance legislation, explain how the Tanzanian tax system tries to make it an 'even playing field' between Tanzanian domestic and multinational businesses.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) "Thin capitalisation" generally refers to the situation where a company is financed excessively with debt as opposed to equity. Thin capitalisation provisions seek to counter such practice by deeming interest on some debt to be non-deductible, essentially on the basis that such debt is to be treated as equity. Some countries believe that thin capitalisation provisions are appropriate because of the relative tax advantages of financing an operation in their country by debt rather than equity. Typically, the advantages of debt financing compared to equity financing are as follows:

- Interest on debt is typically deductible, whereby dividends paid on equity are nondeductible. Accordingly, the use of debt funding tends to reduce the tax collected by the country in which an investment is located.
- Withholding tax rates on interest are often lower than the rates on dividends. This leads to a further erosion of tax collections in the jurisdiction of an investment when that investment is financed predominantly by way of debt.
- Although not relevant in the jurisdiction of the investment, the benefits of debt financing may be offset by the fact that interest will typically be assessable in the hands of the recipient, whereas dividends often qualify for concessional treatment. Nonetheless, it is sometimes possible to provide the debt through a group finance company in a low tax jurisdiction, or through the use of a hybrid entity whereby the interest is treated as a dividend to the recipient.

(b) The key to "thin capitalisation" provisions is establishing the amount of debt the interest on which will be allowed as a deduction, or alternatively the amount of allowable interest expenses. There are a number of ways of doing this. In particular:

- Traditionally, in many jurisdictions the amount of debt on which interest is an allowable deduction has been determined by specifying a maximum debt equity ratio for the company. For example, the provisions might specify that interest on debt of no more than three times the equity will be allowed to be deducted. This requires a careful definition of the terms "debt" (whether all debt, related party, foreign lenders, etc.) and "equity" (whether retained earnings, provisions, convertible debt, etc. is included).
- An alternative approach is to adopt rules similar to the US earnings-stripping provisions where interest deductions are limited to a percentage of the net profit before interest.
- Finally, a more modern approach to determining the acceptable level of debt funding (or gearing) which recognises that different groups and industries have different approaches to finance, is to allow a debt-equity ratio in a jurisdiction based on the group's overall debt: equity ratio. So if, for example, a multinational group has an overall debt-equity ratio of 7:3, this could be the starting point for determining an acceptable ratio in a particular jurisdiction.

(c) If a jurisdiction is concerned that inbound investment is being funded excessively by debt and that not enough of the group's equity is being allocated to the jurisdiction, it is not logical to apply restrictions only to related party debt. To do so implicitly treats the problem as one of narrow tax planning by the group. In particular, the benefits of debt funding to a taxpayer in a jurisdiction apply irrespective of whether the debt is from a related party. Indeed, bank debt in many cases provides for greater benefits than related party debt because it sometimes attracts lower rates of withholding tax. From the perspective of a multi-national group which has significant overall borrowings, financing an investment in a foreign jurisdiction with a high level of borrowings is simply a matter of allocating a disproportionate share of the aggregate borrowings to that jurisdiction. Put another way, a group

financed with a mixture of debt and equity can, in the absence of relevant thin capitalisation rules, choose to allocate its total equity and total debt between jurisdictions in a tax efficient manner. Accordingly, focusing solely on related party debt does not properly address the issue of thin capitalisation. For this reason, some jurisdictions now look to all debt when applying thin capitalisation restrictions and seek to measure the gearing ratio in the jurisdiction to the groups global gearing ratio. A further reason why looking only to related party debt is not logical is that in the absence of effective anti-avoidance provisions (either general or specific to the thin capitalisation provisions), circumventing the restrictions by interposing an unrelated party (such as a bank) in the transaction would appear to be relatively straightforward.

Answer to SEQ 2

(a) Transfer pricing usually refer to the setting the terms of transactions between related parties on a non-arm's length basis in order to move income, profits or expenses between group companies which suffer different tax rates so as to reduce the overall tax burden of a corporate group. The types of transactions which may be subject to transfer pricing arrangements include the sale of goods, the provision of services, the sharing of expenses, the apportionment of profits between jurisdictions and interest on loans and advances. A transfer pricing arrangement may also involve the interposition of a company in a zero tax jurisdiction between two other group companies in order to derive a portion of the overall profit from a transaction in a manner whereby no tax is suffered. If there were no limits on transfer pricing, corporate groups acting rationally would shift all profits away from high tax jurisdictions to low or nil tax jurisdictions.

(b) There are numerous examples of how a transfer pricing arrangement may work including the following:
- Sale of goods from a high taxed company to a low taxed company at an artificially reduced price.
- Loaning money from a high taxed company to a low taxed company at an artificially low interest rate.
- Provision of management services by a low-taxed company to a high taxed company at an artificially high price.

(c) Disagree. The principal means of countering transfer pricing is through domestic tax law provisions addressing the issue. Nonetheless, because transfer pricing is fundamentally a cross-border issue, the OECD has taken an interest in the issue. In particular, the OECD has published guidelines for determining arm's-length prices in an effort to encourage all countries to adopt a consistent approach to the question and, therefore, minimise double taxation which may otherwise arise where countries adopt different bases for determining such prices. The OECD has also worked to ensure that the OECD Model DTA does not prevent the application of domestic transfer pricing provisions, but also that where justified transfer pricing adjustments are made by one jurisdiction, the other jurisdiction will make corresponding adjustments to the taxation of the related party. Accordingly, although the OECD promotes the adoption of fair transfer pricing rules and the inclusion of associated provisions in DTAs, these measures are not the primary means of countering transfer pricing. Rather, domestic tax legislation is the principal means by which transfer pricing is countered.

Answer to SEQ 3

(i) **Excessive debt finance from foreign members of the group**

Multinational companies are motivated to finance their foreign subsidiaries through loans rather than share capital because in many jurisdictions including Tanzania, interest paid on loan finance

is allowable, whereas, dividends paid to equity providers are not. As a result, when a Tanzanian resident subsidiary of a foreign multinational is heavily financed by debt obtained from foreign members of the group, its taxable profit will be substantially reduced by interest payments made on such loans. To prevent huge reductions of taxable profit by way of interest deductions, thin capitalisation rules are put in place. These rules limit the amount of interest that would be allowed as a deduction when computing taxable business profits. This is done by not allowing as an expense, the amount of interest paid when the company's debt equity ratio exceeds a certain limit. In Tanzania, some mining companies are subsidiaries of foreign companies. These foreign companies may finance the subsidiaries through high level of debt. Interest on such loans will only be allowable as an expense when the debt equity ratio does not exceed the ratio 3:1. When the amount of debt obtained results in this ratio being exceeded, then interest on the excess debt is not an allowable deduction.

(ii) **Cheap loans to foreign members of the group**

Making loans at an interest rate which is lower than the commercial rate has the effect of reducing the taxable profits for the company receiving the interest. This is because the taxable profits will be lower than they should have been if the higher interest or commercial rate had been used. A Tanzanian resident subsidiary can therefore substantially reduce its tax liabilities by making loans to foreign members of the group and charging a reduced rate of interest on such loans. When a Tanzanian resident company makes a loan to a foreign related company, it must charge interest on such a loan at a commercial rate. When the interest rate charged on such a loan is less than the commercial rate, the company receiving the interest is deemed to have received the interest at the commercial rate.

(iii) **Transfer pricing policies**

Multinational companies may produce goods in one country which are then transferred for sale to other countries. Multinational companies may manipulate the transfer price so that profits arise in a country where the rates of taxation are lower so that the overall tax position of the group is minimised. A Tanzanian resident subsidiary may therefore transfer or sale goods to a foreign member of the group at a price which is lower than the market value of those goods therefore reducing the taxable profit of the Tanzanian resident company. This will normally be in a situation where the tax rates that apply in the country in which the foreign company operates are lower than those applying to the Tanzanian resident company. Alternatively, the Tanzanian resident may purchase goods from foreign members of the group at a price that is higher than the market price so as to increase cost of sales and thus reduce taxable profit. Anti-avoidance legislation attempts to prevent a company from transferring goods out of the country at a price which is lower than the market price of those goods. As such, when a Tanzanian company is required to transfer goods produced in Tanzania to a company that is resident abroad, then the transfer price should be equal to at least, the market value of the goods. When the transfer price is lower than the actual market value of the goods being transferred, then the profit element must be added when computing taxable profits.

Answer to SEQ 4

(a) The thin capitalisation restrictions are domestic provisions introduced by different States to avoid a company with a small amount of capital or equity to contract big amounts of debt from a group or related company and accumulate tax deductible interest expense which reduce the amount of tax collected by that State. The principle behind the restriction is that under normal market rules a

company with no assets should not be able to secure large amounts of debt from third parties and therefore the use of company loans may be being used only to obtain unlawful reduction of the tax normally due in the host jurisdiction. The effect of the thin capitalisation provisions applying is that the company will see denied the tax deduction for any interest expense which exceeds a certain threshold or does not comply with the requirements of the provisions. As a general rule any disallowed interest can be carried forward for the following years. In some countries the rules may be extended to third parties loans where there is an influence of group companies in the obtaining of said loan. The more common examples of this is the granting of a guarantee by a parent group company or a back to back loan. Many countries use a debt to equity ratio to determine what would be an acceptable amount of debt under the thin capitalisation provisions. This ratio is normally around the 3:1 mark but it can be higher or lower depending on the jurisdiction. Some countries complement their thin capitalisation rules with an earning stripping rule. In this case a lower debt to equity ratio (e.g. 1.5:1) is put in place where the company receiving the interest payment is not subject to tax in the same Country as the company paying the interest (e.g. USA). Other companies use the transfer pricing provisions as criteria for the analysis of acceptable amounts of debts. Where the amount of debt exceeds what would be authorized to an independent party the corresponding interest expense will be disallowed as a tax deduction (e.g. UK). In some countries the thin capitalisation legislation allows the company obtaining the loan and the tax authorities to enter into an advance agreement on the acceptable amounts of debt either through a specific advance thin capitalisation agreement or through an Advance Pricing Agreement. The thin capitalisation analysis can also in some cases consider the worldwide situation of the group by comparing the amount of debt obtained by all the companies in a certain jurisdiction exceeds a determined percentage of the overall group worldwide gross external debt and disallows any interest expense exceeding this percentage (e.g UK). Other criteria used by some jurisdictions to kick-in thin capitalisation provisions is the debt to EBITDA (earnings before interest, tax, depreciation and amortization) ratio or the debt to assets ratio. In this countries the net interest expenditure in excess of a determined percentage of a company's EBITDA or total assets will be disallowed. This can apply to third parties or related companies loans (e.g. Germany and Denmark).

(b) Potential alternative structures for funding outside the thin capitalisation provisions include:

- Sale and lease back agreements where the group company buys an asset from its subsidiary and then leases the asset back to the seller. This is normally qualified as an operating lease which as a general rule will not be considered debt under the thin capitalisation provisions.
- Debt factoring where the subsidiary sells its trade receivables for future payments or doubtful debts at a discount considering its book value given that it will receive the payment immediately. It is important this operation follows the transfer pricing provisions and market conditions which would apply between independent parties.
- A back to back loan where the group company intervenes in the relationship between the bank and the subsidiary by guaranteeing the loan through a deposit made with the same bank in another jurisdiction or through the granting of parent company guarantees. In some situations a fee may be charged to the subsidiary which could also be tax deductible in the host jurisdiction.
- The group company may increase the equity portion of its subsidiary either through cash or assets contributions so that it can comply with any debt to equity ratios applicable under the thin capitalisation provisions.
- The parent company and subsidiary may agree on fees due for financial services as cash pooling treasury management, foreign spot transactions, currency purchase agreements, swap

transactions which will not as general rule be qualified as interest expense. However, some jurisdictions may include these fees in the definition of interest for thin capitalisation purposes.

- The group company may provide a smaller loan at a bigger interest rate assuming the transfer pricing principles allow for this rate considering the market and risk aspect of the loan.

Answer to SEQ 5

It is a fairly common view that multinational companies are able shift profits and reduce their taxes, for example by operating in low tax jurisdictions, or having a complicated group structure, which gives rise to an advantage over domestic businesses.

However, there is significant anti-avoidance legislation in place, together with new legislation coming in that tries to ensure there is more of a 'level playing field'. This legislation is discussed below:

(i) Controlled foreign corporation

Rules are in place to prevent companies from diverting activities from the Tanzania and operating through companies in low tax jurisdictions. The rules work by apportioning profits of companies that don't meet the exemptions and have profits that pass through 'gateways', to the Tanzania Company. The rules are seeking to ensure that the equivalent Tanzania tax is paid on profits that are being artificially diverted from the Tanzania.

(ii) Permanent establishments (PE)

It is often believed that if a company operates through a low tax jurisdiction then it will not be subject to Tanzania tax. However permanent establishment rules ensure that if a non-resident company is either operating through a fixed place of business in the Tanzania, or carries out business through a dependent agent, they will be liable to Tanzanian tax. The Tanzanian tax paid is based on profits that would be attributed to the Tanzania activities if it was a separate and distinct enterprise.

(iii) Transfer Pricing

If a Tanzanian resident company pays for services or goods from an overseas connected company, then if it pays a price that is above what would be paid from an unconnected company, this could give rise to a Tanzania tax advantage. This is because profits would be artificially reduced. However transfer pricing seeks to ensure prices are based on arm's length rate. Companies must document why a price has been selected and demonstrate that it is arm's length. The rules apply to all transactions such as :

- Services
- Goods
- Loans {rates, terms and amounts]
- Intellectual Property
- Intangibles

(iv) Thin capitalization

Thin capitalization rules are linked to transfer pricing. They ensure that companies are not 'excessively' leveraged. If a company has a level debt that would not arise had it lent from a third party, then the excess interest is not allowed as a deduction.

SECTION C

INTERNATIONAL TAXATION

C5

STUDY GUIDE C5: TRANSFER PRICING

Get Through Intro

Every country is entitled to its due share of tax revenues. On account of globalisation of business, persons who operate in various countries can so arrange their affairs, that profits can be **transferred** from a high tax country, to a low tax country. This causes loss of tax revenue to the Government.

This Study Guide covers discussion of transfer pricing problem, the standards and methods used by multinationals in setting transfer prices that are acceptable for taxation purposes. The guide also covers discussion on other aspects of transfer pricing like APA, TP documentation and TP on specific transactions.

Learning Outcomes

a) Discuss the meaning of transfer pricing
b) Discuss the rationale for introduction of transfer pricing regulations in Tanzania
c) Describe the provisions of the Tanzania Transfer Pricing Regulations
d) Describe recommended transfer pricing methods (comparable uncontrolled price; resale price; cost plus; profit split; transactional net margin; other methods of transfer pricing.)
e) Explain the basic comparability factors in the process of TP benchmarking
f) Explain and illustrate Functional analysis
g) Explain the provisions relating to Advance Pricing Agreement
h) Explain the provisions relating to Safe Harbours'
i) Outline the basic documentation requirements for transfer pricing benchmarking
j) Describe specific transactions
   - Intra-group service
   - Intangible property

Discuss the meaning of transfer pricing; discuss the rationale for introduction of transfer pricing regulations in Tanzania and describe the provisions of the Tanzania Transfer Pricing Regulations.

[Learning outcome a, b, and c]

1. Meaning Of Transfer Pricing

Transfer pricing usually refer to the setting the terms of transactions between related parties on a non-arm's length basis in order to move income, profits or expenses between group companies which suffer different tax rates so as to reduce the overall tax burden of a corporate group. The types of transactions which may be subject to transfer pricing arrangements include the sale of goods, the provision of services, the sharing of expenses, the apportionment of profits between jurisdictions and interest on loans and advances. A transfer pricing arrangement may also involve the interposition of a company in a zero tax jurisdiction between two other group companies in order to derive a portion of the overall profit from a transaction in a manner whereby no tax is suffered.

2. Rationale For Introduction Of Transfer Pricing Regulations In Tanzania

Transfer pricing is the general term used to refer to the problem of allocating profits among the parts of a corporate group. Companies which have subsidiaries resident in countries with lower corporate tax rates may attempt to divert profits by inter-company pricing arrangements. This would result in reduced tax liabilities for the whole group and normally loss of significant tax revenue to the country. Transfer pricing rules therefore act as anti-avoidance rules meant to protect government tax revenues. Countries are enacting general provisions in their tax laws directed against tax avoidance, which give powers to reconstruct transactions. It seems to be increasingly accepted by the OECD that such rules are not in conflict with tax treaty obligations and can be applied to international transactions. In general, rules prevent a company to transfer goods from one country to another at a price that is lower than the market price of those goods. In most countries, including Tanzania, when transfer prices are lower than the actual market values of the goods being transferred, then the profit element must be added when calculating the taxable profits. Similarly, when loan interest is charged at less than the commercial lending rate, the company receiving the said loan interest is deemed to have received interest at the commercial rate.

The objectives of the transfer pricing regulation are to:

(i) Ensure that Tanzania is able to tax on an appropriate taxable basis corresponding to the economic activities deployed by taxable persons in Tanzania, including in their transactions and dealings with associated enterprises;

(ii) Provide the Tanzanian authorities the tools to fight tax evasion through over or underpricing of controlled transactions between associated enterprises;

(iii) Reduce the risk of economic double taxation.

(iv) Provide a level playing field between multi-national enterprises and independent enterprises doing business within Tanzania; and

(v) Provide taxable persons with certainty of transfer pricing treatments in Tanzania.

3. Provisions Of The Tanzania Transfer Pricing Regulations

Tanzanian Transfer Pricing Regulations contain set of 16 regulations arranged under 6 main parts as follows

- ✓ Part I: Preliminaries(Regulation1-3)
- ✓ Part II: Arm's Length Principle(ALP),Comparability, Methods, Documentation (Regulation4-7)
  - The regulations require transactions between associates to be consistent with the arm's length principle. They empower the Commissioner to make adjustments when transactions are not in line with ALP.
  - To establish if transactions are in line with the ALP principle appropriate transfer pricing method shall be used.
  - Five TP methods: Traditional Transaction Methods (Comparable Uncontrolled Price (CUP); Resale Price; Cost Plus;) Transactional Profit Methods (Profit Split; Transactional Net Margin Method ;) any other method prescribed by the Commissioner.
  - Non compliance attracts a penalty of 100% of the under paid tax-charged for any transfer pricing adjustment made as part of a tax audit.
  - The method used should lead to a price that is consistent with the price charged between independent persons dealing with comparable uncontrolled transactions in comparable circumstances.
  - Comparability should be assessed using 5 factors: Characteristics of Property or Services; Functional Analysis (functions performed, assets used risks taken);Contractual Terms; Economic Circumstances; and Business Strategies.
  - Any uncontrolled transactions may be used as a comparable when there is similarity in the 5 comparability factors with the controlled transaction. Differences should be ignored if not material to affect price, cost or profit of the transactions or reasonable accurate adjustments can be made to correct the differences.
  - Contemporaneous transfer pricing documentation is required to be prepared before the tax return is submitted.
  - The regulations do not require the transfer pricing documentation to be submitted with the tax return, but stipulates that it should be provided to the tax authority within 30days when requested.
  - Non-compliance with transfer pricing documentation requirement attracts a penalty which includes imprisonment for a maximum of 6 months and/or a fine of not less than 50m Tanzanian shillings on conviction.
  - Information to be included in the transfer pricing documentation include :the organizational structure; the nature of business or industry and market conditions, the controlled transactions, strategies and assumptions used to set the price; comparability, functional and risk analysis; selection and application of the transfer pricing methods etc.

- ✓ Part III: Branch, Head Quarters persons, OECD/UN documents (Regulation8-9)
  - That a branch shall be deemed to be a separate and distinct person from its Head Quarter
  - That the regulation shall be construed in a manner consistent with the arm's length principle in article 9 of the OECD /UN Model of Tax Convention on Income and Capital and OECD TP Guideline and UN –TP Practical Manual.
- ✓ Part IV: Intra group services, Intangible property (Regulation10-11)
  - Regulations10 and 11 deals with intra group services, intangible property and intra group financing.

- It requires a demonstration by a taxpayer that intra group services have been rendered and intangible property has provided economic benefit or commercial value to the business.
- Further, the charge made should be justifiable and at arm's length.

✓ Part V: APAs and Corresponding adjustments (Regulation 12-13)

- The Tanzania transfer pricing regulations allows taxpayers to apply for Advance Pricing Arrangements ("APA").
- APAs are a good provision given the increasing number of appeals against TRA adjustments. The APA shall only be valid for future periods and for a maximum period of 5years with annual compliance requirements.
- The regulations allow corresponding adjustments with associates in countries with DTA with Tanzania.

✓ Part VI: General (Powers of the Commissioner, Revocations) - (Regulation 14-16).

- The Commissioner has power to make adjustments where he believes that transactions are not at arm's length.

Describe recommended transfer pricing methods (comparable uncontrolled price; resale price; cost plus; profit split; transactional net margin; other methods of transfer pricing; explain the basic comparability factors in the process of TP benchmarking and explain and illustrate Functional analysis.

[Learning outcome d, e, f, and g]

4. Recommended Transfer Pricing Methods

Organization for Economic Co-Operation and Development (OECD) has provided guidelines to both multinational corporations and tax authorities about transfer pricing methods to minimize international double taxation and tax avoidance. Basically, the guideline explains five transfer pricing methods; which can be used to gauge whether transfer prices are in conformity with the arm's length principle.

These five methods are:

- the comparable uncontrolled price method,
- the resale price method,
- the cost plus method,
- the transactional net margin method and
- the transactional profit split method

The first three methods are commonly known as „traditional transactional methods‟. Although the taxpayer is given the right to choose any method, the emphasis should be on arriving at an arm‟s length price. It is advised that methods (iv) and (v), commonly referred to as „transactional profit methods‟, be used only when traditional transactional methods cannot be reliably applied or exceptionally cannot be applied at all. This will depend heavily on the availability of comparable data. The method that requires the fewest adjustments and provides the most reliable measure of an arm‟s length result is preferred by the Government Tax Authorities as this will reduce the scope and nature of future disputes. Therefore, in deciding the most appropriate method, the following must be considered:

(a) The nature of the controlled transaction, determined by conducting a functional analysis,

(b) The degree of actual comparability when making comparisons with transactions between independent parties;

(c) The completeness and accuracy of data in respect of the uncontrolled transaction;

(d) The reliability of any assumptions made; and

(e) The degree to which the adjustments are affected if the data is inaccurate or the assumptions incorrect

(i) Comparable uncontrolled price method (CUP Method)

This method compares the transfer prices of goods or services between related parties (controlled transactions to the prices of similar / identical goods or services between unrelated parties (uncontrolled transactions). Therefore, the prices of uncontrolled transactions can be taken from the transactions between the taxpayers and other independent parties (internal comparables) or the transactions between independent parties (external comparable).

The aim of the comparison is to determine whether the transfer prices differ from the prices between unrelated parties. If there is a difference, the transfer pricing may not comply with the arm's length principle and may need adjustment or substitution with the prices between unrelated persons. Actually, the transfer prices are comparable to the prices between independent parties when the differences between them cannot affect the market price and reasonable adjustments can eliminate those differences. The comparable uncontrolled price method is useful in determining the arm's length transactions when the market prices of transacted goods or services are available and it is the most reliable method, but it is very difficult to make adjustments of the differences between controlled and uncontrolled transactions when the goods or services involved are so unique.

Example

Manufacturer A exports its product to associate company B for Tshs 200,000 per unit. Manufacturer X exports the same product, in similar quantities and under similar terms to company Z, an independent party operating in similar markets as B for Tshs 150,000.

Required

Determine the arm's length price for sale of the product from A Ltd to B Ltd using CUP method

Answer

The CUP method will be applied using the unit price of Tshs 150,000 per unit an external comparable price as a comparable arm�"s length price.

The strengths of the CUP method include:

- it is not a one-sided analysis as the price is arrived at between two parties to the transaction; and
- Avoiding the issue of which of the related parties involved in the controlled transaction should be the tested party for transfer pricing purposes. This issue arises if the other two traditional transaction methods are applied. These methods determine a transfer price based on the perspective of the tested party in the analysis. For example, if the resale price method is used, the related party sales company is the tested party in the transfer pricing analysis. However, if the cost plus method is used, the related party manufacturer will be the tested party. The resulting transfer prices based on these two methods will probably differ from each other; and
- it involves a detailed transactional comparison.

The weaknesses of the CUP method include:

- it will very often be hard to find closely comparable uncontrolled transactions as strict comparability standard is required particularly with respect to product comparability; and
- Internal comparable frequently don't exist and external comparable are difficult to find in practice.

(ii) The resale price method

Using the resale price method, the transfer price is calculated by deducting resale price margin or gross margin from the resale price. The gross margin may be taken from comparable uncontrolled transactions or from gross margin normally earned from comparable controlled transactions. Indeed, the gross margin covers among other things, risks taken, selling expenses and profit.

Finally, after deduction of the gross margin and other expenses of transferring goods or services from associated supplier company to associated buyer e.g. insurance, fares, customs duties from the resale price, the transactions can be regarded as arm's length transactions of the supplied goods or services. This approach may be useful in determining transfer prices of distributors, and may have a few adjustments.

Example

ICO is a distributor of software developed by its parent company in the US. The end customer price (or retail price) of the software is Tshs 5,000,000. Assuming comparable independent distributors in Tanzania earn margins of 10%.

Required

Determine the arm's length price for sale of the product from Parent to ICO using the retail price method.

Answer

The arm's length transfer price would be as follows:

	Tshs
Final Retail Price in Tanzania	5,000,000
Less : Margin earned by comparable distributors(10% x5,000,000)	500,000
Arm's length transfer price using RPM	4,500,000

Strengths and Weaknesses

The strengths of the resale price method include:

- it is based on the resale price, a market price, and thus represents a demand driven method *[to be developed further, including whether in many developing countries resale price method may be more accurate than cost plus – also to consider situation of high cost suppliers]*;
- it can be used without forcing distributors to make unrealistic profits. The distributor should earn an arm's length gross profit margin, however, it can make operating losses due to high selling expenses caused by strategies such as a market penetration strategy;
- the application of the transactional net margin method, which analyses a financial ratio based on operating profits, will generally result in an arm's length range of positive operating profits. The tested party in the analysis should then probably also earn a positive operating profit within the range. However, the resale price method does not necessarily result in positive operating profits to be earned by the tested party. *[As a result it can be seen as more realistic.]*

The weaknesses of the resale price method include:

- it is a one-sided analysis, as its focus is on the related sales company as the tested party in the transfer pricing analysis. It is possible that the arm's length gross profit margin and hence transfer price, which is based on a benchmarking analysis, can lead to an extreme result (i.e. loss-making) for the related supplier of the sales company; and
- the data on gross margins may not be comparable due to accounting inconsistencies.

(iii) The cost plus method

This method calculates production related direct and indirect costs incurred by a supplier of goods or services in producing them. Therefore, the method starts with the supplying associate and not the buying associate. Thereafter, a mark-up earned by the supplier is added to determine the transfer price.

The arm's length mark-up may be taken from the same supplier from similar but uncontrolled transactions (internal comparables) or by referring to mark-up that could have been obtained by an independent supplier in uncontrolled transactions (external comparables).

This method may be used mostly by manufacturers of semi-finished goods who do not incorporate intangible assets (because of measurement problems) or service providers who do not include unique services. Furthermore, the cost plus method is the easiest method but it can discourage production and efficiencies. Additionally, the method may be affected by accounting policies and fluctuations of costs of raw material and other items.

Example

Taxpayer B is a Tanzanian subsidiary of foreign multinational A. B manufactures electrical components which it exports to A. The total cost per unit of manufactured product is Tshs 80,000. B then sells the product to A at a price of Tshs 100,000 per unit at a mark-up of 25%. An independent manufacturing company, performing the same functions, bearing similar risks and using similar assets, selling to another independent company is found to have a mark-up on cost of 40%.

Required

Determine the arm's length price for sale of the electrical components from B to A using cost plus mark up method

Answer

Arm"s length price of electrical component sold to A by B (in Tshs) = 80,000 + (80,000 x 40%) =**112,000**

Strengths and Weaknesses

The strengths of the cost plus method include:

- third parties are found that indeed use cost plus method to set prices; and
- it is based on internal costs, the information of which is available to the multinational enterprise.

The weaknesses of the cost plus method include:

- there may be no link between the level of costs and the market price;
- accounting consistency is required between the controlled and uncontrolled transactions;
- it is a one-sided analysis as the analysis focuses on the related party manufacturer. Hence, the arm's length gross profit mark-up found may lead to an extreme result for the other related parties involved in the controlled transaction (e.g., operating losses); and
- if method is based on actual costs, there may be no incentive for the manufacturer to control costs.

The transactional net margin method

The method determines transfer prices using net profit figures; i.e. net profit relative to costs, sales or assets of the taxpayer earned from controlled transactions but which is comparable to uncontrolled transactions. Generally, the net profit is weighted

- to costs for manufacturing and service activities when the taxpayer is doing manufacturing activities;
- to sales for sales activities when a taxpayer is mainly doing sales; and
- to assets for asset-intensive activities when the activities of the taxpayers are asset intensive.

Example

Assume a resale price of Tshs 10,000,000, operating expenses of Tshs 2,000,000 and an arm's length net profit margin of 5%.
Required
Determine the arm's length price using Transactional Net Margin Method

Answer

The transfer price is determined by working backwards using the available information:

Arm"s length price/TP/COGS =Sales –Expenses -Net profit

Expenses=Tshs 2,000,000
Net Profit =Net profit margin Sales=5%×Tshs 10,000,000=Tshs 500,000

Hence, Arm's length price=Tshs 10,000,000-Tshs 2,000,000-Tshs 500,000
= Tshs 7,500,000

Strengths and Weaknesses

The strengths of the TNMM include the following:

- net margins are less affected by transactional differences (than price) and functional differences (than gross margins). Product and functional comparability are thus less critical in applying the TNMM;
- less complex functional analysis needed, as TNMM is applied to only one of the related parties involved;
- because TNMM is applied to the less complex party, it can be used even though one of the related parties holds intangible assets for which comparable returns cannot be determined;
- it is applicable to both sides of the controlled transaction (i.e. either the related party manufacturer or distributor); and
- the results resemble the results of a modified resale price / cost plus method of analysis.

The weaknesses of the TNMM include the following:

- net margins are affected by factors (e.g. variability of operating expenses) that do not have an effect, or have a less significant effect on, price or gross margins. These factors affect net profits and hence the results of the TNMM, but may have nothing to do with the company's

transfer pricing. It is important to consider these (non-pricing) factors in the comparability analysis;

- information challenges, including the unavailability of information on profits attributable to uncontrolled transactions;
- measurement challenges: may make it difficult to determine sales revenue, operating expenses and assets relating only to the relevant controlled transactions or functions in order to calculate the selected profit level indicator. For example, if a related party distributor purchases products from both a related party and an unrelated enterprise for resale, it may be impossible to determine sales revenue, operating expenses and assets attributable to only the controlled transactions to reliably perform a net margin method of analysis. Furthermore, in case the companies are engaged in different activities, it will also be very difficult to allocate sales revenue, operating expenses and assets between the relevant business activity and other activities of the tested party or the comparables. This measurement problem is an important practical problem;
- TNMM is applied only to one of the related parties involved. The arm's length net margin found may thus result in an extreme result for the other related parties involved in the controlled transaction (e.g., operating losses to one of the parties while the other party is guaranteed a net profit). This weakness also applies to the cost plus / resale price method, but may be more important under the TNMM, because net margins are affected by factors that may have nothing to do with transfer pricing. A check of the results of all related parties involved is therefore appropriate;
- it may be difficult to "work back" to a transfer price from a determination of the arm's length net margins; and
- several countries do not recognize the use of TNMM. Consequently, the application of TNMM to one of the parties to the transaction may result in unrelieved double taxation when the results of the TNMM analysis are not accepted for the other party.

(iv) The Profit Split Method

The profit spilt method is usually applied where transactions are so integrated that they cannot be evaluated separately. Under similar circumstances, independent enterprises may decide to set up a form of partnership and agree to some form of profit spilt.

The first step in the profit spilt method is to identify the combined profit to be split between the associated parties in a controlled transaction. In general combined operating profit is used, ensuring that both income and expenses of the multinational are attributed to the relevant associated person consistently. That profit is then split between the parties according to an economically valid basis approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Two alternative approaches to the profit spilt method are as outlined below:

(a) Residual Profit Split Approach

(b) Contribution Analysis Approach

Under both approaches, the first step is to determine the combined profit attributable to the parties to the transaction. The combined profit is then allocated as follows:-

(i) Under the residual profit split approach, each of the parties to the transaction is assigned a portion of profit according to the basic functions that it performs. The residual profit or loss is then allocated between the parties on the basis of their relative economic contribution in respect of the amount to be allocated.

(ii) Under the contribution analysis approach, it is generally the combined operating profit (profit before interest and tax) that is divided between the parties on the basis of the relative contribution of each party's combined gross profit.

Strengths and Weaknesses

The strengths of the profit split method include:

- that it is suitable for highly integrated operations for which a one sided method may not be appropriate;
- its suitability in cases where the traditional methods prove inappropriate due to a lack of comparable transactions;
- its avoidance of an extreme result for one of the associated enterprises involved due to its two-sided approach (i.e. all parties to the controlled transaction are being analyzed); and
- its ability (in fact unique among commonly used transfer pricing methods) to deal with returns to synergies between intangible assets or profits arising from economies of scale.

The weaknesses of the profit split method include:

- the relative theoretical weakness of the second step. In particular, the theoretical basis for the assumption that synergy value is divided pro rata to the relative value of inputs in unclear (although this approach is arguably consistent with the way interests are divided between joint ventures);
- its dependence on access to data from foreign affiliates. Associated enterprises and tax administrations may have difficulty obtaining information from foreign affiliates;
- third parties in general do not use the profit split method to establish transfer prices (maybe only in joint ventures); and
- certain measurement problems exist in applying the profit split method. It may be difficult to calculate combined revenue and costs for all the associated enterprises taking part in the controlled transactions due to, for example, differences in accounting practices. It may also be hard to allocate costs and operating expenses between the controlled transactions and other activities of the associated enterprises.

(i) Characteristics of the property or services;

(ii) Functions performed, assets employed and risks assumed by the respective persons; (functional analysis)

(iii) Contractual terms;

(iv) Economic and market conditions circumstances; and

(v) Business strategies.

5. Basic Comparability Factors In The Process Of TP Benchmarking And Illustrate Functional Analysis

(a) Characteristics of Property or Services

Similarity in product characteristics is more relevant when comparing prices rather than profit margins between controlled and uncontrolled transactions. Comparison of product characteristics is used to a greater extent in the application of the Comparable Uncontrolled Price (CUP) method than any other method. Characteristics that are compared should include:

(i) in the case of tangible property: the physical features, quality and the volume of supply of property;

(ii) in the provision of services: the nature and extent of services; and

(iii) in the case of intangible property: the form of transaction (e.g. licensing or sale), type of property (e.g. patent, trademark or know how), the duration and degree of protection; and the anticipated benefits from the use of property.

In summary the OECD Guidelines, at paragraph 1.19, mention a non-exhaustive list of features that may be relevant in comparing two products:

Tangible property	**Intangible property**	**Services**
• Physical features	• Form of the transaction	• Nature of services
• Quality and reliability	• Type of property	• Extent of services
• Availability	• Duration of protection	
• Volume of supply	• Degree of protection	
	• Anticipated benefits from use	

(b) Functional Analysis of Functions Performed, Risks Assumed and Assets Employed

Functional analysis is a way of analysing and documenting details of the related party transactions. Through functional analysis, a proper understanding of the assets used, functions performed and risks borne in related party transactions can be listed and discussed. The major components of functional analysis include:

(i) **Functions performed** – a functional analysis should detail the functions performed by each of the related party in a controlled or related party transaction. An understanding of the functions performed is key in understanding the remuneration due to the parties to a transaction.

(ii) **Assets utilised** – a functional analysis should also provide details of the assets utilised by each of the parties to a controlled transaction. An analysis of assets utilised should include both the tangible assets and the intangible assets utilised by each party to a controlled transaction. The functional analysis should also detail the owners of the assets, since it may be possible for an entity to utilise an asset that it does now own.

(iii) **Risks assumed** – a functional analysis should provide an analysis of the risks borne by each of the parties to a controlled transaction. The entities that bear risks such as market risk, research and development (R&D) risks, inventory risk, and foreign currency risks, should be properly identified and documented. In addition, functional analysis should discuss the factors put in place to mitigate and manage such risks.

A functional analysis is used in, and important to, a transfer pricing study for the following:

- to identify the tested party (where necessary) ;
- to identify the most appropriate transfer pricing method; and
- to identify the profit level indicator (where required).

(c) Contractual terms

Contractual terms are relevant in determining the comparability of a controlled and uncontrolled transaction as they may influence the price or margin of a transaction. Allocation of responsibilities, risks and benefits between enterprises are normally defined in a contract agreement. Any differences between the contractual terms of the transactions being examined would need to be adjusted in

determining an arm"s length price for the controlled transaction. The terms and conditions in a contract may include:

(i) the form of consideration charged or paid;

(ii) sales or purchase volume;

(iii) the scope and terms of warranties provided;

(iv) rights to updates, revisions or modifications;

(v) the duration of relevant licenses, contracts or other agreements, and termination or renegotiation rights;

(vi) collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and

(vii) terms of credit and payment.

(d) Economic circumstances

Arm’s length prices may vary across different markets, even for transactions involving the same product or service. To achieve comparability, it is important to ensure that the markets in which the parties operate are comparable. Any differences must either not have a material effect on price, or be differences for which appropriate adjustments can be made.

Factors that may affect the price or margin of a transaction include:

(i) the geographic location of the market;
(ii) the size of the market;
(iii) the extent of competition in the markets;
(iv) the level of supply and demand in the market as a whole and in particular regions;
(v) customer purchasing power;
(vi) cost of production including the costs of land, labour and capital, and transport costs;
(vii) the level of the market (e.g. retail or wholesale);
(viii) the date and time of transactions;
(ix) the availability of substitute goods and services; and
(x) the extent of government intervention e.g. whether goods compared are price controlled.

(e) Business Strategies

Business strategies adopted by an enterprise influence the price charged for a product. In a comparability analysis, it is necessary to evaluate whether an independent person in the same circumstances as that of a controlled person would have adopted similar strategies and if so, what rewards would have been expected. Business strategies that are relevant in determining comparability include innovation and new product development, degree of diversification, market penetration schemes, distribution channel selection, market level and location.

6. Provisions Relating To Advance Pricing Agreement

An advance pricing arrangement (APA) is an arrangement whereby the taxpayer and tax authority (ies) agree in advance that the transfer pricing policies to be used for a transaction or set of transactions between associated enterprises based on agreed assumptions satisfy the arm's length principle. The purpose is to provide taxpayers with certainty and protection from audit, investigation or

reassessment by the tax authority (ies). APA's can be unilateral (i.e. between the taxpayer and a single tax authority), bilateral (i.e. between the taxpayers and the tax authorities relating to both sides of the transaction) or multilateral (i.e. between the taxpayers and multiple tax authorities - used for transactions involving multiple members of the MNE).

Period covered for an APA

TRA generally accept an APA request to cover three to five future FYs (i.e. covered period). However, the duration of the covered period should be based on taxpayers' assessment that there will not be any significant changes during the covered period that may affect the validity of the APA. Based on experience, most APA requests cover 3-5 prospective years, in addition to its application to 1-2 prior years.

TRA appreciates that the usefulness of an APA to a taxpayer may be diminished if a timely agreement cannot be reached. In this regard, TRA will do its best to expedite the APA process and reach agreement with the foreign tax authorities as soon as practicable. However, the actual duration of the process would depend on the complexity of the issues involved in each case, and the response time of the Taxpayer and the foreign tax authorities. TRA will update taxpayers on the progress of their requests and indicate the expected timeframe for completion on a regular basis.

Process for an APA request

(i) **Pre-filing Meetings**

The first step to an APA application is to arrange for pre-filing meetings with TRA. At these meetings, taxpayers should present the salient information such as the company's business model and industry information, transactions to be covered, the period of the APA etc. If TRA is willing to accept the case for APA, the taxpayer will be advised on the necessary follow-up actions (such as the content of the application to be submitted etc.) and what is expected of the APA process (e.g. the expected timeframe for completion etc.). For bilateral and multilateral APAs, taxpayers should undertake similar meetings with the relevant foreign tax authorities and seek their agreement for an APA as well as their specific requirements with respect to the APA process. It would be helpful if taxpayers share such information from their meetings with the foreign tax authorities with TRA.

(ii) **Formal APA Submission**

Unless TRA or the relevant foreign authorities do not agree to the APA request, taxpayers should proceed to submit the formal APA application, which should include the following key components:

a. General information concerning the taxpayer such as the nature of its business and its industry environment, worldwide organizational structure, etc;
b. Details and explanation of the proposed transfer pricing methodology and analysis;
c. All information and analyses needed to produce the arm's length results for the related party transactions;
d. The set of critical assumptions under which the proposed transfer pricing methodology and analysis will operate;
e. Period covered by the APA, including whether the APA would be rolled back to prior years;
f. Any other information that TRA or the other tax authorities have requested for.

In considering the details to be submitted, taxpayers may also find it useful to refer to the guidance described paragraph 13 of the guideline.

(iii) **Review and Negotiating APA**

Upon receiving the formal submission, TRA will commence the process of seeking an APA with the relevant foreign authorities. This may include meetings with taxpayers to seek clarifications,

obtaining more information, conducting site visits, consultations and negotiations with the relevant foreign competent authorities, etc. As with the MAP, the negotiation of a bilateral or multilateral APA is a government-to-government process. Hence, taxpayers do not, as a general rule, participate in or attend as observers at the negotiations or consultations between the competent authorities but taxpayers may be called upon to provide clarification. However, as the taxpayers concerned are also stakeholders in this process, TRA would regularly update them on the outcome of the competent authority consultations and the expected time frame to complete their cases.

(iv) **Post-Agreement Meeting and Implementation of APA**

When an agreement is reached, TRA will meet with the taxpayer within thirty days of reaching the agreement to discuss the details and implementation of the agreement. TRA will also discuss with the taxpayer on the APA compliance and monitoring requirements.

7. Provisions Relating To Safe Harbours'

The safe harbour provision, in the context of transfer pricing, refers to these provisions that relieve a taxpayer from complying with the transfer pricing provisions, when certain criteria or minimum requirements are met. The criteria set, for which taxpayers are relieved from complying with the transfer pricing provisions, provide an easier and cheaper way. The criteria are set in line with the arm's length principle. Safe harbour provisions also provide some level of certainty in respect of transfer pricing, since taxpayers are certain that there will be no transfer pricing examinations provided they meet the threshold set by the safe harbour criteria.

Examples of safe harbour:

- A taxpayer (e.g. a distributor) is relieved from complying with transfer pricing regulations, where its operating returns lie within a certain range for specific industries. The range is set for certain industries, bearing in mind the functions, assets and risks of such industries.
- A provision whereby taxpayers do not have to mark up the cost of provision of services, where the services provided meets set criteria for low-value services.
- A case where the taxpayer is relieved from complying with transfer pricing regulations for the sale of tangible products to non-resident associated companies, where the transfer prices lie within a certain range of domestic prices.

Safe harbour provisions simplify the compliance problem with respect to transfer pricing. They also provide certainty with respect to transfer pricing.

Some of the benefits of safe harbour to taxpayers and tax administration include:

- Providing certainty with respect to transfer pricing examinations;
- Simplifying compliance with transfer pricing regulations;
- Freeing resources to concentrate on other aspects of the business for taxpayers and to concentrate on more risky areas for tax administration; and
- Providing an opportunity for tax planning purposes to the taxpayer.

However, safe harbour provisions come with potential problems. The following are some of the problems which could be associated with safe harbour.

- It could potentially lead to a non-arm's length arrangement by taxpayers in some jurisdictions. In an attempt to meet the criteria for safe harbour, a taxpayer may arrange its transfer pricing matters so as to qualify for safe harbour in one jurisdiction. This may lead to non-compliance with the arm's length principle.
- It could also be misused by taxpayers for tax planning purposes.

- The criteria for safe harbour may lead to substantial compliance costs, thus negating the need for safe harbour in the first place.

Outline the basic documentation requirements for transfer pricing benchmarking and describe specific transactions (Intra-group service and Intangible property)

[Learning outcome h, and i]

8. Basic Documentation Requirements For Transfer Pricing Benchmarking

The taxpayer is required to maintain contemporaneous documentation to assist in demonstrating whether the taxpayer‟s transfer pricing policy is appropriate for tax purposes. At the same time, this alleviates the risk of transfer pricing adjustment and has relevance to penalty consideration during a transfer pricing audit

Main objectives of transfer pricing documentation are:

1. To ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions of transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns;
2. To provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment and;
3. To provide the relevant tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practises of the entities subject to tax in the jurisdiction.

Contemporaneous Transfer Pricing Documentation

(a) A documentation is deemed “contemporaneous” if it is prepared:
    (i) at the point when the taxpayer is developing or implementing any arrangement or transfer pricing policy with its associated person; and
    (ii) if there are material changes, when reviewing these arrangements prior to, or at the time of, preparing the relevant tax return of his income for the basis year for a year of assessment.

(b) In preparing the documentation, the arm‟s length transfer price must be determined before pricing is established based upon the most current reliable data that is reasonably available at the time of determination. However, taxpayers should review the price based on data available at the end of the relevant year of assessment and update the documentation accordingly.

List of Documentation

A transfer pricing documentation may consist of the following

(a) **Organizational Structure**

(a) Taxpayer’s worldwide organizational and ownership structure (including global organization chart and significant changes in the relationship, if any), covering all associated persons whose transactions directly or indirectly affect the pricing of the documented transactions.
    (ii) Company organization chart.

(b) **Group financial report**

TP documentation should include the group financial report, equivalent to an annual report, for the most recent accounting period.

(c) **Nature of the business/industry and market conditions**

(i) Outline of the taxpayer's business including relevant recent history, the industries operated in, analysis of the general economic and legal issues affecting the business and industry, the taxpayer's business lines and the property or services in the controlled transactions;

(ii) The corporate business plans to the extent of providing an insight into the nature and purpose of the relevant transactions between the associated persons;

(iii) A description of the structure, intensity and dynamics of the relevant competitive environment(s).

(d) **Controlled transactions**

(i) Description of details of the property or services to which the international/domestic transaction relates; any intangible rights or property attached thereto, the participants, the scope, timing, frequency, type and value of the controlled transactions (including all relevant related party dealings in relevant geographic markets);

(ii) Names and addresses of all associated persons, with details of the relationship with each such associated person;

(iii) The nature, terms (including prices) and conditions of international transactions (where applicable) entered into with each associated person and the quantum and value of each transaction;

(iv) An overview description of the business, as well as a functional analysis of all associated persons with whom the taxpayer has transacted;

(v) All commercial agreements setting forth the terms and conditions of transactions with associated persons as well as with third parties;

(vi) A record of any forecasts, budgets or any other financial estimates prepared by the person for the business as a whole and for each division or product separately.

(e) **Pricing policies.**

(f) **Assumption, strategies and information regarding factors that influenced the setting of pricing policies**

(i) Relevant information regarding business strategies and special circumstances at issue, for example, intentional set-off transactions, market share strategies, distribution channel selection and management strategies that influenced the determination of transfer prices;

(ii) Assumptions and information regarding factors that influenced the setting of prices or the establishment of any pricing policies for the taxpayer and the related party group as a whole;

(iii) Documentation to support material factors that could affect prices or profits in arm's length dealings.

(g) **Comparability, functional and risk analysis**

(i) A description of the characteristics of the property or service transferred, functions performed, assets employed, risks assumed, terms and conditions of the contract, business strategies pursued, economic circumstances and any other special circumstances.

(ii) Information on functions performed (taking into account assets used and risks assumed) of the related party involved in the controlled transaction as well as a description of FAR of

group of companies to the extent that they affect or are affected by the controlled transactions carried out by the taxpayer.

(iii) Details of comparables, as mentioned in paragraph 9 including for tangible property: its physical features, quality and availability; for services: the nature and extent of the services; and for intangible property: the form of the transaction, the type of intangible, the rights to use the intangible that are assigned and the anticipated benefits from its use.

(iv) The data collected and the analysis performed to evaluate comparability of uncontrolled transactions with the relevant controlled transactions.

(v) Criteria used in the selection of comparables including database screens and economic considerations.

(vi) Identification of any internal comparables.

(vii) Adjustments (details and reasons for those adjustments) made to the comparables.

(viii) Aggregation analysis (grouping of transactions for comparability) where paragraph 15 applies.

(h) **Selection of the transfer pricing method**

(i) Documentation of the process involved in the selection of particular methodologies.

(ii) Description of data and methods considered, the analysis performed to determine the arm's length price and the rationale for the selection of this methodology including reasons for its use in preference to other transfer pricing methodologies.

(i) **Application of the transfer pricing method**

(i) Documentation of assumptions and judgments made in the course of determining an arm's length outcome (refer to the Comparability, Functional and Risk analysis section above);

(ii) Documentation of all calculations made in applying the selected method, and of any adjustment factors, in respect of both the tested party and the comparable;

(iii) Appropriate updates of prior year documentation relied upon in the current year to reflect adjustments for any material changes in the relevant facts and circumstances.

(j) A list of advance pricing arrangements entered into by members of the group with respect to transactions to which the taxpayer is a party.

(k) Documents that provide the foundation for or otherwise support, or were referred to, in the development of the transfer pricing analysis.

(l) Taxpayers should keep readily available documents and information that were used in preparing the transfer pricing documentation as they are necessary to support the transfer pricing analysis. This may include:

(i) Official publications, reports, studies and databases;

(ii) Reports of market research studies carried out by recognized institutions;

(iii) Technical publications brought out by recognized institutions;

(iv) Agreements and contracts entered into with associated persons or with unrelated persons, which may be of relevance to the international transactions;

(v) Letters and other correspondence documenting any terms negotiated between the person and the associated person;

(vi) Supporting documents for the economically significant activities and functions undertaken by the taxpayer. For example, where skilled and experience staff constitute human resource assets for the taxpayer, documentation pertaining to these staff which may be relevant here include:

- Details of experience;
- Educational qualifications;
- Areas of particular expertise;
- Job description and duties;
- Remuneration;
- Written statements provided by key staff and used by taxpayer in determining the functions, risks and asset of the company;

(vii) Other relevant documents.

Acceptability of Documentation

To ensure the acceptability of the contemporaneous transfer pricing documentation, reasonable efforts should be given to:

(a) Undertake a transfer pricing analysis to ascertain that transfer prices comply with the arm's length principle and reflect commercially realistic outcomes for all controlled transactions.

(b) Maintain documents that are applicable to the circumstances and be prepared to provide additional information or documentation not contained above, but which may be relevant for the determination of the arm's length price.

(c) Prepare the documentation in accordance to the Rules and The Guidelines.

(d) Implement and review the arm's length transfer pricing policies and redesign the transfer pricing policy to accommodate any changes in the business environment.

(e) Prevent from providing vague, useless or inadequately founded information.

(f) Apply a coherent and transparent approach in identifying uncontrolled transactions.

(g) Provide detailed analysis of functions, assets, risks, market conditions and business strategies.

(h) Apply a transfer pricing method in accordance to the Rules.

(i) Ensure that the factual, economic and empirical representations in transfer pricing documentation are company, product and market specific.

(j) Ensure that the transfer pricing documentation is accurate and precise, and matches the accounting, financial and benchmarked data/comparables.

(k) Highlight and document any specific event that may have hindered the MNE‟s performance so that appropriate fact-based adjustments can be considered.

(l) Prevent from preparing documentation which is of relatively limited use, incomplete and does not properly support the transactions.

Maintain adequate background documents and full records containing particulars about the factual assumptions and relevant factors that have been taken into account in working out the arm's length price

9. Specific Transactions

9.1 Intra-group services

Intra-group services are services provided by one or more members of a multinational group for the benefit of the other members within the group. In general, the types of services that members of a multinational group can provide to each other include, but are not limited to, management services, administrative services, technical and support services, purchasing, marketing and distribution services and other commercial services that typically can be provided with regard to the nature of the group's business. The costs of such services, initially borne by the parent or other service companies within the multinational group, are eventually recovered from other associated persons through intra-group arrangements.

In general, no intra-group service should be found for the following activities:

(a) **Shareholder activities**

Shareholder activity refers to an activity that one group member (usually the parent company) performs solely because of its responsibility as a shareholder due to its ownership interest in one or more members of the group.

Examples of non-chargeable shareholder activities include:

- Costs pertaining to the juridical structure of the parent company such as meetings of shareholders of the parent company, issuing of shares in the parent company and costs of the supervisory board;
- Costs relating to the reporting and legal requirements of the parent company such as producing consolidated accounts or other reports for shareholders, filing of prospectuses; and
- Costs of raising funds for the acquisition of new companies to be held by the parent company (distinct from fund raising on behalf of its existing subsidiaries).

(b) **Duplicative services**

(i) Duplicative services are services performed by a group member that merely duplicates a service that another group member is already performing in-house, or that is being performed by a third party. In such instances, any duplicative claim will be automatically disallowed. The ability of a group member to independently perform the service (for instance in terms of qualification, expertise and availability of personnel) shall be taken into account when evaluating the duplication of services performed.

Example

A subsidiary has qualified personnel to analyse its capital and operational budget. This analysis is then reviewed by the parent company's financial personnel. The review by the parent company is considered duplicative.

(ii) However, there are exceptions in which duplication of services can be charged such as:

- Special circumstances where duplication is only temporary. For example in implementing a new system, a company may simultaneously continue to operate an existing system for a short period, in order to deal with any unforeseen circumstances that may arise during the initial implementation; or
- To reduce the risk of a wrong business decision such as by getting a second legal opinion on a particular project.

(c) **Services that provide incidental/passive association benefits**

This refers to services performed by one member of a multinational group, such as a shareholder or coordinating centre, which relates only to specific group members but incidentally provides a benefit to other members of the group. Incidental benefit may also arise as a consequence of an associated person being part of a larger concern and not because of a service that has actually been provided. Such incidental benefits would not warrant a charge to the incidental recipient because the perceived benefit is so indirect, and remote, that an independent person would not be willing to pay for the activities giving rise to the benefit and therefore should not be considered as intragroup service to the incidental recipient.

Example

An enterprise that had obtained a higher credit rating due to it being a member of a multinational group should not be charged for its mere association with the group. However, if the higher credit rating is due to a guarantee provided by another group member, then an intragroup service can be considered to have been rendered.

(d) **On-call services**

An on-call service is where a parent company or a group service centre is on-hand to provide services such as financial, managerial, technical, legal or tax advice to members of the group at any time.

(i) This service is considered non-chargeable under the following circumstances:

- Service is easily and promptly available even without any standby arrangement;
- The potential need for such service is remote;

- Where there is no/negligible benefits derived from the service.

(ii) If there are exceptional circumstances which require on-call services to be considered as chargeable services, it must be proven that an independent person in comparable circumstances would incur such charges to ensure availability of the services when the need for them arises.

Other services that are commonly found between associated persons include –

(a) activities performed by one member of a multinational group to meet the identifiable needs of its associated person;

(b) activities that are centralized in the parent company or regional headquarters companies or group service centre; and

(c) ancillary or subsidiary services which are services rendered in connection with other transactions such as the transfer of a property (e.g. intangible asset) or the commencement of the effective use of a property. TP guidelines requires that charges for the services are shown separately or can be shown separately should the need arise.

Application of arm's length principle for intragroup services

In applying the arm's length principle to intragroup services, taxpayers should consider:

(i) Whether services have been provided; and

(ii) If so, whether the charge for these services are at arm‟s length prices.

The following factors should serve as a guide in determining whether services have been rendered:

(i) Whether the activity provides a respective group member with economic or commercial value to enhance its commercial position and whether an independent enterprise in comparable circumstances would be willing to pay or perform in-house for its services

(ii) If the activity is not one for which the independent would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra – group services under the arm's length principle

(iii) In general, no intra – group services should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing for itself; or that is being performed for such other group member by a third party

(iv) An associated enterprise should not be considered to receive an intra – group services when it obtains incidental attributable solely to its being part of a large concern, and not to any specific activity being performed.

(v) Passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit – making potential of particular members of the group. Each case must be determined according to its own facts and circumstances

(vi) The method to be used to determine arm's length transfer pricing for intra – group services should be determined according to these guidelines, often, the application of these guidelines will lead to use of the CUP or Cost Plus Method for pricing intra – group services.

Methods of charging for provision of services

In charging for the provision of services, a service provider could adopt a direct charge method or an indirect charge method. The direct charge method is preferred because it facilitates the determination of whether the charge is consistent with the arm‟s length principal, and evidence for direct charge is usually readily available.

1. Direct Charge Method

(a) The direct charge method is applicable for a specific service where the service, the beneficiary of the service, the cost incurred and the basis of charge can be clearly identified. Hence, the cost can be allocated directly to the recipient.

(b) Direct charge method must also be applied when the specific service forms part of the main business activity of the service provider, and is provided to both associated persons and independent parties.

2. **Indirect Charge Method**

   The indirect charge method is applicable where the direct charge method is impractical or if the arrangements for the services provided are not readily identifiable i.e. where the costs are attributable to several related enterprises and cannot be specifically assigned to the recipients of services.

   Example

   Circumstances when the indirect charge method may be applicable:

   - Where sales promotion activities carried out centrally at international fairs or in global advertising campaigns benefit the group members as a whole and is reflected in increased quantity of goods produced or sold by members of the group;
   - The provision of information technology services like management information system which involves development, implementation and maintenance of inter-company electronic data such as transmission of marketing data, production and scheduling forecast, accounting data, etc.
   - Provision of accounting services to all members of the multinational group.

   The method is based upon cost allocation and apportionment by reference to an allocation key which must be appropriate to the nature and purpose of service provided. For example, the provision of payroll services may be more related to number of staff than turnover, while the allocation of usage of networking infrastructure could be allocated according to the number of computer users.

   The arm‟s length principle requires that the amount allocated to a respective member of a group is in proportion to the individual member benefit or expected benefit from the services or reflects the share of the total benefits of the service attributable to that particular recipient. Taxpayers are expected to document the analysis undertaken in arriving at the choice of allocation key.

9.2 Intangible Properties

These are unique products valued for their intellectual or intangible contents which can be legally or not legally protected. Categorization of these properties can be made into two broad types:

(a) Trade intangibles such as patents created through risky and costly research and development know-how, designs and models that are used in producing a product or in providing a service; and
(b) Marketing intangibles i.e. trademarks and trade name that are used in the exploitation of the products, customer lists, distribution channel and so forth

From a transfer pricing perspective, the more valuable the functions performed, the assets used and the risks assumed by an entity, the higher the profit potential allocated to it. In this respect, the greatest share of the profit potential is generally found to be attributed to intangibles and entrepreneurial, non-diversifiable risks. Identifying intangibles used in a controlled transaction (e.g. manufacturing, distribution, services) and their role in the value creation is important to select and apply the most appropriate transfer pricing method to the circumstances of the transaction. There are also many transactions which solely or mainly relate to intangibles (e.g. cost contribution / cost sharing arrangements, R&D activities, sales / licences / put at disposal of intangibles).

Intangibles being by nature potentially geographically mobile, many tax authorities scrutinise intangible transfers and the transfers of profit potential that typically go with them and require such transfers to be made at arm‟s length conditions.

Existence of Intangible Properties

It is essential to first determine the existence of the property when considering the issue of intangible properties, i.e. by looking into the benefit derived from the intangible. When a company demonstrates a higher than average rate of return on assets or higher than average profits for a given level of physical assets over a period of time, it indicates the likely presence of intangibles. Intangible for the purpose of these book is intended to address something which is not a physical asset or a financial asset and which is capable of being owned or controlled for use in commercial activities. Intangibles that are important to consider for transfer pricing purposes are not always recognized as intangible assets for accounting purposes. For example, costs associated with developing intangibles internally through expenditures such as research and development and advertising are sometimes expensed rather than capitalized for accounting purposes and the intangibles resulting from such expenditures therefore are not always reflected on the balance sheet. Such intangibles may carry significant economic value and may need to be considered for transfer pricing purposes. Basically, the arm's length principle applies to intangible property in the same way as for any other type of property, however, the treatment of intangible property can be one of the most difficult areas to apply correctly in transfer pricing practice, due to the fact that the transaction may represent a number of components, both tangible and intangible, bundled together to form a single product. The property may have a special character complicating the search for comparable and also due to the fact that MNE may, for entirely commercial reasons, structure their transaction in a way that would not be adopted by independent firms.

In applying the arm's length principle to controlled transactions involving intangible property, some special factors relevant to comparability between the controlled and uncontrolled transaction should be considered. These factors include;

(a) The expected benefits from the intangible property (possibly determined through a net present value calculator);
(b) Any limitations on the geographic area in which rights may be exercised;
(c) Export restrictions on goods produced by virtue of any rights transferred;
(d) the exclusive or non-exclusive character of any rights transferred;
(e) the capital investment (to construct new plants or to buy special machines);
(f) The start – up expenses and the development work required in the market;
(g) The possibility of sub-licensing the licensee's distribution network and whether the license has the right to participate in further developments of the property by the licensor.

9.3 Intra group financing

Among the services between associated persons is intra-group financing. This may be in the form of financial assistance for business purposes that includes loans, interest bearing trade credits, advance or debt and the provision of any security or guarantee. The financial assistance arrangements between associated persons can arise from the following situations:

(a) Where a taxpayer, directly or indirectly, acquires from or supplies to an associated person financial assistance for a consideration; or
(b) Where a taxpayer supplies financial assistance directly or indirectly to an associated person without consideration.

In both situations, the taxpayer should charge or pay the associated person interest at a rate which is consistent with the rate that would have been charged in a similar transaction between independent persons dealing at arm's length.

Substitution and Imputation of Arm's length Interest

Where the interest rate imposed or would have been imposed on a controlled financial assistance is not at arm's length, the Commissioner may make an adjustment to reflect the arm's length interest rate or impute interest on the controlled financial assistance. Adjustments will be made where:

(a) For the supply of financial assistance, the consideration is less than the consideration that would have been received or receivable in an arm's length arrangement;
(b) For the acquisition of financial assistance, the consideration is more than the consideration that would have been given or agreed to be given in an arm's length arrangement; or
(c) No consideration has been charged to the associated person for the supply of the financial assistance.

Determination of Arm's Length Interest

An arm's length interest rate is an interest rate charged, or would have been charged, at the time the financial assistance was granted in uncontrolled transactions with or between independent persons.

In determining an arm's length interest rate for financial assistance, the comparable uncontrolled price (CUP) method is considered to provide the most reliable measure. In this context, the CUP method determines an arm's length interest rate by reference to interest rates between independent parties on loan with highly similar terms and conditions. Where differences exist, adjustments should be done to eliminate these differences.

Comparability Factors

There are comparability factors that should be considered when searching for and analyzing financial transactions and in determining arm's length interest. These include:

(a) The nature and purpose of the financial assistance;
(b) The amount, duration and terms of the financial assistance;
(c) The type of interest rate (eg: fixed or floating interest rate);
(d) Embedded options;
(e) Guarantees involved in the financial assistance; Collateral for the financial assistance, creditworthiness of the borrower;
(f) Location of the lender and borrower.

When ascertaining the arm's length interest rate, appropriate indices such as London Inter Bank Offered Rate (LIBOR) or specific rates quoted by banks for comparable loans can be used as a reference point. Adjustments are then made on the rates used as reference point based on the outcome of comparability analysis to arrive at the arm's length interest rate.

Documenting Financial Assistance Pricing Policy

Taxpayers are required to substantiate and document that, the terms of an intercompany financial assistance, specifically the interest rate applied, are at arm's length. This encompasses preparation of an analysis on the setting of the correct level of underlying interest and documentation on other factors of comparability such as loan structure, etc. Taxpayers also need to review existing inter-company agreement on a periodic basis to ensure that all the terms and conditions of the loan remain at arm's length.

9.4 Cost Contribution Arrangement (CCA)

Concept of a CCA

A CCA is a framework (in the form of contractual agreement) agreed among business enterprises to share the costs and risks of developing, producing or obtaining assets, services or rights, and to determine the nature and extent of the interests of each participant in those assets, services or rights. Each participant‟s proportionate share of the overall contributions to the arrangement will be consistent with the participant‟s proportionate share of the overall expected benefits to be received under the arrangement. The participant would be entitled to exploit its interest in the CCA separately as an effective owner, not as a licensee. Where a taxpayer enters into a CCA with its associated persons, the arrangement should reflect that of an arm‟s length arrangement.

Types of CCA

There are two major types of CCA most commonly encountered in practice:

(i) **Arrangement for the joint development of intangible property**
In this arrangement each participant contributes different assets, resources and expertise, and receives a share of rights in the developed property based on the contribution.

(ii) **Service Arrangement**
CCA could exist for any joint funding or sharing of costs and risks, for developing or acquiring property or for obtaining services such as pooling resources for the development of advertising campaigns common to the participants‟ market. However, if a service arrangement does not result in any property being produced, developed or acquired, the principles for dealing with intragroup services will apply to that arrangement whether it is described as CCA or not.

Example

Three members of a multinational group, marketing a product in the same regional market where consumers have similar preferences, want to enter a CCA to develop a joint advertising campaign. A fourth member of the group helps develop the advertising campaign but does not itself market the product. This fourth member is not a participant in the CCA because it does not have any beneficial interest in the services subject to the CCA activity and would not, in any case, have a reasonable expectation of being able to exploit any interest. The three participants in the CCA would, therefore, compensate the fourth member by way of an arm's length payment for the advertising services provided to the CCA.

Applying the arm's length principle

To demonstrate whether a CCA accords with an arm's length arrangement in comparable circumstances, the following matters should be addressed:

(a) CCA should be entered into with prudent and practical business judgment with a reasonable expectation of its benefits. An independent party would not enter a CCA where the value of the contribution exceeds the expected benefit. Estimation of the expected benefit to be derived from the arrangement can be computed in the following manner:
   (i) Based on the anticipated additional income that will be generated or the expected cost savings; or
   (ii) The use of an appropriate allocation key, perhaps based on sales, units used, produced or sold, gross or operating profits, numbers of employees, capital invested, or alternative keys.

(b) Terms of the arrangement should be agreed upon up-front and in accordance with economic substance, judged by reference to circumstances known or reasonably foreseeable at the time of entry into the arrangement.

   Consideration for the entry, withdrawal and termination of a CCA should be dealt with at arm's length, as follows:
   (a) Where a participant's contribution is not consistent with its expected share of benefits from the CCA, a balancing payment may be required between the participants to adjust their respective contributions;
   (b) Where a participant transfers its pre-existing rights of a prior CCA to a new participant, the exiting participant must be compensated based upon an arm's length value for the transferred interest (buy-in payment). The amount of the buy-in payment shall be determined based on the price an independent party would have paid for the rights obtained by the new participant, taking into account the proportionate share of the overall expected benefit to be received from the CCA;
   (c) Where a participant disposes off part or all of its interest, he should be compensated with an arm's length payment (buy-out payment).

Self-Examination Questions

Question 1

Explain the major components of a functional analysis, and why such an analysis is used in a transfer pricing study.

Question 2

Explain how each of the following methods works in practice:

(c) CUP

(d) Resale price method

(e) Cost plus method

(f) TNMM or CPM

(g) Profit Spilt Method – using Residual analysis

(h) Profit Spilt Method – using Contribution analysis

You must provide an example to illustrate the practical application of each method.

Question 3

"Transfer pricing is, at its core, an anti-avoidance weapon designed to stop tax cheats. It is the only weapon available and has succeeded in preventing the very worst cases of abuse".

Do you agree with this assessment? Explain your answer in detail.

Question 4

You are required to list and briefly describe the transfer pricing methods that are recognised by the OECD.

What are the criteria for selecting the most appropriate method to the circumstances of a case?

Question 5

You are required to explain, giving reasons for your answer, how it may be determined whether charges made for intra-group back-office/management services are arm's length?

Question 6

Explain the profit split method, and indicate the circumstances in which it is the most appropriate transfer pricing method.

Question 7

Bale Company Ltd (BC) is a company resident in mainland Tanzania, which is engaged in the manufacture and trade of smartphones, tablets and various computer products. BC distributes products through its well-established distribution network in Tanzania. In order to streamline its production, BC undertook a re-organisation two years ago. Two new companies were established to conduct the marketing and advertising of BC's products: one for the mainland Tanzania market and the second, Chris & Chris Ltd (CCL), for the Zanzibar market.

BC retains responsibility for all work relating to the manufacture of its products, including the sourcing of raw materials, research and development, and quality control. CCL purchases goods from BC for retail and distribution in Zanzibar.

Due to the effectiveness of its marketing and production strategies, the group has performed very strongly in the two years since the re-organisation, and has out-performed its competitors. BC and CCL believe it was their highly integrative approach to marketing and manufacturing which drove the growth of the two companies. BC is entitled to tax incentives in mainland Tanzania, and its current income tax rate is 12.5%.

For accounting purposes, BC has sold goods to CCL at its production cost plus a 30% mark-up. The management of BC and CCL are anxious that the existing pricing method might not be acceptable to the Tanzania Revenue Authority (Zanzibar), as CCL's profit was three times of that of BC during the two years since the re-organisation.

Required:

(a) Explain all types of transfer pricing adjustment method available, and their applicable circumstances according to the practice of the Tanzania Revenue Authority (Zanzibar).

(b) Determine which transfer pricing method is most applicable to BC and CCL in view of their present situation, and explain why.

Question 8

Transfer pricing can be defined as:

"The price charged by individual entities for goods or services supplied to one another within a multi-department, multi-office, or multinational firm."

Required:

- **(a)** Explain how oil and gas companies are able to use Transfer Pricing techniques to minimise their profits and hence reduce their tax liabilities.
- **(b)** Discuss what a given government may do to minimise the effect of such behaviours, and possible tax avoidance in the application of Transfer Pricing, on its tax revenues. You should use examples to support your discussion.

Question 9

The area of transfer pricing is riddled with nomenclature that is not readily understood by lay people. You have been approached by the recently appointed executive director of a large Tanzanian private company which has recently expanded into overseas markets in Kenya, Malawi and Sudan. He is well versed in the commercial world but has no idea about transfer pricing, and in particular which issues he might face concerning dealings between Tanzanian subsidiaries and subsidiaries based in any of the three countries overseas.

The executive director has been to a number of seminars in order to gain an understanding of the issues involved, but has encountered difficulties due to the manner in which transfer pricing specialists often tend to throw around terms without explanation.

Required:

Provide the executive director with a simple, plain English language explanation of each of the following terms, and how they fit into the overall fabric of transfer pricing, within the particular context of the company and its overseas subsidiaries. In particular, you are required to provide examples to illustrate the following terms:

1) Comparable Uncontrolled Price;
2) Transactional Net Margin Method;
3) Functional Analysis;
4) Advance Pricing Agreement; and

Question 10

Article 9 of the OECD Model Tax Convention describes how the arm's length principle can be used in transfer pricing to allocate profits among different entities within a multinational enterprise for the purposes of taxation.

Required:

(a) Explain the meaning and main objectives of the arm's length principle as set out in the OECD Model Tax Convention.

(b) Describe Five (5) approaches outlined in the OECD Model Tax Convention that may be used to determine an arm's length price for taxation purposes.

Question 11

Read the story about petroleum operations in the imaginary republic of Eldorado
and then answer the question below:

Transfer Pricing Issues At The Ecco-Exodos Petroleum Operations

The following is an overview of petroleum operations at Ecco oil field and the Exodo refinery, in the imaginary republic of Eldorado.

Ecco Oil field currently produces 10,000 barrels per day, having declined from previously high levels. The oil field has produced 450 million barrels since it started in the 1970s. Elephant Oil

Eldorado Ltd (EOEL) is a sole contractor and operator under a Production Sharing Agreement (PSA) with the Eldorado Government. Under the PSA, Eldorado's Government receives revenues as follows:

- Royalty, equal to 10% of produced oil.
- Profit oil share, equal to 55% of (oil production – royalty – petroleum expenditures).
- The Government can elect to receive royalty and profit oil share either as oil delivered at the Ecco field installations, or corresponding value in cash. The Government has always elected to receive them in cash, because (among other reasons) it has no facilities for handling oil.

The PSA, article 19, provides that oil from the Ecco field shall be valued on the basis of cargoes sold on the open market. In practice, all Ecco oil goes into the Exodos refinery. Elephant Oil Eldorado Ltd sells the oil to Elephant Eldorado Refining Co. (EERCo), which is a 60% shareholder in the Eldoret refinery. EERCo is incorporated in the Cayman Islands and is fully owned by Elephant Oil Corporation. The value of one barrel of oil at the Ecco field is therefore:

> Oil price invoiced by EOEL to EERCo minus (-) Pipeline transport tariff in the Ecco-Exodos pipeline = Value of oil at Ecco field

Petroleum expenditures to run the Ecco field are deductible for the calculation of profit oil share. Elephant Oil has an organization in Eldorado to carry out operations. The operations are supported extensively by elephant's international organization. Most of the imported materials and equipment are supplied through Elephant Oilfield Supply Co. a company incorporated in the Cayman Islands. Engineering services are provided from Elephant Technology Management Ltd in the UK.

During last year, Eldorado's Government received USD 82 million as royalty and profit oil share from the Ecco field. Production averaged 11,000 barrels per day, and the international market price for crude oil of similar quality was around 105 USD per barrel. In addition, it received USD 9 million as corporate income tax from EOEL, from the 25% corporate income tax rate.

The **Ecco-Exodos Pipeline** is owned by Elephant Eldorado Pipeline Co (EEPCo), which is incorporated in the Cayman Islands. EOEL pays a pipeline tariff of USD 9 per barrel of crude oil transported through the pipeline. The original construction cost of the pipeline in the 1970s was USD 60 million.

The **Eldoref refinery** is operated by Eldoref Ltd., which is a joint venture between EERCo (60%) and Eldorado Petroleum Co (EPCo, 40%), the latter being owned by a collection of Eldoradian investors including a brother of the Prime Minister Extravaganza. The owners pay their share of the refinery's monthly operating expenditures and any capital expenditures. Each owner then is entitled to use the corresponding share of the refinery's capacity by feeding in crude oil and receiving the refined products. The crude oil comes partly from the Ecco field, partly as imports which are to a large extent supplied by Elephant Petroleum Trading (Cayman Islands) Co. The petroleum products from the refinery are sold by the refinery owners to several distribution companies serving Eldorado's market, including Elephant Eldorado Fuels Ltd.

Eldoref Ltd is incorporated in Eldorado, but pays very little taxes there. This is because the owners only compensate Eldoref Ltd for the costs of operating the refinery, so there is essentially no profit in this company.

Cayman Islands is a small state in the Caribbean which has no corporate tax.

(Source: Petroleum fiscal design in selected jurisdictions, Erick 2016)
Required:

Identify the transactions mentioned in the story which create a risk for the Government of Eldorado to lose revenues due to transfer pricing issues as fiscal avoidance. For each identified transaction, specify how the transaction creates a risk of fiscal avoidance.

Question 12

The following observations were made by two experts from Organization for Economic Cooperation and Development (OECD) Centre for Tax Policy and Administration. The first commentator asked: “If transfer price is purely arbitrary, and the change in after-tax profit due to any transfer pricing arrangement is done by merely changing book entries without any change to procedure, operations or added value, then where do these additional profits come from?” The second expert noted that “Transfer pricing can deprive governments of their fair share of taxes from global corporations and expose multinationals to possible double taxation. No country be it poor, emerging or wealthy wants its tax base to suffer because of transfer pricing. The arm’s length principle can help”.

Required:

a. Illustrate, through hypothetical figures, on how transfer pricing can be used by multinations to maximize their after tax profits by tax avoidance.

b. Discuss on various measures aimed at solving the problem of avoiding tax through transfer pricing.

c. Outline Tanzania Revenue Authority’s (TRA’s) response in addressing the issue of transfer pricing.

d. Discuss the effect of transfer pricing on the tax burden carried by other tax payers

e. Analyze how abuses in transfer pricing strategies may arise.

Answers to Self-Examination Questions

Answer to SEQ 1

Functional analysis is a way of analysing and documenting details of the related party transactions. Through functional analysis, a proper understanding of the assets used, functions performed and risks borne in related party transactions can be listed and discussed.

The major components of functional analysis include:

(i) Functions performed – a functional analysis should detail the functions performed by each of the related party in a controlled or related party transaction. An understanding of the functions performed is key in understanding the remuneration due to the parties to a transaction.

(ii) Assets utilised – a functional analysis should also provide details of the assets utilised by each of the parties to a controlled transaction. An analysis of assets utilised should include both the tangible assets and the intangible assets utilised by each party to a controlled transaction. The functional analysis should also detail the owners of the assets, since it may be possible for an entity to utilise an asset that it does now own.

(iii) Risks assumed – a functional analysis should provide an analysis of the risks borne by each of the parties to a controlled transaction. The entities that bear risks such as market risk, research and development (R&D) risks, inventory risk, and foreign currency risks, should be properly identified and documented. In addition, functional analysis should discuss the factors put in place to mitigate and manage such risks.

A functional analysis is used in, and important to, a transfer pricing study for the following:

(i) to identify the tested party (where necessary) ;
(ii) to identify the most appropriate transfer pricing method; and
(iii) to identify the profit level indicator (where required).

Answer to SEQ 2

CUP:

- The CUP method is the most direct method and compares the prices charged by independent companies to the same or similar products or services.
- Under the CUP method, the prices for inter-company transfer of goods and services is determined by reference to the prices charged by independent companies, providing same or similar goods and services.
- Comparability of the products or services is very key to the application of CUP, since product qualities and characteristics are very central in the determination of prices.
- Attributes often include volumes, credit period, etc., which should also be considered.

Resale Price Method:

- The resale price method works by examining the price at which products purchased from related companies is resold to third parties. An appropriate margin is given to the reseller, taking into account the functions performed, assets utilised and risks borne.
- The resale price method provides a remuneration at the gross margin level.
- The method is suitable for a reseller who does not add significant value to the product.
- An example of the application of the resale price method is where a contributor purchases goods from related companies and sells them on to third party customers.

Cost Plus Method:

- The cost plus method provides a remuneration above the costs incurred in the provision of a good or a service. The cost plus method start by the identification of costs for the provision of services or tangible goods.
- An appropriate mark-up is then applied, based on functions performed, assets used and risks borne.
- The mark-up to be applied can be determined by reference to that applied by third party companies. This can be derived from commercial databases.
- An example of the application of cost plus method could be for contract manufacturing, where the costs for contract manufacturing are determined and an appropriate mark-up is then applied.

TNMM or CPM:

- The TNMM provides a remuneration at the net margin level.
- The method provides a net margin on an appropriate basis, such as assets, sales or cost.
- The method is appropriate for the provision of services, distribution activities or contract manufacturing activities.
- An example is where a distributor is provided an operating margin, taking into account the functions performed, assets used and risks borne.

- The provision of services by WGL or the distribution activities by WGA could be remunerated by use of the TNMM or CPM method.

Profit split method – residual analysis:

- Under the profit split method, the profit derived from the controlled transaction is split between the parties to the transaction.
- Under the residual analysis, a routine profit is first provided for each of the parties for the routine functions performed in the controlled transaction.
- Any profit (or loss) remaining is then split between the related entities engaged in the controlled transaction. This split is done based on what independent entities in similar circumstances would have done, for example based on assets or costs.
- The profit split method is appropriate for highly integrated activities, or cases where all the parties in a controlled transaction contribute a unique contribution to the transaction and as such cannot be separately analysed.

Profit split – contribution analysis

- Under the contribution analysis, an analysis of the contribution by each party to the controlled transaction is carried out and valued accordingly.
- The conjoined profit from the controlled transaction is then split, based on the contribution by each of the parties to the controlled transaction.
- The method is suitable for highly integrated operations, and cases where both entities make a valuable and unique contribution to the controlled transaction.
- The method can be used, for example, where both companies to the controlled transaction contribute intangible assets.

Answer to SEQ 3

Transfer Pricing was originally an accounting concept. For groups to ensure profits were split correctly around group entities. It is arguable this is still the case, however due to the tax landscape and tax planning progressing transfer pricing has recently been viewed as a method to prevent tax avoidance by MNEs. Whilst many MNEs do still use TP in order to ensure that group companies contributions and results are monitored. However it can also be used to manipulate and save tax. By relocating services to low cost locations real costs savings are made, transfer pricing will ensure that any location savings which are not passed onto the customers will be realised by the low tax jurisdiction.

Transfer Pricing aims to ensure that groups cannot transfer valuable assets to low tax jurisdictions without ensuring substance is present. TP encourages anti-avoidance by ensuring groups have sufficient commercial justification for their transactions and documentation in place.

The BEPS project is arguably an indication that TP has not been entirely successful in preventing abuse and the OECD have recommended 14 Actions to help improve the tax global landscape.

Transfer Pricing is a key component in BEPS and arguably TP will be even more effective at preventing tax abuse and harmful tax practices in the future. In conclusion, I do not entirely agree with the statement. The aim of TP is not to directly impose anti avoidance on MNES but to ensure that all transactions are fairly priced and that profits are realised in the locations where there is substance and functions are performed, assets located and risks assumed. It should be used in conjunction with general anti avoidance rules to ensure that tax transactions are not undertaken purely for tax avoidance and non-commercial reasons.

Answer to SEQ 4

The five transfer pricing methods recognised by the OECD consist in three “traditional transaction methods”: the comparable uncontrolled price method (“CUP” method), the resale price method, and the

cost plus method; and two "transactional profit methods": the transactional net margin method ("TNMM") and the transactional profit split method.

1. The CUP Method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.
2. The Resale Price Method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the "resale price") is then reduced by an appropriate gross margin (the "resale price margin"), determined by reference to gross margins in comparable uncontrolled transactions, representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises.
3. The Cost Plus Method begins with the costs incurred by the supplier of property or services in a controlled transaction for property transferred or services provided to an associated enterprise. An appropriate mark-up, determined by reference to the mark-up earned by suppliers in comparable uncontrolled transactions, is then added to these costs, to make an appropriate profit in light of the functions performed and the market conditions. Such arm's length mark-up may be determined by reference to the mark-up that the same supplier earns in comparable uncontrolled transactions (an "internal comparable"), or by reference to the mark up that would have been earned in comparable transactions by an independent enterprise ("external comparable"). In general, the mark-up in a cost plus method will be computed after direct and indirect costs of production or supply, but before the operating expenses of the enterprise (e.g. overhead expenses).
4. The Transactional Net Margin Method examines a net profit indicator, i.e. a ratio of net profit relative to an appropriate base (e.g. costs, sales, assets), that a taxpayer realises from a controlled transaction (or from transactions that are appropriate to aggregate) with the net profit earned in comparable uncontrolled transactions. The arm's length net profit indicator of the taxpayer from the controlled transaction(s) may be determined by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions (internal comparables), or by reference to the net profit indicator earned in comparable transactions by an independent enterprise (external comparables).
5. The Transactional Profit Split Method first identifies the combined profits to be split for the associated enterprises from the controlled transactions in which the associated enterprises are engaged. It then splits the combined profits between the associated enterprises on an economically valid basis that approximates the division of profits that would have been anticipated between independent enterprises.

Under the OECD TPG, the selection of a transfer pricing method always aims at finding the most appropriate method for a particular case, taking account of the following four criteria The respective strengths and weaknesses of the OECD recognised methods;

i) The appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis;

ii) The availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and / or other methods; and

iii) The degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.

Answer to SEQ 5

TP guidelines view on intra-group back-office / management services is that such a service charge between associated enterprises will be considered consistent with the arm's length principle where:

(c) It is charged for a service that is actually rendered,

(d) The service provides, or when rendered was expected to provide, the recipient with economic or commercial value to enhance its commercial position,

(e) It is charged for a service that an independent enterprise in comparable circumstances would have been willing to pay for if performed for it by an independent enterprise, or would have performed in-house for itself, and

(f) Its amount corresponds to that which would have been agreed between independent enterprises for comparable services in comparable circumstances.

(g) A service charge made to an enterprise is not considered consistent with the arm's length principle where it is made by an associated enterprise solely because of the shareholder's ownership interest in one or more other group members. Examples of such shareholder's activities include:

  i. Costs or activities relating to the juridical structure of the parent company, such as meetings of shareholders of the parent, issuing of shares in the parent company and costs of the parent company's supervisory board;

  ii. Costs or activities relating to reporting requirements of the parent company, including the consolidation of reports; and

  iii. Costs or activities related to raising funds for the acquisition of participations in members of the group of associated enterprises (unless those members are directly or indirectly acquired by the enterprise to which the services are charged and the acquisition benefits or is expected to benefit that enterprise).

Where it is possible to identify specific services provided by an enterprise to an associated enterprise, the TP Guidelines express a theoretical preference for determining for each specific service whether it is charged in accordance with the arm's length principle. It is however recognised that a direct-charge method for charging intra-group services is so difficult to apply in practice in many cases that multinational enterprises often use cost allocation and apportionment methods "which often necessitate some degree of estimation or approximation, as a basis for calculating an arm's length charge." Where services are rendered by an enterprise jointly to various associated enterprises and it is not possible to identify specific services provided to each of them, the total service charge can be allocated among the associated enterprises that benefit or expect to benefit from the services according to reasonable allocation criteria.

The above is particularly valid for back-office / management services. Different methods may need to be applied to financial services (loans and guarantees for instance) and, depending on the facts and circumstances of the case, to operational activities such as research and development, contract manufacturing, commissionaire agreements. Central purchasing functions and similar activities that are regarded as profit centres rather than cost centres may also need to be dealt with differently.

Furthermore, cost allocations would generally not be acceptable where specific services that form a main business activity of the enterprise are provided not only to associated enterprises but also to third parties. In effect, in such cases, the determination of an arm's length charge should take account of a comparability analysis of the provision of services to associated and independent enterprises. 12

Chapter VIII of the TP Guidelines provides guidance on cost contribution arrangements ("CCAs"). Where a CCA is put in place to share the costs and risks of producing or obtaining services, each participant's contributions to the CCA must be "consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from the arrangement." The TP Guidelines note that "what distinguishes contributions to a CCA from an ordinary intra-group transfer of [...] services is that part or all of the compensation intended by the participants is the expected benefits to each from the pooling of resources and skills. [...] Such arrangements are found when a group of companies with a common need for particular activities decides to centralise or undertake jointly the activities in a way that minimises costs and risks to the benefit of each participant." CCAs are therefore often used to share the costs of a service activity which needs to be funded by all group participants irrespective of the actual usage of the service that each participant will make in a given year, insofar as it can be expected that over the duration of the agreement each participant will benefit from the funded activity in proportion to its participation.

Answer to SEQ 6

The profit split method (the "PSM") is a transfer pricing method that allocates the combined operating profit or loss from a transaction to associated enterprises in a manner that reflects the division of profits that would have been expected in an arm's length arrangement. This may include a division based on the relative contribution of each participant to the controlled transaction (the "transaction"). The relative value of each participant's contribution will normally be determined by taking into account the functions performed, risks assumed, and resources employed by the participant. There is a variety of profit split methods, including the comparable profit split method, the residual profit split method, and the total profit split method (IBFD, 2017).

Most Appropriate Method

As part of BEPS, Action 10, the OECD released revised draft guidance on PSM in June 2017. Although the OECD Guidance is non-exhaustive (and other indicators might apply), it identifies three indicators where the PSM may be most appropriate when analysing a transaction.

1. *Unique and valuable contributions by each of the parties to the transactions.* Contributions (e.g. functions performed or assets used/contributed) are unique and valuable where: they are not comparable to contributions made by uncontrolled parties in comparable circumstances; and their use in business operations is a key source of actual/potential economic benefit.

2. *A high degree of integration in certain business operations.* This means that the way in which one party 'performs functions, uses assets and assumes risks' (FARs) is interlinked with – and cannot reliably be evaluated in isolation from – the way in which another party FARs. Integration may also imply interdependency.

3. *Shared assumption of significant risks or separate assumption of closely-related risks.* This describes two situations where the playing out of the risks of each party cannot be reliably isolated.

Answer to SEQ 7

(a) Related party transactions should follow the arm's length principle. The arm's length principle uses the transactions of independent enterprises as a benchmark to determine how profits and expenses should be allocated for the transactions between associated enterprises. It compares what an enterprise has transacted with its associated enterprise with what a truly independent enterprise would have done in the same or similar circumstances. Transactions actually undertaken by the

associated enterprises would be considered, except where the economic substance differs from its form or the structure is not one that commercially rational independent enterprises would arrange. Acceptable transfer pricing method under the OECD guideline, which is also acceptable to the TRA include: the comparable uncontrolled price method, the resale price method, the cost plus method, the transactional net margin method, the profit split method, and other approaches that are in compliance with the arm's length principle. Under the comparable uncontrolled price (CUP) method, the price of property or services transferred in transactions between associated enterprises is compared to the price of property or services transferred in transactions between independent enterprises under comparable conditions. Discrepancies between these two sets of prices indicate that the transaction does not conform to the arm's length principle. Therefore the prices used by the associated enterprises should be replaced by the prices used by the independent enterprises. The comparable uncontrolled price method may apply to all types of related-party transactions. The resale price method (RPM) is based on the price that associated enterprises use when reselling products to independent enterprises.

- Arm's length purchase price = Resale price to independent enterprises × (1 − Gross margin of comparable unrelated party transaction)
- Gross margin of comparable unrelated party transaction = Gross profit of comparable unrelated party transaction / Net sales of comparable unrelated party transaction x 100%

The resale price method generally applies to simple processing business in which a reseller does not carry out any substantial value-added processing activities such as modifying the shape, function, structure of the goods involved or changing the trademark of the goods or to pure purchase and sale business.

Under the cost plus method (CPM), the arm's length price shall be reasonable cost incurred for a related-party transaction plus the gross profit of a comparable non-related-party transaction. The cost plus method generally applies to related-party transactions involving the purchase and sale, transfer and employment of tangible assets, the provision of labour services, or financing.

Under the transactional net margin method (TNMM), the net profits of a related-party transaction shall be determined on the basis of the profit margin indicators of a comparable non-related-party transaction. The cost plus method generally applies to related-party transactions involving the purchase and sale, transfer and employment of tangible assets, the transfer and employment of intangible assets and the provision of labour services.

Under the profit split method (PSM), the amount of profits that shall be distributed respectively to an enterprise and its associated party shall be calculated on the basis of contribution to the consolidated profits of the associate transaction involved made respectively by them. The profit split method consists of the general profit split method and the surplus profit split method. The profit split method generally applies to situations in which related-party transactions are so closely integrated that it is difficult to make separate evaluations on the results of transactions for all parties thereto.

(b) BC and CCL is highly integrative. There should be no comparable uncontrolled price due to their uniqueness in production and marketing strategy. That is both companies have added special value to the goods produced and sold. Also, there is no comparable mark-up to either BC or CCL. Hence RPM and CPM are not applicable. There is no comparable profit margin and TNNM may not be applicable. Due to their integrative strategy, PSM may be applicable to them.

Answer to SEQ 8

(a) Transfer pricing is the requirement in many countries to adopt pricing for goods and services between related companies at "arm's length pricing", generally meaning what would be paid if the parties were not related. The purpose of these provisions is to prevent profit shifting to reduce tax. For example, where a company in a high taxing country tries to reduce tax by paying excessive prices for goods and services purchased from a relate company in a lower taxing country, the transfer pricing provisions prevent excessive tax deductions for excessive prices by requiring the company to purchase at prices that an independent company would pay for the same goods and services. Through transfer pricing, a taxpayer seeks to minimize income and maximize deductible expenditures in high tax jurisdictions and vice versa in low-tax jurisdictions. A transfer pricing mechanism that could affect revenue in the oil and gas sector is the creative use by firms of price hedging mechanisms perhaps involving transactions between related parties, causing great difficulty in assessing whether hedging instruments are used for transfer pricing purposes rather than to reduce risk.

More common measures to maximize expenditure deductions include:

- The provision by related parties of highly leveraged debt finance at above-market interest rates.
- Claiming excessive management fees, deductions for headquarter costs, or consultancy charges paid to related parties.
- The provision of capital goods and machinery in leasing arrangements at above-market costs charged by a related-party lessor.
- If the petroleum tax rate is above the standard tax rate, there may be an incentive to establish a domestic shell firm that will on-lend financing capital from related parties to the oil company giving rise to an interest deduction at a higher tax rate than is charged on the interest earnings in the shell company.

(b) Abusive transfer pricing can be very difficult to detect and prevent. Properly designing the tax code, though, is an important first step. At a minimum, the tax legislation should include safeguards requiring that transactions between related parties be assessed on an arms-length basis, or perhaps that certain deductions be capped as a share of total costs. Some countries also impose a limit on the allowable (for tax purposes) debt-leverage of a project. It is also advisable to seek close cooperation with the tax authorities in the home countries of the more important investors. For example, the Organisation for Economic Cooperation and Development (OECD) issued suggested methodologies and procedures relating to transfer pricing. OECD transfer pricing methods proposed to determine an arm's length price include the comparable uncontrolled price (CUP), resale price method (RPM), cost plus method (CPM), transactional net margin method (TNMM), and profit split methods.

Also, the Tanzania Government set rules relate to Transfer Pricing and arm's length transactions: The Tanzania's transfer pricing legislation details how transactions between connected parties are handled and in common with many other countries is based on the internationally recognised 'arm's length principle'.

Answer to SEQ 9

Transfer Pricing is a method used to ensure that any related party transactions are justifiable, and to avoid any tax exposures for "moving profits between jurisdictions." Transfer pricing could be used to reduce global tax payments by Company A charging a high price to Company B, if A is in a low tax jurisdiction (or has tax losses) and B has higher tax rates, thus increasing profits in A and increasing costs in B.

There are a number of methods that have been adopted through the OECD framework and I will give some examples of each:

a) Comparable Uncontrolled Price (CUP)
This method would traditionally be used to compare the rates we charged related parties to those charged by/to an independent party, to ensure an arm's length price is charged. There are limitations of using this method, specifically whether the two transactions really are comparable

b) Transactional Net Margin Method (TNMM)
This is used when margins between companies in comparable industries or providing similar services. Similar to point (a) above, there is very limited, comprehensive public information between companies to enable a true comparison.

c) Functional Analysis
Functional Analysing is conducted to gain better insights into specifically what is performed and value added, whilst typing to determine on appropriate costs for each process. This requires in-depth knowledge of the business and industry.

d) Advance Pricing Agreements (APA)
APAs are possible where both contracting parties submit the basis and support to their respective government authorities to seek approval of the basis being proposed. This method reduces any uncertainty but due to the need for four parties to be involved and each party working to benefit themselves, it is a very costly and time consuming process and usually prepared for the larger multinationals.

Answer to SEQ 10

(a) **Meaning of the Arm's length principle**
The arm's length principle states that transactions between connected parties should be treated for tax purposes by reference to the amount of profit that would have arisen if the same transactions had been executed by unconnected parties. The terms which would be expected to be seen between independents are referred to as being at `arm's length. The arm's length principle is applied to a controlled transaction by replacing hypothetically the actual terms or price under which a transaction was done with arm's length terms and for tax purposes, recalculating the profits accordingly.

Main objectives of the arms' length principle

The main objectives of the arms' length principle include the following:

(1) To achieve a fair division of taxing profits and to address international double taxation as the trading arrangements and pricing policies under which multinational groups operate can result in terms considerably different from those which would have been seen between independents engaged in the same or similar transactions for a number of reasons.

(2) To make the correct application of the separate entity approach possible and therefore secure the appropriate tax base in each jurisdiction involved;

(3) To eliminate effects and distortions of the associated enterprises' special commercial and financial conditions on the levels of profits;

(4) To provide broad parity of tax treatment for MNEs and independent enterprises, that is to provide a tax treatment which is neutral towards the type of entity;

(5) To put associated enterprises and independent enterprises an equal footing for tax purposes;

(6) To serve the general principles of equality and neutrality in tax law;

(7) To avoid a distortion of the relative competitive positions between associated and independent enterprises;

(8) To promote international trade and investment by removing tax considerations from economic decisions.

(b) **Approaches used to determine an arm's length price**

The OECD Guidelines consider five methods for reaching the arm's length price which are divided into traditional transactional methods and transactional profit methods. The traditional transaction methods include, the comparable uncontrolled price, the resale minus and the cost plus methods whilst the transactional profit methods are the profit split and transactional net margin method.

(1) Comparable Uncontrolled Price method

This method simply compares the price in the controlled transaction with the price in a comparable uncontrolled transaction. If there is a difference, then the commercial and financial relationship between the associated parties may mean the price is not at arm's length. The price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction. However, identifying good, reliable comparable uncontrolled transactions can sometimes be difficult in practice

(2) Resale minus

The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price known as the resale price is then reduced by an appropriate gross margin on this price (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to marketing operations and is most useful where a company purchases goods for distribution from a connected party.

(3) Cost plus

The starting point of this method is be the costs incurred by the supplier of the goods or services. A 'plus' percentage should be added to this to give the supplier a profit appropriate to the functions carried out and the market conditions. The profit element should be calculated by reference to the profit the supplier earns in comparable uncontrolled transactions (an “internal comparable”). Failing this possibility (because the supplier does not enter into comparable uncontrolled transactions), the mark up that would have been earned in comparable transactions by an independent enterprise (an “external comparable”) can serve as a guide.

The cost plus method is most useful where semi-finished goods are transferred between related parties (e.g. a manufacturing company selling to a distribution affiliate), where joint facility agreements have been concluded, or where the controlled transaction is the provision of services.

(4) Profit split method

The profit split method attempts to eliminate the effect of a control relationship on profits accruing to each connected party by determining the division of profits that independent enterprises would have expected to realise from engaging in the tested transactions using either a contribution analysis profit split or a residual profit split.

This method is recommended for very complex trading relationships involving highly integrated operations, where it is sometimes genuinely difficult to evaluate those transactions on a separate basis. The profit split method is therefore a 'two-sided' transfer pricing method.

(5) Transactional Net Margin method

This method begins by comparing the net margin which the tested party makes from a controlled transaction with the net margin it makes from an uncontrolled one (an "internal comparable"). Where this proves impossible then the net margin which would have been made by an independent enterprise in a comparable transaction (an "external comparable") may serve as a guide.

They concentrate on finding the arm's length net profit margin as opposed to the gross profit margin sought by the 'traditional' methods of CUP, resale minus and cost plus.

Answer to SEQ 11

(a) (i)

- Selling subsidiary i.e. **EERCO at low price**
- Using services of Elephant Technology Management Ltd in the UK✓
- **charging high cost**✓
- Purchasing materials and equipment from a company incorporated in the Cayman Islands - **charging high cost**
- Using Ecco-Exodos -Pipeline at **high cost**
- Using Eldoref refinery- at **high cost**

Answer to SEQ 12

(i) Transfer pricing refers to the allocation of profits for tax and other purposes between parts of a multinational corporate group.

The question should be approached by demonstrating how a multinational can reduce overall after tax profit by adopting a transfer price which will allow a company (subsidiary or parent) in a country with favourable tax rate to bear the tax burden and the one in a country with high tax rate to pay little or no tax at all. Two cases may be used to illustrate the point/experience.

Scenario 1

Given different corporation tax rates in different countries, MNC may arrange to shift some profits to a country with favourable tax rate, and therefore pay little tax

Consider the following transactions

Subsidiary:

Cost of goods by a Subsidiary (in country 1 in which tax rate is 20%) shs.100,000.

Repacked, exported and sold/transferred to Parent company in Home country at 200,000

Therefore, transfer price is 200,000

Hence, profit made by subsidiary is (200,000 – 100,000) = 100,000

Tax (20%* 100,000) = 20,000

Parent company:

Sold the goods at 300,000
Transfer price was the purchase/import price by parent company 200,000
Therefore profit made (300,000 – 200,000) = 100,000
Tax (60%* 100,000) = 60,000

Overall profits; overall tax; overall after tax profits

Profit in the subsidiary's company host country = 100,000
Profit in the MNC' home country = 100,000
Total/overall profit = 200,000
Overall tax paid is (20,000 + 60,000) = 80,000

The effect of this overall tax paid after arranging for transfer price is – it reduces the overall before tax profit of shs.200,000 to an after tax profit of 200,000 – 80,000 = 120,000. The subsidiary (in favourable tax rate regime) contributed higher to the overall profit while parent company (tax rate in home country is high) contributed less to the profit.

Scenario 2

Overall after tax profit may be increased merely by changing the transfer price to an arbitrary higher figure. Therefore, given high tax rate in parent company home country, the parent company may shift all the profits to the subsidiary in which tax rate is low. In this case, parent company will not pay tax at all

Refer transactions and particularly in scenario 1. But now transfer price is increased and the same transfer price is adopted by the MNC as a selling price. Specifically, as the transfer price is arbitrary it can be shs.300,000. This means that parent company is buying and selling at the same price as follows:

Subsidiary:

Cost of goods (incurred by subsidiary) = 100,000

Transferred to parent company at = 300,000

Profit made by subsidiary (300,000 – 100,000 = 200,000

Tax paid by subsidiary (20%*200,000) = 40,000

Parent company:

Transfer price/purchase price	300,000
Selling price	300,000
Profit made (300,000) – 300,000)	0
Tax paid (60%*0)	0

Overall tax paid is therefore 40,000 compared to 80,000 in scenario 1 and after tax profit becomes 200,000 – 40,000 = 160,000 in which subsidiary contributes 160,000 to this while parent company's contribution is 0. So what has happened is to shift all the parent's company profits to the subsidiary and not pay tax in the home country at all.

(ii) **Solution to tax avoidance through transfer pricing**

Discussion of the measures designed to address the problem of avoiding tax by MNCc through transfer pricing should be/is expected around the following

- Creating an international tax regime

In the international tax area there are a variety of national tax policies, bilaterial tax treaties (BTTs), and model treaties and guidelines developed by institutions such as the OECD and the United Nations. At the bilateral level, most OECD countries have negotiated bilateral tax treaties (BTTs) **to define the tax base, set up transfer pricing rules, and arrange for dispute settlement procedures.** At the multilateral level tax codes and guidelines for members are developed. These are not binding commitments but most member countries have used OECD **codes and guidelines to set up their own tax system.**

A combination of these government policies can be seen as constituting international tax regime. The regime **reduces transaction costs associated with international capital and trade flows; resolve tax disputes between tax authorities and MNCs, and between home and host governments; and reduces the possibilities for opportunistic behavior by MNCs and countries/governments by formalizing rules and dispute procedures.**

- *The tax transfer pricing regime/the arm's length standard*

International tax transfer pricing regime is centred around the international norm of the firm's length standard. The solution that tax authorities (in OECD countries) have adopted to reduce the probability of transfer **price manipulation is to develop specific transfer pricing regulations as part of the corporate income tax code**. These regulations are based on the concept of **arm's length standard,** *which requires two related parties to set the same transfer price for an intrafirm transactions as two unrelated parties would have set if they had been engaged in the same or similar transaction under the same or similar circumstances.*

Under the arm's length standard, the associated enterprises are treated as separate entities for tax purposes, rather than as parts of integrated multinational enterprises. Each entity must price its related party transactions as if (i.e. under the hypothetical assumption that) the entities are at arm's length. *The arm's length price is therefore the price two unrelated parties would reach through bargaining in a competitive market.* The OECD recognizes that it may be impossible to determine a single one arm's length price so an arm's length range or equally reliable prices may be acceptable because transfer pricing is not an exact science.

The **key to determining** an arm's length price is the **comparability** of the related party and **independent transactions.** *Comparability means* there should be no differences in the 'economically relevant characteristics' of the two situations that could materially affect the pricing method or that such differences can be taken in to account. Economically relevant characteristics include characteristics of the property or services transferred, the functions performed by the parties, the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.

(iii) Tanzania Revenue Authority's (TRA's) response in addressing the issue of transfer pricing

Tanzania Revenue Authority has developed **transfer pricing guideline** to be used as a **practical guide** which provides that each transfer pricing arrangement case will be decided on its own factors and circumstances, taking in to account the taxpayers' business strategies and commercial judgment. These Transfer Pricing Guidelines (hereinafter referred to as the Guidelines) are largely based on the governing standard for transfer pricing which is the arm's length principle as set out under the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines and the United Nations (UN) Practical Manual on Transfer Pricing for Developing

Countries, (hereinafter referred to as OECD/UN Guidelines) TRA abides by this arm's length principle and believes that this is the most appropriate standard to determine transfer prices of related parties.

In addition to the guideline, there is also **income tax transfer pricing regulations, 2014**

(iv) **The effect of transfer pricing on the tax burden carried by other tax payers**

The answer/candidates' views may be constructed around the fact that tax avoidance transfers the tax obligation as discussed below:

The parent company operates in the home country. The government of home country spend money on behalf of its citizens – providing education, health care, roads etc. It collects much of the money it needs from citizens and companies by means of a tax on income – progressive tax system (refer PAYE and corporation tax for income tax purpose; consumption taxes).

Assume that a multinational has increased its profits by tax avoidance. As the government's expenses (in providing the services mentioned above) have not changed it must make up this shortfall elsewhere. From its other tax payers, say from its citizens. So its citizens pay more tax, the government can now spend the same amount as before, the multinational's profits have increased.

In other words, the multinational's increased profits arise from money which is in effect collected by the government by taxation from its taxpayers, i.e. the burden of tax is shifted to other tax payers in this manner.

The multinationals are thus in effect taxing the people and in this way increasing the multinational's profits and thus their own incomes and wealth.

(v) Abuses in transfer pricing strategies

Abuses arise when the MNE taxpayer uses transfer pricing to shift income to low or no tax jurisdictions, typically by adding steps to an intercompany transaction such that most of the profit is made in a low (or no) income tax jurisdiction.

SECTION C

INTERNATIONAL TAXATION

C6

STUDY GUIDE C6: THIN CAPITALISATION

Get Through Intro

The way in which a taxpayer is financed has an impact on the calculation of the taxpayer's taxable income. This raises tax concerns regarding the balance between the amount of equity capital and debt capital. A taxpayer which is considered to have too little equity when considered against the amount of its debt is said to be thinly capitalised for tax purposes. Thin capitalisation typically becomes an issue in cases where a taxpayer is funded either directly or indirectly by non-resident connected persons. This guide explains the meaning and approaches employed by tax authorities to prevent thin capitalisation. Moreover the guide discusses thin capitalisation rules in Tanzanian Income Tax regime.

Learning Outcomes

a) Explain the meaning of the term ''thin capitalisation''
b) Describes the reasons why entities may choose to be thinly capitalised.
c) Explain various approaches to prevent thin capitalisation
d) Describes thin capitalisation rules in Tanzania

Explain the meaning of the term ‘’thin capitalisation’’ and describes the reasons why entities may choose to be thinly capitalised.
[Learning outcome and b]

1. Meaning Of The Term ‘’Thin Capitalisation

Thin capitalisation refers to the situation in which a company is financed through a relatively high level of debt compared to equity. Thinly capitalized companies are sometimes referred to as —highly leveraged or —highly geared companies. In other words a company is considered thinly capitalized when its capital is made up of a much greater proportion of debt than equity. This is usually done with the sole or primary motive to benefit from its tax advantages. The 1987 OECD Report states that the term thin capitalization is commonly used to describe “hidden equity capitalization through excessive loans’’

2. Reasons Why Entities May Choose To Be Thinly Capilised

From a tax point of view companies choose thin capitalisation because existing corporate tax systems allow companies to deduct interest expenses from the corporate tax base whereas equity returns to investors are not tax deductible. Income earned by a corporation and distributed to its shareholders (in the form of dividends) is subject to two levels of tax – corporate tax when the income is earned by the corporation and shareholder tax when the income is distributed to the shareholders as a dividend. In the case of a non-resident shareholder, the shareholder tax is usually imposed as withholding tax.

A multinational company can choose its capital structure according to differences in international taxation, in order to minimise the tax burden of the whole group of companies. For instance, a company located in a low tax country could lend to an affiliate in a high tax country. This would allow the company located in the high tax country to deduct interest payments from its profits resulting in a significant reduction of the overall tax payment which would not be the case if the company were funded with equity. A simple illustration of the relative advantage of debt over equity financing is shown in Table 1.0 below: Company A, being financed entirely by equity and Company B, being financed by excessive Debt.

Table 1.0 Illustration of the Relative Advantage of Debt over Equity Financing

	COMPANY A	**COMPANY B**
Capital Structure:	Tshs ’000	Tshs ’000
Equity	20,000	1,000
Loan from parent company	Nil	19,000
Total	**20,000**	**20,000**
Chargeable Income:		
Profit	1,000	1,000
Deduction on interest payments (say @ 5% on 19,000 loan (company B only)	Nil	(950)
Income chargeable to tax	1,000	50
Tax say @ 30% corporate rate	**300**	**15**

Table 1.0 above shows that tax saving of Tshs 285, 000 (300,000-15,000) is made by financing with debt rather than equity. Considering that Multinational companies deal in transactions worth millions rather than thousands, the tax savings are all the more significant. In fact international debt shifting is suspected to be a core factor behind empirical findings that multinational firms seem to pay substantially lower taxes, as a share of pre-tax profits, as compared to nationally operating firms

Given this bias for debt over equity financing, many countries have introduced rules to limit the deductibility of interest expenses in cases where the leverage is considered excessive. These rules are commonly known as "Thin capitalization rules"

Explain various approaches to prevent thin capitalisation and describes thin capitalisation rules in Tanzania [Learning outcome c and d].

3. Approaches To Prevent Thin Capitalisation

Generally, countries will commonly use one of the following approaches or combinations thereof to control thin capitalisation:

(i) No rules approach

Several tax jurisdictions do not have specific rules to curb thin capitalization. Some civil law countries rely on their general anti avoidance provisions, such as the ''abuse of law'' or the '' abuse of rights. 'The common law countries apply similar judicial doctrines of substance over form. For example Austria does not have specific thin capitalization rules. However, Austria's Supreme Administrative Court established certain broad and liberal guidelines, which are used to determine whether the equity for commercial purposes is adequate for tax purposes. If the equity is inadequate, a portion of the indebtedness to shareholders may be regarded as the equivalent of shareholders' equity. Other countries with no specific thin capitalisation include: Brazil, Colombia, India, Singapore, Indonesia Israel, Sweden, etc. Some countries, as already stated above, rely on general anti-avoidance provisions rather than specific thin capitalization rules.

(ii) Fixed Debt to Equity Ratio

Several tax jurisdictions specify a maximum debt-equity ratio to restrict the loans provided by controlling nonresident shareholders. The rules often (but not always) stipulate the minimum controlling interest that indicates the ability of a shareholder to influence the financing decisions within the company. Under this method, the resident borrower cannot deduct the interest on loans from certain nonresident shareholders in excess of the specified debt –equity ratio. The ratios and equity ownership or voting control limits in different jurisdictions vary widely.

For example :(OECD countries only).

Table 1.1:The ratios and equity ownership or voting control limits in different jurisdictions

	Debt-equity ratio	Equity ownership or voting control
Belgium	7:1	-
Switzerland	7:3	>50%
Denmark	4:1	>50%
Italy	4:1	=>25%
Austria	4:1	-
Czech Republic	4:1	-
Netherland	3:1	=>33.3%
Spain	3:1	=>25%
Korea	3:1	=>50%
Poland	3:1	=>25%
Mexico	3:1	-
Turkey	3:1	=>10%
Hungary	3:1	-
Canada	2:1	=>25%
Portugal	2:1	=>10%
Australia	3:1	40%/50%
France	1.5:1	=>50%
Germany	1.5:1	>25%
United States	1.5:1	>50%

Source: *Rohatgi, Roy. Basic International Taxation. (2002) at page 396*

(iii) Arm's length approach

This approach is based on the general principles of transfer pricing The key determinant is whether an unrelated party would provide debt funds on the same basis as the related party loan arrangement. It examines the facts and circumstances to decide if the loan was unusual, and whether independent parties would grant it under the same conditions. Thus, the term and nature of financing and the commercial circumstances in which it is made are reviewed to determine if it is really debt or equity.

The advantage of the arm's length approach is that it provides for a much closer approximation of the debt the corporation could borrow at arm's length and thus removes asymmetrical treatment between companies that are members of multinational enterprises and those that are not. The arm's length analysis is tailored to the facts and circumstances of each case, and allows a more tailored approach to the determination of deductible debt interest. In contrast, a ratio approach (described below) relies on an often inflexible standard embodied in a ratio.

Depending on the exact wording of the relevant legislation, an arm's length approach to thin capitalisation may be achieved through a country's general transfer pricing rules.

An arm's length approach may also allow elimination of double taxation through the application of a tax treaty, if it is accepted by both treaty partners that the approach represents the application of the arm's length principle and thus falls within the ―associated enterprises‖ article of the relevant treaty. There is less than full consensus, however, on the extent to which thin capitalisation provisions fall within the scope of tax treaties.

The disadvantage of utilising an arm's length approach is its large resource and skill requirements. In order to apply the arm's length approach, the tax authorities needs to understand the processes third party lenders uses to determine the maximum amount they would lend to a specific taxpayer. Tax authorities need to have expertise to step into the role of the third party lender and establish the specific characteristics of the group affiliate to determine an appropriate amount of debt

In practice this means that, in implementing a pure arm's length approach

i) Tax Authorities need to gain significant understanding of third party lending practices
ii) And need to investigate the application of those criteria with regards to specific taxpayers,
iii) And, inevitably, this will require a degree of judgment to determine the proper treatment for each factual situation.

In some countries, tax administrations engage in discussions with third party lenders to understand how a third party would determine how much it would be willing to lend. Third party lenders may use criteria based on the free cash flows of the business, and the bank's perception of the group affiliate's ability to pay the interest and repay the loan to determine lending amounts. For this lending decision, third party lenders take into account many factors including the forecasted cash flows of the borrower (which they stress test), the quality of the management of the group affiliate, an economic analysis of the industry sector, the overall health of the economy, the quality of the collateral that can support the loan, and a bank's own liquidity position

(iv) Hidden Profits Distribution

Some countries have specific provisions under their tax laws that allow loan interest to be reclassified as a hidden profit or constructive dividend in certain circumstances. This would have the same effect as when the shareholder had provided finance in the form of equity. As a consequence, the reclassified interest (representing a dividend) increases the corporation's profit and hence the corporate tax applicable. Further, as the interest is treated as distribution of profit, the dividend withholding tax rate is applicable. These rules will usually apply where the parties to the transaction are related parties or if the subsidiary company is undercapitalised and a loan from the parent or affiliated companies is of a permanent nature or is granted on a non-arm's length basis

4. Thin Capitalisation Rules In Tanzania

Main methods Tanzania uses to counteract thin capitalisation are:-

(i) Fixed Debt to Equity Ratio

Section 12(2) of the Income Tax Act,(Cap 332) provides that an exempt-controlled resident entity may deduct interest expenses; however, the deduction shall not exceed the sum of interest equivalent to a debt-to-equity ratio of 7:3 (or 2.33 to 1). The term debt is defined within the provision as, any debt obligation excluding, a non-interest bearing debt obligation; a debt obligation owed to a resident financial institution, and a debt obligation owed to a non-resident bank or financial institution on whose interest tax is withheld in the United Republic. Whereas the term equity is defined as paid up share capital; paid up share premium; and retained earnings on an unconsolidated basis determined in accordance with generally accepted accounting principles. Interest must be incurred wholly and exclusively in the production of income from a business or investment to qualify for the deduction.

(ii) Arm's length approach

The Income Tax Act Cap 332 contain transfer pricing provisions (requiring the use of arm's length approach on transactions between associates. The Income Tax Act Cap 332 provides that any arrangement between persons who are associate, adjustment income or deduction with respect to quantification, apportionment or allocation shall be made necessary to reflect the total income or tax payable that would have risen for them if arrangement been conducted at arm's length. The principle in these provisions is that transaction between associate (connected person) are to be conducted at arm's length. This means that the transaction in the arrangement between connected persons should have the financial characteristics of transaction between independent people under the same or similar circumstances where each person will strive to obtain the utmost benefit from the transaction. The section therefore provides mechanism by which the commissioner adopts the arm's length principle to quantify apportion and allocate amount involved in the transaction based on condition which would have existed between unconnected person.

Self-Examination Questions

Question 1

(d) Explain why some jurisdictions consider it appropriate to enact "thin capitalisation" provisions or publish administrative guidance to address the issue of "thin capitalisation".

(e) Give examples of different means by which "thin capitalisation" provisions or guidance might determine the amount of excessive interest expenses.

(f) Some "thin capitalisation" provisions are concerned only with limiting the deductibility of interest on debt between related parties. Is such a limitation logical, particularly when applied in the circumstances of a corporate group carrying on substantial business activities in a large number of jurisdictions? Explain your answer.

Question 2

Thin capitalisation rules in a host state's domestic legislation can represent an obstacle which companies need to carefully consider before setting up their funding strategy for a new project. However, the complex variety of funding alternatives can be seen as an opportunity to plan a company's funding operations in order to preserve the tax utilisation of paid interest expenses.

Required:

(c) Explain what is meant by 'thin capitalisation rules', and discuss the different ways in which thin capitalisation rules may introduce limitations for companies, and their tax effects.

(d) Discuss possible planning alternatives which may be used to bypass thin capitalisation restrictions.

Question 3

A foreign parent company, AMADEUS LIMITED has a loan of Tshs 40,000,000 to its wholly-owned subsidiary in Tanzania, Amazon Tanzania Limited. Amadeus Limited's equity in Amazon Tanzania Limited is Tshs 2,000,000 and interest payable on the debt for the 2018 year of assessment is Tshs 6,000,000.

Required:

Determine the interest that should be allowed for tax purposes in 2018 year of assessment for Amazon Tanzania Limited. Explain your answer.

Answers to Self-Examination Questions

Answer to SEQ 1

(d) "Thin capitalisation" generally refers to the situation where a company is financed excessively with debt as opposed to equity. Thin capitalisation provisions seek to counter such practice by deeming interest on some debt to be non-deductible, essentially on the basis that such debt is to be treated as equity. Some countries believe that thin capitalisation provisions are appropriate because of the relative tax advantages of financing an operation in their country by debt rather than equity. Typically, the advantages of debt financing compared to equity financing are as follows:

- Interest on debt is typically deductible, whereby dividends paid on equity are nondeductible. Accordingly, the use of debt funding tends to reduce the tax collected by the country in which an investment is located.
- Withholding tax rates on interest are often lower than the rates on dividends. This leads to a further erosion of tax collections in the jurisdiction of an investment when that investment is financed predominantly by way of debt.
- Although not relevant in the jurisdiction of the investment, the benefits of debt financing may be offset by the fact that interest will typically be assessable in the hands of the recipient, whereas dividends often qualify for concessional treatment. Nonetheless, it is sometimes possible to provide the debt through a group finance company in a low tax jurisdiction, or through the use of a hybrid entity whereby the interest is treated as a dividend to the recipient.

(e) The key to "thin capitalisation" provisions is establishing the amount of debt the interest on which will be allowed as a deduction, or alternatively the amount of allowable interest expenses. There are a number of ways of doing this. In particular:

- Traditionally, in many jurisdictions the amount of debt on which interest is an allowable deduction has been determined by specifying a maximum debt equity ratio for the company. For example, the provisions might specify that interest on debt of no more than three times the equity will be allowed to be deducted. This requires a careful definition of the terms "debt" (whether all debt, related party, foreign lenders, etc.) and "equity" (whether retained earnings, provisions,convertible debt, etc. is included).
- An alternative approach is to adopt rules similar to the US earnings-stripping provisions where interest deductions are limited to a percentage of the net profit before interest.
- Finally, a more modern approach to determining the acceptable level of debt funding (or gearing) which recognises that different groups and industries have different approaches to finance, is to allow a debt:equity ratio in a jurisdiction based on the group's overall debt:equity ratio. So if, for example, a multinational group has an overall debt:equity ratio of 7:3, this could be the starting point for determining an acceptable ratio in a particular jurisdiction.

(f) If a jurisdiction is concerned that inbound investment is being funded excessively by debt and that not enough of the group's equity is being allocated to the jurisdiction, it is not logical to apply restrictions only to related party debt. To do so implicitly treats the problem as one of narrow tax planning by the group. In particular, the benefits of debt funding to a taxpayer in a jurisdiction apply irrespective of whether the debt is from a related party. Indeed, bank debt in many cases provides for greater benefits than related party debt because it sometimes attracts lower rates of withholding tax. From the perspective of a multi-national group which has significant overall borrowings, financing an

investment in a foreign jurisdiction with a high level of borrowings is simply a matter of allocating a disproportionate share of the aggregate borrowings to that jurisdiction. Put another way, a group financed with a mixture of debt and equity can, in the absence of relevant thin capitalisation rules, choose to allocate its total equity and total debt between jurisdictions in a tax efficient manner. Accordingly, focussing solely on related party debt does not properly address the issue of thin capitalisation. For this reason, some jurisdictions now look to all debt when applying thin capitalisation restrictions and seek to measure the gearing ratio in the jurisdiction to the groups global gearing ratio. A further reason why looking only to related party debt is not logical is that in the absence of effective anti-avoidance provisions (either general or specific to the thin capitalisation provisions), circumventing the restrictions by interposing an unrelated party (such as a bank) in the transaction would appear to be relatively straightforward.

Answer to SEQ 2

(c) The thin capitalisation restrictions are domestic provisions introduced by different States to avoid a company with a small amount of capital or equity to contract big amounts of debt from a group or related company and accumulate tax deductible interest expense which reduce the amount of tax collected by that State. The principle behind the restriction is that under normal market rules a company with no assets should not be able to secure large amounts of debt from third parties and therefore the use of company loans may be being used only to obtain unlawful reduction of the tax normally due in the host jurisdiction. The effect of the thin capitalisation provisions applying is that the company will see denied the tax deduction for any interest expense which exceeds a certain threshold or does not comply with the requirements of the provisions. As a general rule any disallowed interest can be carried forward for the following years. In some countries the rules may be extended to third parties loans where there is an influence of group companies in the obtaining of said loan. The more common examples of this is the granting of a guarantee by a parent group company or a back to back loan.

Many countries use a debt to equity ratio to determine what would be an acceptable amount of debt under the thin capitalisation provisions. This ratio is normally around the 3:1 mark but it can be higher or lower depending on the jurisdiction. Some countries complement their thin capitalisation rules with an earning stripping rule. In this case a lower debt to equity ratio (e.g. 1.5:1) is put in place where the company receiving the interest payment is not subject to tax in the same Country as the company paying the interest (e.g. USA). Other companies use the transfer pricing provisions as criteria for the analysis of acceptable amounts of debts. Where the amount of debt exceeds what would be authorised to an independent party the corresponding interest expense will be disallowed as a tax deduction (e.g. UK). In some countries the thin capitalisation legislation allows the company obtaining the loan and the tax authorities to enter into an advance agreement on the acceptable amounts of debt either through a specific advance thin capitalisation agreement or through an Advance Pricing Agreement.

The thin capitalisation analysis can also in some cases consider the worldwide situation of the group by comparing the amount of debt obtained by all the companies in a certain jurisdiction exceeds a determined percentage of the overall group worldwide gross external debt and disallows any interest expense exceeding this percentage (e.g UK). Other criteria used by some jurisdictions to kick-in thin capitalisation provisions is the debt to EBITDA (earnings before interest, tax, depreciation and amortization) ratio or the debt to assets ratio. In this countries the net interest expenditure in excess

of a determined percentage of a company's EBITDA or total assets will be disallowed. This can apply to third parties or related companies loans (e.g. Germany and Denmark).

(d) Potential alternative structures for funding outside the thin capitalisation provisions include:

- Sale and lease back agreements where the group company buys an asset from its subsidiary and then leases the asset back to the seller. This is normally qualified as an operating lease which as a general rule will not be considered debt under the thin capitalisation provisions.
- Debt factoring where the subsidiary sells its trade receivables for future payments or doubtful debts at a discount considering its book value given that it will receive the payment immediately. It is important this operation follows the transfer pricing provisions and market conditions which would apply between independent parties.
- A back to back loan where the group company intervenes in the relationship between the bank and the subsidiary by guaranteeing the loan through a deposit made with the same bank in another jurisdiction or through the granting of parent company guarantees. In some situations a fee may be charged to the subsidiary which could also be tax deductible in the host jurisdiction.
- The group company may increase the equity portion of its subsidiary either through cash or assets contributions so that it can comply with any debt to equity ratios applicable under the thin capitalisation provisions.
- The parent company and subsidiary may agree on fees due for financial services as cash pooling treasury management, foreign spot transactions, currency purchase agreements, swap transactions which will not as general rule be qualified as interest expense. However, some jurisdictions may include these fees in the definition of interest for thin capitalisation purposes.
- The group company may provide a smaller loan at a bigger interest rate assuming the transfer pricing principles allow for this rate considering the market and risk aspect of the loan.

Answer to SEQ 3
Determination of Allowable Interest – 2018 Year of Assessment

Interest allowable shall not exceed debt to equity ratio of 7:3 as provided for under thin capitalization rules. So with only equity capital of Tshs 2, 000,000, the interest payable on the debt of Tshs 40,000,000 should be subject to the thin capitalization rule.

Interest charged = 6,000,000
Equity Investment = 2,000,000

Interest Allowed

$$\frac{7 \times \text{Equity} \times \text{Interest Charged}}{3 \times \text{Total foreign loan from parent company}} = \frac{7 \times 2{,}000{,}000 \times 6{,}000{,}000}{3 \times 40{,}000{,}000}$$

700,000

SECTION C

INTERNATIONAL TAXATION

C7

STUDY GUIDE C7: TAX HEAVENS

Get Through Intro

Tax havens, or low tax jurisdictions have been a feature of tax planning for many years. In the last decade there has been a concerted effort on the part of the global tax community, spearheaded by the OECD to a great extent, to combat tax evasion and tax avoidance, and this has meant examining in greater detail the use of tax havens. This guide explains the meaning, features and types of tax havens. Moreover the guide describes the reasons for a country to become a tax havens and forms of tax avoidance in tax havens.

Learning Outcomes

a) Explain the meaning and features and uses of tax havens
b) Explain main types of tax havens
c) Describe forms of tax avoidance in tax havens
d) Describe incentives for a country to become a tax havens
e) Explain the cost of tax havens to LDCs
f) Describe the OECD Committee on Fiscal Affairs (CFA) harmful tax competition report

Explain the meaning and features and uses of tax havens; explain main types of tax havens and describe forms of tax avoidance in tax havens.

[Leaning outcome a, b and c]

1. Meaning And Features Of Tax Havens

1.1 Meaning

A tax haven means a nation with nil or moderate level of taxation and /or liberal tax incentives for undertaking specific activities such as exporting. Tax havens of the world are not only countries. They include states or provinces within countries that are under their own jurisdiction. Examples of such tax havens of the world are Delaware and Oregon which are tax havens in the United States

1.2 Features of the Most Commonly Used Tax Havens

Typically the following features are seen in low tax centres / tax havens:

(a) no/low income or corporation tax;
(b) no/low capital taxes, either on capital gains or profits or on accumulated capital/wealth;
(c) no/low taxes on transactions in shares or property in general, e.g. no stamp duties, registration taxes, or capital duty on increases in share capital;
(d) no/low withholding taxes on local dividends, interest, royalties, and fees;
(e) has no controls on **foreign exchange** movements;;
(f) has a legal system that ensures **secrecy**;
(g) signs DTA with several countries & facilitates Treaty Shopping.
(h) good commercial and company law to enable contracts to be enforced and companies set up;
(i) good local lawyers, accountants, trust and other professional administrators;
(j) work permits relatively straightforward to obtain;
(k) the local currency should be a stable one;
(l) good banking and financial system;
(m) good communications links with other countries worldwide;
(n) good roads and transport facilities, e.g. airport, etc; and
(o) stable economic, political and social system
(p) makes laws specifically designed to help "financial engineering", "creative accounting" and "tax avoidance".

1.3 Typical uses of tax havens include:

1. holding assets, including intangibles rights;
2. acting as a parent company location for a group;
3. acting as an in-house captive insurance company location for a multi-national group of companies or even as an insurance company for customers of the group (e.g. in relation to extended warranties);
4. acting as a treasury centre, to avoid taxation of exchange gains on currencies, or to lend money to group companies (sometimes by means of issuing discounted securities which can avoid withholding tax issues), or to raise funds (e.g. by means of a Eurobond issue);
5. acting as a service centre for other group companies, e.g. by giving professional advice, or providing back-office functions (e.g. in the case of banks or insurance companies), or buying goods on behalf of the group to obtain better buying terms, or undertaking factoring activities for the benefit of the group;
6. providing warehousing facilities for the group in relation to the export of goods;

7. providing a focal point for the registration of ships, and possibly reducing the need to meet certain rules that would otherwise apply in another location;
8. undertaking contract manufacturing or assembling of products; and
9. acting as a pure “money box” location, to accumulate tax free interest Other activities may be undertaken, but the degree of those activities is often restricted by the lack of adequate local people or by the nature of the location.

   More recently low tax centres have acted as a hub for e-commerce activities, e.g. as a location for servers and web-sites, which may be developed or updated onsite.

2. Forms Of Tax Avoidance In Tax Havens

Multinational Corporations face a perennial charge for their misuses of tax havens to shield income from the local tax collector.

The tax avoidance in tax havens takes palace broadly by two methods.

(a) Profit Diversion
(b) Profit Extraction

1. Profit Diversion:

Under this, profit is diverted away from high tax jurisdiction into the tax haven thereby avoiding income tax on the money thus diverted. For ex Company X, which is, a MNC sells at a low price to a subsidiary in a tax haven country that in turn sells worldwide the same product at high prices.

2. Profit Extraction:

In this method, a company in a tax haven country renders services to a company in a high tax jurisdiction and extracts money from that jurisdiction in the form of consultancy fees, licensing fees, technology fees, royalty etc as being gross by inflated so that effectively money is brought into the tax haven while the high tax jurisdiction subsidiary claims these fees as deductible expenses.

3. Main Types Of Tax Havens

(a) Nil tax haven countries

These have no taxation at all on income of any sort accrued from these nations. This type encompasses many of the tax havens in the carribean, such as the Bahamas, Bermudas and the Cayman islands. For Example, Bahamas levies a flat tax of 100$ per year on all Bahamian Companies. It has no tax treaty with any country require it to disclose any information.

(b) Nil tax outside haven countries

These impose tax on any income accruing from within its territory but exempt from tax any income brought into the tax haven from outside. A country whose tax benefits are characteristic of this type is Hong Kong. Although Hong Kong imposes a nominal tax of 15% on Hong Kong sourced income, foreign source income is completely exempt. Panama is another good example of nil tax outside haven countries.

(c) Low tax haven countries

Here, income is not exempted but taxed at lower rates. A good example for a country representing this type of tax haven is The British Virgin Islands. It has a 12 % income tax rate. Another example is the Netherlands Antilles, a colony of the Netherlands located few miles off the coast of Venezuela. Income taxes in these countries are very low, and there are special tax privileges to shipping, aviation and holding companies.

(d) Special Exemption tax haven countries

These are special exemptions, which are given in the form of a special act or concessions to attract investment by MNC's. This group includes those countries that are trying to promote development in certain regions or encourage industrialization within the country. The most notable example here is the Republic Of Ireland, which exempts from taxation the export earnings of corporations that setup manufacturing operations in certain regions.

Describe incentives for a country to become a tax havens; explain the cost of tax havens to LDCs; and describe the OECD Committee on Fiscal Affairs (CFA) harmful tax competition report.

[Learning outcome d, e and f]

4. Incentives For A Country To Become A Tax Havens

There are several reasons for a nation to become a tax haven. Some nations may find they do not need to charge as much as some industrialized countries in order for them to be earning sufficient income for their annual budgets. Some may offer a lower tax rate to larger corporations, in exchange for the companies locating a division of their parent company in the host country and employing some of the local population. Other domiciles find this is a way to encourage conglomerates from industrialized nations to transfer needed skills to the local population.

5. Cost Of Tax Havens To LDCs

(i) **Tax havens facilitate tax avoidance and evasion,** which undermine the revenue bases of both developed and developing countries. Additional revenues are urgently needed both to tackle the deficits incurred during the financial crisis in rich countries, and to invest in the fight against poverty in poor countries. The roaring trade undertaken by tax havens leads to the tax burden being shifted from the companies and rich individuals who use their services, on to ordinary people and businesses who comply with their tax obligations. At the same time, the loss of government revenues means lower investment in public services.

(ii) **Loss in tax revenue:** In public discussion, the loss of tax revenue is considered to be one of the most negative effects of secrecy jurisdictions. Thus, the loss of tax revenue might lead to a lack of financial assets that can be used for state investments in the development of the economy as well as for social and environmental projects. This lack of financial assets and tax revenue mainly impacts upon low- and middle-income individuals as they are mostly reliant on a functioning community and social sector.

(iii) **Jeopardizing financial market and economic stability:** There are various examples of how tax havens/ secrecy jurisdictions can negatively affect financial market and economic stability. Hence, while channelling assets and liabilities through tax havens/secrecy jurisdictions, financial institutions can hide negative liabilities and convey a false outlook on their financial stability. In this regard, the predominant lack of disclosure requirements in secrecy jurisdictions has to be considered as creating an enabling environment for hiding ownership structures and major interests. Therewith, risks might not be disclosed and, in turn, cannot be evaluated objectively and effectively by market participants.

(iv) **Enabling criminal activities:** The opacity of tax havens/ secrecy jurisdictions creates an intentional and legally facilitated framework that potentially hinders the investigation into

market participants active in tax havens/ secrecy jurisdictions as well as the activities conducted. As a result, money laundering, terrorist financing, drug trafficking, human trafficking, illegal arms trading, all sorts of fraud, and many more can be considered as natural outcomes of legally facilitated secrecy.

6. OECD Committee On Fiscal Affairs (CFA) Harmful Tax Competition Report

In 1998 a report entitled "Harmful Tax Competition, An Emerging Global Issue was published by the OECD Committee on Fiscal Affairs (CFA) which established a forum to promote certain desirable features in tax systems, i.e.:

1. those which encompassed transparency;
2. the need to have tax systems that did not encourage non-resident investment at the expense of local residents, i.e. ring-fenced incentives, so that systems that could alter the local tax bases for assessing profits where there were no resulting substantive economic benefits to the local community could be outlawed. These principally applied to multi-national companies in their dealings with tax authorities;
3. to ensure money laundering provisions are in place;
4. to have proper financial regulations in place; and
5. to have substantial exchanges of information between OECD as well as non- OECD nations.

The harmful tax report followed on from an earlier report produced by the OECD:
"Tax Havens – Means to prevent abuse by taxpayers" (1987). Three other related reports were published in the same year dealing with conduit companies, base companies and bank secrecy. These and the 1998 harmful tax reports had as a central focus the financial service industries within tax havens.
The 1998 report made recommendations in three categories: domestic legislation and practice; tax treaties; and International co-operation. Concerning domestic legislation and practice the report recommended that countries consider:

- Adopting Controlled Foreign Company rules
- Adopting Foreign Investing Fund rules
- Make amendments to their use of the exemption method for DTR
- Introducing information reporting rules
- Making public details of advance clearances
- Following the OECD Transfer Pricing guidelines
- Removing impediments to banking information

With regard to tax treaties the report suggested that:

- Countries should undertake programs to intensify relevant exchange of information with tax havens and preferential tax regimes;
- Countries should include provisions aimed at restricting treaty benefits in DTC and consider how current provisions can be used;
- The commentary on the model convention be clarified to remove uncertainty and ambiguity regarding the compatibility of domestic anti abuse measures with the model DTC;
- That the committee maintain a list of provisions used by countries to exclude from the benefits of DTCs certain entities or types of income and that the list be used by member countries when negotiating DTCs and for discussion in the forum;
- Countries consider terminating their DTC with tax havens and not entering DTCs with such countries;
- A co-ordinated enforcement program;
- A review of the rules on applying to the enforcement of tax claims of other countries.

On international co-operation the 1998 report recommendations included:

- That member countries endorse the guidelines on harmful tax practices set out in the report;
- That the forum be given a mandate to produce a list of tax havens;
- Those countries having links to tax havens do not contribute to harmful tax competition;
- That a dialogue be started with non member countries.

As a part of the 1998 report, the Forum on Harmful Tax Practices was set up; initially to list tax havens. The Isle of Man then determined radically the course of the OECD's discussions with the tax havens by insisting that they would only agree to the requests of the OECD on the condition that OECD members themselves comply with the harmful tax report (Switzerland and Luxembourg refused to back the harmful tax report) and that if they agreed to the OECD requests they should also be included as a part of the OECD in its decision-making processes. These conditional commitments then became a normal negotiating pattern for tax haven negotiators with the OECD Forum.

In the meantime the OECD harmful tax report had incurred the wrath of many businesses and economists. Their main argument against the report was that competition in tax rates was no bad thing: governments often wasted taxpayers' money. Other arguments used against the OECD were:

1. The OECD were an elite body and many so called havens were struggling economically;
2. The OECD itself lacked a level playing field in many areas;
3. The proceedings of the Forum were not transparent, and the OECD harmful tax report and its Forum were influenced and manned by tax officials;
4. There was no scrutiny of the report by businesses or national parliaments;
5. Tax evasion and avoidance were deliberately blurred, and the two concepts were largely equated with each other;
6. Human rights issues were ignored.

The Business and Industry Committee of the OECD (“BIAC”) published a report: “A Business View of Tax Competition” in 1999, taking up many of the points made above. There was then a period of reflection, whilst the Forum continued its work and tax havens negotiated. Dick Hammer, chairman of BIAC, and Jeffrey Owens, OECD CFA, got together and wrote an article in March 2001 agreeing that there should be transparency that taxpayers should meet their obligations and that competition in tax rates was no bad thing. June 2000 saw the publication of the interim OECD report: “Towards Global Tax Co-operation”, updating what OECD and non-OECD nations were doing subsequent to the initial 1998 report and identifying compliant and non-compliant tax havens. From an original list of 47 the list of potential tax havens had been reduced to 35 countries.

The 2000 report also provided details of member country preferential tax regimes. 21 countries with 61 regimes termed ‘preferential tax regimes’ which were regarded as potentially harmful were listed including Belgian co-ordination centres, Australian offshore banking units and US foreign sales corporations.

However holding company regimes were not included because of the complexities involved.

The member countries, with the exception of Switzerland and Luxembourg, agreed to adhere to guidelines adopted in the report which involved a commitment not to adopt any new harmful tax regimes and to identify and eliminate any existing harmful tax practices within 5 years.

The US intervened in the OECD debates in May 2001 holding the view that nations need to be conciliatory and work together in assisting tax-havens in having good and robust financial systems. There was also a high level of scepticism in the US towards the objectives of the OECD. The “black list” of tax havens were regarded by some as violating trade laws and discriminatory under World Trade Organisation rules. In 2002 commitments were received from many countries to implement the standards

allowing them to join a newly created Global Forum on transparency and exchange of information for tax purposes. 2004 saw the publication of the OECD Progress Report on Harmful Tax Practices. A brief overview can be found in your Kees Van Raad. In February 2004 the black list of havens was reduced to: Andorra; Liberia; Lichtenstein; Marshall Islands; and Monaco.

The OECD suggested that sanctions could be used against the above territories. There were suggestions that banking clearing facilities could be denied to these locations, and that other countries should deliberately impose transaction levies and penalties, as well as the normal OECD calls for controlled foreign company legislation, denial of foreign tax credits, denial of tax deductions, imposing withholding taxes on payments, and avoiding any full comprehensive treaty negotiations with or involving such locations. The 2004 report also showed progress on potentially harmful regimes. The table of conclusions indicated that 29 had been abolished or were in the process of being abolished, 15 had been amended to remove any potentially harmful features and 14 were found not to be harmful on further analysis. The three remaining were Luxembourg, Switzerland and a proposed Belgium co-ordination regime. By May 2009, the OECD's Committee on Fiscal Affairs was able to remove Andorra, Monaco and Liechtenstein from the list of uncooperative tax havens in light of their March 2009 statements that they intend to rapidly implement international standards and the timetable set for such implementation.
There were now no countries remaining on the list of uncooperative tax havens. In August 2009 an update on progress in countering tax avoidance was published by the OECD in the form of 'questions and answers'. Progress was measured in terms of the number of countries agreeing to implement an exchange of information agreement. Exchange of information agreements can be implemented via the bilateral double tax convention or the 2002 model agreement on exchange of information (TIEA). In some cases countries have implemented domestic legislation to allow unilateral exchange of information. The report stated great progress had been made in getting countries to adopt the standard. All 30 OECD countries had endorsed Article 26 of the DTC. The OECD defines the standard as a minimum of 12 agreements that provide for full exchange of information on request in all tax matters without regard to domestic tax interest requirement or bank secrecy for tax purposes. The 2009 progress report acknowledges that many former 'havens' have cooperated with the process and the significant increase in the number of TIEAs signed is a reflection of this co-operation. In 2009 the Global Forum was restructured in response to the G20 call to strengthen implementation of the standards. As mentioned above, low tax centres were being forced to abandon ring fenced tax incentives solely for non-resident corporate investment, e.g. in the form of local "exempt companies". Therefore a few jurisdictions introduced rules that meant that all companies were exempt from direct tax, whether owned by foreign or local residents. The 2010 report was dubbed "The year of implementation of the standards".
The OECD announced the publication from September 2010 of in depth peer review reports. Under these provisions countries review each other's regulations. The Global Forum Terms of Reference break down the standard into three main parts: A – availability of information, B – access to information, C – exchange of information. For the exchange of information to be effective, each jurisdiction should have appropriate international exchange of information instruments in place with all relevant partners, but it must also make sure that the information sought is available and accessible to its competent authority. Information which is not available or cannot be accessed cannot be exchanged. However, even if a jurisdiction never exchanges information, implementing the Global Forum's standards on availability of and access to information is key to ensuring that it can protect its domestic tax base. It was noted that since 2009 the total number of signed exchange agreements had surpassed 500, with 32 additional jurisdictions being recognised as meeting the standards (being more than 12 DTCs or TIEAs). Of the reports published in June 2011, the most common deficiencies related to the lack of available information on persons that are represented by nominees and on foreign companies; incomplete accounting information for some forms of limited liability companies and partnership; and slow responses by requested countries.

The focus in 2011 and 2012 was on the peer review process and findings. In a separate report of 2011 "The Era of Bank Secrecy is Over" it was commented that OECD and G20 efforts on information exchange were paying off, as almost EUR 14 billion of additional tax revenue had been secured in the past two years (2009- 2011) in 20 countries where data was available. It comments that further work is needed to improve tax compliance and to tackle aggressive corporate tax strategies.

The OECD report to the G20 in April 2013 covered three strategic initiatives, which have come to dominate the work of the OECD since:

- The latest progress reported by the Global Forum on Transparency and Exchange of Information for Tax Purposes including the upcoming ratings of jurisdictions' compliance with the Global Forum's standards on exchange of information on request;
- Latest developments to address tax base erosion and profit shifting (BEPS), a practice that can give multinational corporations an unfair tax advantage over domestic companies and citizens;
- Efforts by OECD to strengthen automatic exchange of information. Commending the Global Forum's achievements, Secretary-General Gurría noted that, "Now that the tools exist to investigate cross-border tax evasion, all countries must use them to the full."

In the OECD report to the G20 of September 2013 it was noted the Global Forum was moving ahead quickly with its peer reviews and was well into its examination of effectiveness. The report also noted the technical assistance and training which is being provided to the various jurisdictions who have joined the forum. In recognition of the fact that many of the new countries joining the Global Forum are developing countries, and are new to international cooperation in exchange of information, assistance is being provided to create awareness of the international standard, help jurisdictions prepare for their peer reviews and implement the recommendations made.

The Global Forum is also developing important tools to assist jurisdictions in implementing the standard, including a toolkit, work manual and a tracking system for requests for information. A similar approach is being taken with regard to the implementation of the BEPS recommendations, with the announcement of the IMF, OECD, UN and World Bank group initiative for a 'Platform for collaboration on tax' announced in April 2016 (as noted in earlier chapters) which aims to provide developing nations with advice and tools to implement the BEPS measures (see later chapter for details of the BEPS Project). The first toolkit for this project was delivered in November 2015, with more planned. The Global Forum is also involved with the work of the OECD and the G20 in formulating and monitoring a standard for international automatic exchange of information (the CRS and CAA). It was restructured at the end of 2009 to enable it to approach this task effectively. Automatic information exchange is discussed in detail in later chapters. At the time of writing the Global Forum has 135 members.

Other Initiatives

BEPS Action Point 5 – Countering Harmful Tax Practices

An interim report on BEPS Action Point 5, Countering Harmful Tax Practices, was published in September 2014, with its focus on aligning taxation with the 'substance' of transactions. This means considering where people are located, and where the performance of significant people functions takes place. However it was acknowledged that determining the location of substantial activity is inevitably a subjective determination, making objective criteria difficult. It was also noted that certain regimes which apply to mobile activities can unfairly erode the tax bases of other countries, thereby distorting the location of capital and services.

The final October 2015 report on Action Point 5 focuses on two main areas: firstly defining a "substantial activity" criterion to be applied when determining whether tax regimes are harmful; and secondly improving transparency. The report examines various issues, including: possible substance requirements

for intellectual property (IP) and other regimes (including whether some should be phased out); the definition of a harmful preferential regime; the compulsory exchange of tax ruling information; and proposed best practices for cross-border rulings (eg. granting, terms, publication).

The final report considers the position of IP regimes, and in particular it defines the substantial activity requirement for such regimes by proposing a 'modified nexus approach'. Such a regime requires tax benefits to be directly connected to research and development expenditure in the jurisdiction where the IP is located. The only IP assets that would qualify for the new regime would be patents (under a broad definition) and copyrighted software. The Global Forum takes on the task of monitoring these matters, and undertook the review for report purposes. Most notably sixteen existing IP regimes were reviewed and found not to meet the nexus approach. The Report recommends that these non-compliant regimes should be closed to new entrants from 30 June 2016 (similarly for any other IP regime that does not meet the substantial activity requirement). The grandfather period may not be longer than five years after the date the regime is closed to new entrants. In addition enhanced transparency requirements will apply to new entrants into an IP regime after 6 February 2015 and the benefits of an IP regime should not be granted in respect of IP acquired directly or indirectly from related parties after 1 January 2016. Many states, such as the UK, are proposing amendments to their existing IP regimes to ensure they meet the modified nexus approach suggested.

For non-IP regimes, the final report looks at the concept of 'substantial activity' as being based on a similar 'nexus' approach, linking the income qualifying for benefits under the preferential regime and the core activities necessary to earn that income. Core activities at issue would be matters such as geographically mobile financial, and other service, activities. This is aimed at practices which cover: headquarter regimes; distribution and service centres; financing or leasing regimes etc. With regard to holding companies, the substantial activities requirement would as a minimum expect the holding company to have the substance necessary to engage in the activities of holding and managing equity participations (so this should preclude letterbox companies). Improving transparency was the second area considered, with proposed compulsory spontaneous exchange of information on certain tax rulings. This will apply to taxpayer-specific rulings that are:

- (i) rulings on preferential regimes;
- (ii) unilateral Advance Pricing Agreements or other cross border unilateral transfer pricing rulings;
- (iii) cross-border rulings providing for a downward adjustment of taxable profits (in particular excess profit type rulings);
- (iv) PE rulings;
- (v) related party conduit rulings; and
- (vi) a catch-all category for any other type of ruling agreed by the Forum in the future as giving rise to BEPS concerns in the absence of spontaneous information exchange.

Per the final report, progress has been made on automatic exchange of tax rulings with clarification of the exchange being with the countries of the immediate parent and the ultimate parent plus residence countries of affected related parties (and those of the corresponding head office or PE for PE rulings). This compulsory exchange must take place within three months for rulings issued after1 April 2016 (rulings from 1 January 2010 still in effect at 1 January 2014 need to be exchanged by 31 December 2016). With regard to the information exchanged, the recipient country must have the legal framework necessary to protect it, including its confidentiality. Exchange may be suspended where appropriate safeguards are not in place or if there is a breach in confidentiality. The information exchanged must be used only for tax purposes, and if domestic law provides for the information to be used more widely, this will be overridden by the international provisions restricting its use. As noted above, countries are already putting in place provisions to implement the IP regime requirements. Similarly with regard to the proposals for spontaneous exchange of tax ruling information. It is also notable that the EU has also put in place

provisions in its Directive on Administrative Cooperation to implement automatic exchange of cross border rulings, known as DAC3. This was put forward as part of its Tax Transparency Package announced in 2015. Details are provided in Appendix 2 of the changes to this Directive, applicable from 1 January 2017.

Tax Inspectors Without Borders

In May 2012 the OECD's Task Force on Tax and Development launched the concept of "Tax Inspectors Without Borders/Inspecteurs des imports sans frontiers". This is a new initiative to help developing countries bolster their domestic revenues by making their tax systems fairer and more effective.

Building on that concept, the OECD established an independent foundation by the end of 2013, that aims to provide international auditing expertise and advice to help developing countries better address tax base erosion, including tax evasion and avoidance (using currently serving, or recently retired tax officials). The stakeholders from business, civil society, as well as OECD and developing country governments agreed to work together to launch a sustainably financed independent organisation to host a Tax Inspectors Without Borders secretariat . This was approved in June 2013 and was established under an initial 18 month mandate. "Countries helping each other is the only way to effectively fight global tax evasion and avoidance", said the OECD Secretary-General "The ideal is quite simple. Tax Inspectors Without Borders will match 'demand' from developing countries wanting outside help with complex international tax audits with the 'supply' of international experts, drawn mainly from cadres of tax inspectors service on other tax administrations. Joint teams will operate under the local leadership in each country, based on a learning by doing approach". The programme was in a trial operational phase to December 2014. It partnered with the UN Development Programme on its official launch in 2015. The project has strong support from the G20 (August 2013) and at the G8 summit (Lough Erne, June 2013).

Self-Examination Questions

Questions 1

Some countries have a limited tax base from which the government draws their revenue. As a result, this leads to countries over taxing their residents and organizations. In turn, this leads to residents opting to go to tax havens.

Required:

Explain the factors or practices for the identification of tax havens

Answers to Self-Examination Questions

Answer to SEQ 1

A tax haven is a country with lenient tax rules or relatively low tax rate which are often designed to attract foreign investments.

Tax havens are sometimes done in earnest for the benefit of the local residents. However some countries have introduced harmful tax practices that encourage non-compliance with tax laws of other countries. Four factors or practices for the identification of tax haven are:-

1. No or only nominal tax on the relevant income or usually capital.

2. Lack of effective exchange of information by strict secrecy rule and other protections against scrutiny by tax authorities thereby preventing the effective exchange of information on taxpayers benefiting from low tax jurisdiction e.g. Swiss bank accounts in the past.
3. Lack of transparency –e.g. the details of the regime and/or its application is not apparent, or there is inadequate regulatory supervision or financial disclosure.
4. No substantial activities in country where the jurisdiction facilitates the establishment of foreign owned entities without the need for a local substantive presence. This is what makes it doubtful how small islands can host billions of dollars in foreign direct investment if they apparently do not have the necessary resources to yield production.

SECTION D

VALUE ADDED TAX

D1

STUDY GUIDE D1: PARTIAL INPUT TAX CREDIT

Get Through Intro

A taxable person is entitled to claim as a deduction any VAT he has incurred on acquisition of goods or services for the purpose of his business provided that the goods or services are acquired wholly or partly for the purpose of making taxable supplies, including zero rated supplies. The “input tax” is claimed by deducting it from the “output tax” in the VAT return. However, where, a taxable person supplies a mix of taxable and exempt supplies, he may deduct any proportion of input tax attributable to the taxable supplies only. The proportion is determined in accordance with the procedures provided by law. This guide explain the procedures to calculate partial input tax credits

Learning Outcomes

a) Describe partial input tax credit
b) Explain annual input tax adjustments
c) Describe other VAT adjustments

Describe partial input tax credit and explain annual input tax adjustments.

[Learning outcome a and b]

1. Partial Input Tax Credit

Where the input tax is not directly attributable to either taxable or exempt supplies an apportionment must be done, to determine the allowable amount of that input tax. This is to say that, the registered person who deals with taxable supplies and exempt supplies is subjected to partial input credit on goods and services incurred for making both exempt and taxable supplies. Only input tax relating to taxable supplies will be claimed.

For example, a VAT registered person operating a supermarket that sells both taxable items such as sugar and canned milk, as well as exempt items such as maize flour, must do an apportionment for VAT incurred in expenses that cannot be traced solely to the taxable or the exempt supply. These may include rent, electricity, telephone, building maintenance etc.

The apportionment formula is provided under section 70(2) as follows:

I x T/A

Where: (author explanation)

I = Total input tax to be apportioned (input tax not directly attributable to either taxable exempt activity/supply)

T = Value of all **taxable** supplies exclusive of the VAT (standard and zero rated)

A = Value of all supplies exclusive of VAT (standard, zero rated and exempt)

Further, section 70 states that :-

(i) If the ratio of T/A is greater than 0.90 (90%), the taxpayer may claim all input tax incurred for the period.

(ii) If the ratio of T/A is less than 0.10 (10%) the taxpayer shall not be allowed to claim all input tax incurred for the period.

Example

A VAT registered company; purchased and sold both taxable and non-taxable (exempt) supplies during the month of June 2017 as follows (figures are VAT exclusive)

Sales at standard rate	16,000,000
Sales at zero rate	4,000,000
Purchases at standard rate	6,000,000
Business expenses (electricity, telephone etc)	2,000,000

Required:

Calculate deductible input VAT for the month on the assumption that exempt sales for the month totaled

i) Tshs 13,500,000

ii) Tshs 220,000,000

iii) Tshs 1,000,000.

Answer

Deductible input VAT

Input tax (@18%)			
Purchases (standard rated)	1,080,000	1,080,000	1,080,000
Business expenses (see note 1)	(60% of 360,000) 216,000	-	360,000
	1,296,000	**1,080,000**	**1,440,000**
VAT payable (output tax –input tax)			
Output tax	2,880,000	2,880,000	2,880,000
Input tax	(1,296,000)	(1,080,000)	(1,440,000)
	1,584,000	**1,800,000**	**1,440,000**

Note 1

	Assumption 1	**Assumption 2**	**Assumption 3**
Taxable sales			
At standard rate	16,000,000	16,000,000	16,000,000
At zero rate	4,000,000	4,000,000	4,000,000
Total Taxable sales(T)	**20,000,000**	**20,000,000**	**20,000,000**
Total sales			
Taxable sales	20,000,000	20,000,000	20,000,000
Exempt sales	13,500,000	220,000,000	1,000,000
Total sales (A)	33,500,000	240,000,000	21,000,000
T/A	60%	8%	95%
	T/A is not less than 0.10,(10%) and not greater than 0.90,(90%)apportion the input tax on business expenses	T/A is less than 0.10,(10%) do not allow all input tax on business expenses	T/A is greater than 0.90,(90%) allow all input tax on business expenses

2. Annual Input Tax Adjustments

Section 70(3) of the VAT Act ,2014 provides that, the amount of the input tax credit allowed under section 70 shall be provisional, and an annual adjustment of the input tax credit shall be calculated at the end of each accounting year as follows-

(a) add up all the input tax credits allowed under subsection (2) for each of the twelve tax periods occurring during that accounting year;
(b) apply the formula in subsection (2) as if references to "the tax period" in the definitions of "I", "A", and "T" were references to the relevant accounting year;
(c) work out the amount of the adjustment by subtracting the amount worked out under paragraph (b) from the amount worked out under paragraph (a);
(d) if the adjustment so calculated is a positive amount, the taxable person shall make an increasing adjustment equal to that amount in the person's value added tax return for the sixth tax period in the following accounting year, or such earlier tax period as the regulations prescribe; and
(e) if the adjustment so calculated is a negative amount, the taxable person shall be allowed a decreasing adjustment for that amount in the value added tax return for the sixth tax period in the following accounting year, or such earlier tax period as the regulations prescribe.

This means that, the taxable person must carry out adjustment, by recalculating the input tax using the whole year's purchase and sales figures, and compare the results with the sum of the scheme input tax for the twelve VAT returns for the same period. If the annual adjustments reveal any under or over declaration of input tax, an appropriate entry is made.

Describe other VAT adjustments [Learning outcome c]

3. Other VAT Adjustments

Taxable person is required to pay to Tanzania Revenue Authority (TRA) the net amount of Value Added Tax Payable when the net amount is positive or carry forward the to the next period the Value added Tax refund when the net amount is negative (section 67 of the Value Added Tax Act 2014).
The computation of net amount of Value Added Tax shall take into account all output VAT for the period concerned added up with increasing adjustment for that period and reduced by deducting allowed input tax credit and decreasing adjustments of that respective period.

Adjustment event is defined as the event relating to cancellation of the supply, alteration in the consideration for the supply, return of the thing supplied or part thereof to the supplier, or variation of, or alteration to, all or part of the supply and which has the effect that the supply becomes or ceases to be a taxable supply (section 2 of the Value Added Tax Act 2014).

On the other hand, where a taxable supply involves the supply of a voucher, adjusting event means the giving of the voucher in full or part payment for a supply that is exempt; or zero rated.

Increasing adjustments

Section 71(1) of the Value added Tax state clear that, where an adjustment event has the effect that the value added tax previously accounted for by the supplier is less than the value added tax properly payable on the supply;

The supplier shall:-

(i) make an increasing adjustment equal to the amount of the difference; and
(ii) issue a valid adjustment note to the customer within seven days of becoming aware of the adjustment event.

On the other hand, where the customer is a taxable person, he shall be allowed a decreasing adjustment calculated in the similar manner as the computations made by the supplier.

Decreasing adjustments

Contrary to the above paragraph, section 71(2) stipulates that, where an adjustment event has the effect that the value added tax previously accounted for by the supplier exceeds the value added tax properly payable on the supply-

The supplier shall:-

(i) be allowed a decreasing adjustment equal to the amount of the difference; and
(ii) Issue a valid adjustment note to the customer within seven days of becoming aware of the event.

On the other hand, where the customer is a taxable person, he shall make an increasing adjustment calculated subject to the following guidance;

- if the customer is entitled to a full input tax credit for the original acquisition, the amount of the difference;
- if the customer is entitled to a credit for only part of the input tax on the original acquisition, an appropriate proportion of the amount of the difference; or
- if the customer is not entitled to an input tax credit for only acquisition, nil.

Limitation on adjustments to be made

A decreasing adjustment under section 71of the Value Added Tax is subject to the following limitations;

a) **For a customer**,
He must hold a valid adjustment note issued by the supplier at the time when the customer submits value added tax returns for the tax period in which the adjustment is claimed; and

b) **For a supplier**,
(i) He must have issued an adjustment note to the customer and retained a copy for his own records; and
(ii) If the customer is not a registered person, he has repaid the excess value added tax to the customer, whether in cash or as a credit against any amount owing to the supplier by the customer.

Furthermore, if a supplier refunds part or all of the price paid a non-taxable person due to an adjustment event relating to either cancellation of the supply, alteration in the consideration for the supply, return of the thing supplied or part thereof to the supplier, the amount refunded shall, unless there is evidence to the contrary be presumed to include an amount of value added tax equal to the tax fraction of the amount refunded. Contrary to that, if a supplier refunds an amount because of an adjustment event relating with the variation of, or alteration to, all or part of the supply, the amount refunded shall, unless there is evidence to the contrary be presumed to be the amount of value added tax that is no longer payable, unless there is evidence to the contrary (Section 72(2) of the Value Added Tax Act 2014).

Note:

Adjustment notes are required to be issued whenever there is adjustment event and should adopt the form and manner prescribed in the regulations (Form ITX264.02. Adjustment Note). The adjustment note should indicate the following information on its face;

- the date on which it is issued
- the name, TIN and VRN of the supplier
- the nature of the adjustment event and the supply to which it relates
- the effect on the amount of VAT on the supply
- the name, TIN and VRN of the customer if the VAT effect exceed TShs100,000.

An adjustment note shall not be valid if it does not comply with the requirements above. An amended tax invoice may be an adjustment note if it complies with these requirements.

Section 73(1) of the Value Added Tax Act 2014 requires the adjustments (either increasing or decreasing adjustments) to be made in the tax period in which the taxable person becomes aware of the adjustment event. Adjustments may take any of the following forms discussed here under;

Adjustments for bad debts

Due to timing difference between the time suppliers receive the consideration for the supply made by him and the time he makes supply, the issue of bad debt becomes culprit to traders. Further, determination of VAT payment is on one hand based on time of supply instead of time when the supplier actually receives the payments from customer.

Value Added Tax Act, 2014 allow suppliers to claim for VAT relief for VAT paid whenever the supplies made result into irrecoverable debts. The debt is said to be irrecoverable when it meets conditions provided in section 25(3) of the Value Added Tax (General) Regulation, 2015.

According to section 25(3) of the Value Added Tax (General) Regulation, 2015 debt shall be considered irrecoverable if a person has undertaken action for recovery of the debt or has handed over the bad debt to an attorney or debt collector for recovery, the action for recovery has exhaustively proven futile and the taxable person has made all necessary entries in the books of account, including writing-off the bad debt.

Moreover, section 74(2) of the Value Added Tax Act 2014 provides that, where all or part of consideration payable to the supplier for a taxable supply has been overdue for more than eighteen months and the supplier has, in his books of account, written off the amount unpaid as a bad debt, the supplier shall be allowed a decreasing adjustment equal to the amount that remains unpaid after the tax period in which the amount first becomes overdue by more than eighteen months; or the debt is written off as bad in the suppliers books of account.

Likewise, where all or part of the consideration payable to a supplier for a taxable supply has been overdue for more than eighteen months and the customer claimed an input tax credit for the supply, the customer shall make an increasing in adjustment equal to the amount that remains unpaid in the tax period in which the payment first becomes overdue by more than eighteen months.

Note

1. Where a supplier makes a decreasing adjustment for a bad debt, or a customer makes an increasing adjustment for an overdue debt, and the customer pays to the supplier part or all of the previouslyunpaid amount, further adjustments shall be made in order to ensure that;
    (a) in the case of the supplier, the output tax paid is equal to the tax fraction of the consideration actually received; and
    (b) in the case of the customer, the input tax credit is the appropriate proportion of the tax fraction of the consideration actually paid.

2. Adjustment notes shall not be required in respect of bad or overdue debts in order for a supplier to be allowed a decreasing adjustment or the customer to be required to make an increasing adjustment under this section.

Adjustments on private use and self-supply

A person is deemed to have applied property for private use where that person uses or consumes the property for a purpose other than for the person's economic activity. Consequently, a taxable person shall make an increasing adjustment if the person-

a. Is or has been allowed an input tax credit in respect of all or part of the input tax incurred on an acquisition or import of property; and
b. Applies the same property wholly to a private use or having used the property wholly or partly in its taxable activity, applies it to such use from a particular time onwards.

The amount of the increasing adjustment shall be equal to the lesser of the following amounts.

(i) the amount of the input tax credit the person was allowed for the acquisition or import of the goods; or
(ii) if the property has been used in the person's taxable activity before it is applied to private use, the tax fraction of the fair market value of the property at the time it is first applied wholly to a private use, reduced to reflect the extent to which no input tax credit was allowed.

Further, a taxable person shall make an increasing adjustment in respect of property he modifies, improves, or produces, ifthe person applies that property wholly to a private use; anda supply of that property by the person would have been a taxable supply.

The amount of the increasing adjustment required to be made under such condition shall be the tax fraction of the fair market value of the property at the time it is first applied wholly to a private use.

Putting in nutshell, an increasing adjustment relating to private use or self-supply shall be made in the tax period in which the property is first applied to a private use.

Adjustment on making Payment under a Contract of Insurance

Section 76 of the Value Added Tax Act 2014 allow insurer to have the decreasing adjustment onlyif a taxable person makes a payment under the contract of insurance; and meets all of the following conditions:

(i) the supply of the contract of insurance is a taxable supply;
(ii) the payment is not made in respect of a supply to the insurer or an import by insurer or an import by the insurer;
(iii) the payment is not made in respect of a supply to another person, unless that supply is a taxable supply on which value added tax is imposed at a rate other than zero; and
(iv) the person to whom the payment is made is a resident or a non-resident who is a registered person.

Note: Here the amount of the adjustment is the tax fraction of the payment made. The adjustment will be included in the VAT return for the tax period in which the payment made.

Increasing adjustment on receiving insurance premium

Increasing adjustments are made when a person receives a payment under a contract of insurance (regardless of whether the person is party to the contract). The payment should be for recovery of loss

incurred in the course of the person's economic activity; or in relation to an asset used wholly and exclusively in the person's economic activity. Also, the supply of the contract of insurance must have been a taxable supply. The increasing adjustment shall be made in the tax period in which the payment is received and shall be equal to the amount received multiplied by the tax fraction. Exemptions in relations to exempt supplies and private use shall also apply.

Adjustments for payments under subrogation

In a simple term subrogation means "to stand in place of". Subrogation is therefore the right of one person to stand in the place of another in the application of the law. In terms of this principle, the person who has subrogation rights is availed all the rights and remedies to which the insured is entitled. The principle of subrogation applies as a way of preserving the principle of indemnity and to prevent the insured party from profiting from any loss arising in terms of a contract of insurance. The insurer's right to take whatever steps it deems necessary to recover the amount of the loss from the responsible third party, after the insured party has been compensated for that loss. This includes instituting legal action in the name of the insured as it is usually a policy condition that the insurer be provided with the necessary assistance in exercising these rights.

Correction of errors

Because of the large quantity of data or volume of transactions undertaken in a given period time accountants or bookkeepers often makes errors in recording business transaction. These errors can be legitimate mistakes or attempts to conceal theft and fraud. For VAT perspective errors ranges from arithmetic inaccuracy, including VAT in exempt supplies, erroneously inserting wrong consideration of supply (price) in VAT return, incorrectly inserting data in EFD device and etc.

On the other hand, section 42 of the Tax Administration Act 2015 empower commissioner general to enter business premises, inspect documents including financial statements, accounting systems and other financial evidences. Bearing that in mind accountants or book keepers tend to correct their errors before they are uncovered by the TRA official or commissioner general.

Up to this juncture it is worthwhile to mention that, it is tax beneficial for taxable person to correct errors as soon as they are discovered to avoid penalties and possible criminal prosecution.

Further, it is recommended to keep separate record to show when the error was discovered, the period in which the error occurred, and evidence showing whether the error was related to output or input VAT.

For errors discovered before filling VAT return shall be amended in the accounting records and then keep complete set of evidence showing the reason for the occurrence of errors and its implication then the taxable person will be eligible to compute the correct VAT amount and file the correct VAT return.

Contrary to the above, for errors discovered after filling the VAT return it is necessary for the taxable person to disclose error as earlier as it is discovered to avoid penalties and accumulation of interest. Further for errors exceeding one million (i.e. > Tshs.1,000,000), the taxable person will be required to apply in writing within ninety days (**90 days**) to the commissioner general stating the errors that need to be rectified, the reason for the occurrence and its possible implication in the VAT (Section 66 of the Value Added Tax Act 2014; Regulation 21 of the Value Added Tax (General) Regulation 2015).

Lastly for errors not in excess of one million (< Tshs.1,000,000), taxable person can just make respective amendments without seeking or applying to the commissioner general for approval but he/she shall keep sufficient evidence capable or shows the nature of error, reason for its occurrence and how it was

corrected in the next VAT period. Normally for this type of errors increasing or decreasing adjustments are made and a notice of adjustment is the filled to notify the commissioner general the nature of the adjustments made.

Adjustment on cancellation of registration

VAT Registration of the already registered person may be cancelled or come to an end upon happening of the one of the following conditions and the Commissioner General is satisfied that;

(i) The person obtained registration by providing false or misleading information;
(ii) The person is not carrying on an economic activity;
(iii) The person has ceased to produce taxable supplies; or
(iv) The person's taxable turnover falls below registration threshold.

Note: The cancellation of a person's registration shall take effect from the date set out in the notice of cancellation.

Consequently, a person whose registration is cancelled shall;

(i) Immediately cease to be a registered person;
(ii) Immediately cease to use or issue any documents including tax invoices and adjustment notes that identify him as a registered person and surrender Value added tax registration certificate; and
(iii) Within thirty days after the date of cancellation of his registration, file a final value added tax return and pay all taxes due under the Value Added Tax Act 2014.

Further, a person whose registration is cancelled shall make an increasing adjustment in his final value added tax return in respect of property on hand at the time the registration is cancelled, if the person was allowed an input tax credit in respect of the acquisition or import of that property, or for something that has been subsumed into that property.The amount of the adjustment shall be equal to the lesser of;

(a) The tax fraction (i.e. 18/118) of the fair market value of the property on the day immediately preceding the cancellation; or
(b) That amount, reduced to reflect the extent to which the person was not allowed an input tax credit in respect of the acquisition or import of that property or, if applicable, on the inputs to the property (section 80 of the Value Added Tax Act 2014).

Self-Examination Questions

Question 1

(a) Assume that in your normal routine checks to the taxable traders submissions you come across the following information related to purely merchandising entity that deals in duo supplies. These transactions relate to the month of March 2016.
   (i) Purchased 50 bags of rice for TZS.5,000,000.
   (ii) Sold 48 bags of rice for TZS.6,700,000.
   (iii) Paid a total of TZS.1,416,000 to a taxable person as the rice transportation costs.
   (iv) Sold 10 cartons of exercise books and papers for TZS.2,124,000 to the school in the neighborhood.
   (v) Sold 6 cartons of NIDO canned milk for a total of TZS.8,260,000.
   (vi) Purchased 15 cartons of dinner sets at TZS.59,000 each.

(vii) Paid TZS.9,440,000 for purchasing 80 bags of sugar from the whole seller.
(viii) Sold 70 bags of sugar to various customers for TZS.10,620,000.
(ix) Paid TZS.350,000, TZS.750,000 and TZS.80,000 as VAT on tax consultancy, auditing fees and telephone services respectively.
(x) Paid TZS.200,000 and TZS.120,000 as VAT on accommodation and laundry services respectively for his potential customer from Arusha, who was on the assigned business trip.
(xi) Imported a Massey Ferguson tractor valued at TZS.65,500,000 and the clearing agent (taxable person) charged him TZS.3,540,000 for all logistics.
Note: All values are tax inclusive unless specified otherwise.

Required:
Determine the deductible input tax that can be allowed for a claim to the Commissioner General both apportionment methods as provided in a VAT

Question 2
The following information is extracted from VAT return of a tobacco manufacturing company for the month of July 2015.
During the month, the company imported tobacco processing machinery at C.I.F value of TZS.14,000,000. The rate of import duty was 10 per cent. Other standard rated purchase made during the month amounted to TZS.8,000,000.
Value of total supplies during the month was TZS.115,200,000. These supplies included zero rated exports (processed tobacco) of TZS.104,000,000; fertilizer sold to farmers of TZS.6,000,000; local sales of tobacco at standard rate of TZS.4,000,000; and other sales made at standard rate of TZS.1,200,000.
Amount of total input tax paid by the company to all suppliers was TZS.6,400,000. The analysis of this figure is as follows:

(i) Directly attributable to zero rated supplies TZS.4,400,000.
(ii) Directly attributable to exempt supplies TZS.400,000.
(iii) Directly attributable to standard rated supplies TZS.800,000.
(iv) Not directly attributable to exempt nor taxable supplies TZS.800,000.

Required:
Determine the amount of VAT to be paid or claimed.

Question 3
GEU Tanzania Limited is a company registered for Value Added Tax (VAT). It is involved in the buying and selling of general merchandise. The following is information for the transactions entered into in April 2016.

	TZS in '000,000'
Sales – taxable supplies	1,460
Sales – zero rated supplies	180
Sales – exempt	65
Expenditure Purchases – taxable supplies	
- Zero rated supplies	95
Exempt	35

Salaries and wages	325
Repairs to motor vehicles-Toyota pick-up-single cabin (note 1)	165
Security (note 2)	72.5
Electricity	25
Water-un-bottled	10
Rent of shop (inclusive of VAT)	72.55
Fuel for vehicles	12.5

Notes:

1. The motor vehicles are used wholly and exclusively for business and not transporting passengers.
2. Included in security expenditure is an invoice for TZS.8,500,000 dated July 2015, which had not been previously accrued and has not been claimed for before.
3. You should clearly indicate items on which VAT is not chargeable or reclaimable by the use of a zero '0'.

The above figures are exclusive of VAT, unless otherwise stated.

Required:

Calculate the VAT which was payable by GEU Tanzania Limited to the Tanzania Revenue Authority for the month of April 2016.

Question 4

The following transactions were entered into by Tip Top Limited in the month of February 2017.

	Notes	**TZS**
Sales	1	25,562,500
Dividend received		450,000
Purchases	2	8,505,000
Rent	3	2,250,000
Salaries		800,000
Electricity	4	450,000
Water charges		650,000
Consultancy charges	5	4,500,000
Packaging materials		650,000
Furniture and fittings	6	880,000
Staff welfare	7	350,000

Notes:

1. Included in sales figure is the sale of fresh fish totaling TZS.3,000,000.
2. Purchases included the cost of buying fresh fish from fish vendors amounting to TZS.1,650,000.
3. Rent includes amount paid as rent for company premises and housing allowances for General Manager. The housing allowance for the General Manager is TZS.600,000 the balance being for the rent.
4. Electricity costs include TZS.150,000 paid to the General Manager.
5. Consultancy charges were paid to a foreign consultant from Malaysia who is not registered for VAT in Tanzania. VAT is charged on supply of consultancy services in Malaysia at 15%.
6. The cost of furniture and fittings includes cost of labour of TZS.25,000 paid to a carpenter who is not registered for VAT.
7. Staff welfare is the cost of a coffin for a member of staff.

All amounts are stated exclusive of any applicable VAT.

Required:

(i) Prepare workings that indicate the output and input tax associated with each of the above transactions. Where a transaction does not result in any VAT payable or reclaimable, indicate this with a NIL against the transactions, giving a brief explanation (e.g. exempt, zero rated, special relief, out-of-scope etc).

(ii) Calculate the Value Added Tax (VAT) payable to the Tanzania Revenue Authority (TRA), or the excess available for carry forward, for the month of February 2017.

Question 5

Assume you are given the following information below:

Sales/Purchases	**Tshs. VAT exclusive**
Sales of processed water	680,000
Retail taxable sales	56,000,000
Sale of maps to a secondary school	400,000
Sales to Uganda (exports)	15,000,000
Transportation of cows by a VAT registered person	150,000
Importation of standard rated services	12,000,000
Purchase of taxable goods	25,000,000
Purchase of processed water	300,000
Purchase of eggs	200,000
Electricity bill	350,000
Payment of salaries	25,000,000
Purchase of alcohol for employees	3,000,000

REQUIRED:

Compute the deductible input tax.

Question 6

JONGO Traders is a VAT registered trader dealing with building materials. During the month of September 2018, they were able to furnish the following information in the VAT return for the said month;

	TZS
Imports (at CIF)	30,000,000
Exempt sales	64,800,000
Exempt supplies (purchases)	38,880,000
Expenses (all taxable)	20,520,000
Local purchases	70,570,800
Taxable sales	259,200,000

Note: All taxable items are VAT exclusive and where applicable, use VAT import duty and excise duty rates as 18%, 15% and 10% respectively.

REQUIRED:

With reference to the Value Added Tax Act 2014, calculate the amount of VAT payable or refundable by or to JONGO Traders for the month of September 2018.

Answers to Self-Examination Questions

Answer to SEQ 1

Partial Input Tax Credit (S.70)

The amount of the credit allowed for Input tax which this section relates shall be calculated according to the following formula.

$$D.I.T = I \times \frac{T}{A}$$

Where I = Total amount of Input Tax

T = Value of all the Taxable supplies

A = Value of all the supplies made by Taxable person

Whereby:- $\frac{T}{A}$ = > 90% Taxable person shall be allowed for a credit for all of the input tax to which this section relates.

$\frac{T}{A}$ < 10% the Taxable person shall not be allowed a credit.

		Value of Supplier		Input Tax
S/N		**Taxable Tshs.**	**Exempt Tshs.**	**General Tshs.**
1	Bags of rice (50 bags)	-	-	Exempted
2	48 bags of rice sold	-	6,700,000	
3	Transportation	-	-	216,000
4	Stationery	1,800,000	-	-
5	Canned milk	7,000,000	-	-
6	Dinner set	-	-	135,000
7	Purchased sugar	-	-	1,440,000
8	Sales sugar	9,000,000	-	-
9	Tax consultancy	-	-	350,000
10	Audit fees	-	-	750,000
11	Telephone	-	-	80,000
12	Accommodation and laundry services: Not deductible	-	-	-
13	Imported tractor	-	-	540,000
	Total	**17,800,000**	**6,700,000**	**3,511,000**

24,500,000

$$D.I.T. = \frac{T}{A} \times I$$

$\frac{T}{A} = \frac{17,800,000}{24,500,000} x100 = 72.65\% \quad \therefore \frac{T}{A}$ is within 10 and 90%

$\therefore$ D.I.T. = 72.65% x 3,511,000 = 2,550,849 Tshs.

$\therefore$ Deductible Input Tax = 2.550,849 Tshs.

Answer to SEQ 2

Amount of VAT to be paid or claimed

Amount of VAT payable/refundable = Output VAT **less** Deductible input VAT

Deductible input VAT depends with ratio of $\frac{\text{Value of taxable supplies}}{\text{Value of all supplies}}$ i.e T/A

Value of taxable supplies is the sum of the values of zero rated supplies and standard rated supplies.

= 104,000,000 + 4,000,000 + 1,200,000 = 109,200,000

Value of all supplies made during the period = zero rated supplies + standard rated supplies + exempt supplies

= 104,000,000 + 6,000,000 (fertilizer sold to farmers is exempt supplies) + 4,00,000 + 1,200,000 = 115,200,000

Ratio is $\frac{\text{Taxable supplies}}{\text{All supplies}}$ (T/A) = 0.948

As the ratio of T/A is greater than 0.90 (90%), the taxpayer should claim all input tax incurred for the period.

So the Deductible input tax is 800,000 + 4,400,000 = 5,200,000

Output VAT = Standard rate x standard rated taxable supplies

= 18% x (4,000,000 + 1,200,000) = 936,000

Tax payable or to be claimed = output VAT – Deductible input VAT

= 936,000 – 5,200,000 = (4,264,000)

The company is entitled to refund claim of TZS.(4,264,000)

Answer to SEQ 3

VAT payable by GEU Tanzania Limited for the month of April 2016

Output tax	TZS ‘000,000’	VAT Rate	VAT in TZS ‘000,000’
Sales – taxable supplies	1,460	18%	262.8
Sales – zero rated supplies	180	0%	0
Sales – exempt	65	-	0
Total Sales /Output tax	1,705		262.8

Since the ratio of taxable supplies over total supplies is 96% all input taxes are deducted as T/A >.90✓

(i) **Calculation of input taxes**

Expenditure	TZS	Rate	A ‘000,000’
Purchases – taxable supplies	9,150	18%	164.7
- Zero rated supplies	95	0%	0
- Exempt	35	-	0
Salaries and wages	325	-	0
Repairs to motor vehicles (not 1)	165	18%	29.7
Security after deducting TZS.8.5	64	18%	11.52
Electricity	25	18%	4.5
Water-un-bottled	10	-	0
rent of shop (inclusive of VAT)	72.55	18/1	11.06
Fuel for vehicle	12.5	-	0
Total			**221.48**

So, VAT payable is TZS. 262,800,000 – 221,480,000 = TZS.41,320,000

Answer to SEQ 4

B.T

Supplies	Value	Output VAT
Sales	22,562,500.00	4,061,250.00
Sale of fresh fish	3,000,000.00	Exempt
Dividend	450,000.00	Out of scope
Consultancy charges – reverse charge	4,500,000.00	810,000.00
Total	30,512,500.00	4,871,250.00

Input tax

Purchase/importation	Value	Input VAT
Purchases	6,855,000.00	1,233,900.00
Purchases - fresh fish	1,650,000.00	Exempt
Rent – supermarket	1,650,000.00	297,000.00

Housing Allowance	600,000.00	Out of Scope
Salary	297,000.00	Out of Scope
Electricity	300,000.00	54,000.00
Electricity – General Manager	150,000.00	Out of Scope
Water charges	650,000.00	Exempt
Consultancy charges – reverse charge	4,500,000.00	675,000.00
Packaging materials	650,000.00	117,000.00
Furniture and fittings	880,000.00	153,900.00
Staff welfare	350,000.00	Exempt
		2,530,800.00

Deductible input VAT depends with ratio of $\frac{\text{Value of taxable supplies}}{\text{Value of all supplies}}$ i.e T/A

Value of Taxable supplies = (30,512,500-3,000,000-450,000)=27,062,500
Value of all supplies =27,062,500+3,000,000 or (=30,512,500-450,000)= 30,062,500

Ratio is $\frac{\text{Taxable supplies}}{\text{All supplies}}$ (T/A) = 0.9002

As the ratio of T/A is greater than 0.90 (90%), the taxpayer should claim all input tax incurred for the period.

Deductible input Tax =2,530,800.00
VAT Payable = 4,871,250 – 2,530,800.00= 2,340,450

Answer to SEQ 5

Input Tax	
Important of standard rated services	12,000,000
Transportation of cows by VAT person	150,000
Purchase of taxable goods	25,000,000
Purchase of water (assumed processed)	300,000
Electricity bills	350,000
	37,800,000
VAT 18%	0.18
Input tax	6,804,000

Note: Taxable sales are more than 90% of all sales, therefore partial exemption will not apply.

Answer to SEQ 6

Output tax

Output tax = Value taxable sales x VAT rate
The value of taxable sales = TZS 259,200,000
∴ Output tax = TZS 259,200,000 X 18% = TZS 46, 656,000.

Input tax

(1) On imports

Input tax paid=Value of imports x VAT rate

Value of taxable purchases:

CIF value	30,000,000
Import duty value	4,500,000
Excise duty value	3,450,000
	37,950,000

Input tax paid =	37,950,000 x 18% =	6,831,000

(2) On local purchases

=Input tax paid=Value of purchases x VAT rate	
=70,570,800 x18%=	12,702,744

(3) On expenses

Input tax claimable=Value of purchases x VAT rate x T/A	
=20,520,000 x18% x 259,200,000/324,000,000=	16,416,000
Total deductable input tax	35,949,744

VAT payable = Output tax – Input tax = 46,656,000.00 – 35,949,744

VAT Payable = TZS 10,706,256

SECTION D

VALUE ADDED TAX

D2

STUDY GUIDE D2: VAT ON SPECIALISED TRANSACTIONS AND ENTITIES

Get Through Intro

When buying or selling a business as a going concern, one needs to be aware of possible output tax adjustments that may be required under Value Added Tax Act. Failure to account for what some might call "hidden consequences" may result in severe penalties and interest. This guide explains the VAT implication on sale of an economic activity as a going concern. It also explains the VAT treatment of insurance business.

Learning Outcomes

a) Describe VAT implication on sale of an economic activity as a going concern
b) Describe Value Added Tax on Insurance business

Describe VAT implication on sale of an economic activity as a going concern

[Learning outcome a]

1. VAT Implication On Sale Of An Economic Activity As A Going Concern

Unlike the old Value Added Tax law, the Value Added Tax Act 2014 adopts a broader interpretation and uses the words ‘economic activity’ Instead of the words ‘transfer of a business or part of a business’, which should make more transfers eligible for VAT-free treatment.

To be able to grasp the implication of VAT on the sale economic activity as a going concern, first we have to understand the meaning of going concern in a business perspective.

A going concern is a business that functions without the threat of liquidation for the foreseeable future, usually regarded as at least within 12 months. Hence, the declaration of going concern means that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.

Section 20 of the Value Added Tax Act 2014 states clear that, An economic activity shall be sold as a going concern where-

1. Everything necessary for the continued operation of the economic activity is supplied to the person to whom the economic activity is sold; and
2. The purchaser makes the acquisition in the course of or for the purposes of, an economic activity it carries on after the sale.

Further, part of an economic activity shall be an economic activity if it is capable of being operated separately and consequently, the sale of part of the economic activity shall be a sale as a going concern if;

(a) It is capable of being operated separately;
(b) The person’s turnover for that part of the economic activity sold is equal to, or greater than the value added tax registration threshold; and
(c) The purchaser is in a position of conducting the relevant activity without being required to make further acquisition in order to make that part of economic activity operational.

Moreover, section 20(3) of the Value Added Tax Act 2014 provides that, where a taxable person makes supplies in Mainland Tanzania as a part of a transaction for the sale of an economic activity as a going concern by that taxable person to another taxable person, the supplies shall be treated as a single supply that is made in Mainland Tanzania and shall be treated as if it were not a supply.

However, supplier’s entitlement to input tax credits in relation to a single supply will still be eligible in the manner that, any input tax incurred in acquiring goods or services for the purposes of the transaction shall-

(i) Where the supplier otherwise only makes taxable supplies be treated as relating to those supplies; and
(ii) In any other case, be calculated in accordance with partial input tax credit formula

Note:

1. For the sale of an economic activity as a going concern to be treated as a single supply and hence exempted, it shall be demonstrated that;
   (i) The transaction must be between VAT registered persons.
   (ii) The turnover from the economic activity being transferred is equal to or greater than VAT registration threshold
   (iii) The acquisition is made for purposes of continuing with the economic activity after the transfer.
   (iv) The business being transferred should be capable of being operated separately and does not need to make further acquisition to operate the business.
   2. When the purchaser of the economic activity s not registered person for value added tax, the purchaser will be registered upon conclusion of the sale contract. Regulation 10 of the Value Added Tax (General) Regulations 2015 stipulates that, sale is deemed to be concluded where;
   (i) Consideration is paid, whether partial or in full;
   (ii) The deed is duly executed;
   (iii) The right, assets and liability attributes to the sale become the entitlement of the transferee; or
   (iv) The operation of economic activities are in the control of the purchaser.

Describe Value Added Tax on Insurance Business

[Learning outcome a]

2. Value Added Tax On Insurance Business

(i) Insurance is a contract that transfers the risk of financial loss from an individual or business to an insurance company. The company collects small amounts of money from its clients and pools that money together to pay for losses. Putting in nutshell, presence of insurance helps individuals and corporations to pay for damage to their properties or to pay others on their behalf when they injure someone or damage their properties.

(ii) Regulation 2 of the Value Added Tax (General) Regulations, 2015 defined insurance businesses as the businesses of assuming obligation of an insurer in aby class of insurance including assurance, reinsurance, and reassurance, except insurance or re-insurance of life or health insurance.

(iii) In additional to that, Regulation 2 also define insurer, insured and Reinsurance as follows;

(iv) Insurer as person carrying on insurance business other than a broker or agent and includes as association of underwriters who is not doing exempt insurance mentioned above.

(v) Whereas an insured person means a person who has entered into contract of insurance with an insurer. Lastly Reinsurance means the effecting of insurance business as between insurers.

(vi) Basically, insurers use probability and the law of large numbers to determine the cost of insurance premiums it charges its clients based on various risk factors. The rate must be sufficient for the company to pay claims in the future, pay its expenses, and make a reasonable profit, but not so much it turns away customers.

(vii) Insurance companies have a very different business model from most other types of business companies. One key aspect of insurers' business models is the inverted production cycle. Inverted production cycle means policyholders pay premiums upfront and contractual payments

are made only if and when an insured incident has happened. This means that the large majority of insurance liabilities are not liable to unexpected claims. It further, means that insurers receive premiums upfront and deliver a service later.

(viii) On the other hand, insurance brokers and agents Account for Value Added Tax in a normal way as traders does and others. However, taxable supplies provided by the insurer has slight difference from other businesses.

(ix) An insurer accounts for VAT on net premium amount received in relation with a contract of insurance. Further, Value Added Tax (General) Regulation defines net premium amount received as the total premium received in any given tax period less payment made for settlement of any claim arising from a contract of insurance and amounts of premium paid for that period to other insurers for the purpose of reinsurance. Therefore, the VAT tax payable or liability of an insurer or insurance brother depends on the net premiums amount they make.

(x) Similarly, where an insurer subsequent recovers from an insured person part of the claim paid in relation to a contract of insurance, whether through fraudulent claim or claim from a third party under the principle of subrogation, the insurer is required to make an increasing adjustment.

(xi) According to regulation 35 (3) of the Value Added Tax (General) Regulation 2015, when a taxable insured receives payment in respect of settlement of claims under the contract of insurance should account for output tax on that amount but the same insured person cannot claim input tax credit in relation to a purchase of the contract of insurance.

(xii) On the same manner, when an insurer makes payments in respect of a claim under the contract of insurance to an insured person is eligible for input tax credit for the claim irrespective of whether it has been paid to non-taxable person. It also important to note that, the insurer is not eligible to claim input tax credit in relation to a cost of sales, administration and management relating to supply of under the contract of insurance insurers.

(xiii) Lastly as per regulation 35(7) of the Value Added Tax (General) Regulation 2015, the supply of salvage by an insurer attracts Value added tax and the term salvage has been defined as damaged property an insurer takes over to reduce its loss after paying a claim.

(xiv) To conclude on VAT on insurance business, it can be stated that apart from the matters mentioned above, other transactions receives same tax implications and treatments on same manner as to other businesses.

SECTION D

VALUE ADDED TAX

D3

STUDY GUIDE D3: VAT REFUND

Get Through Intro

A key feature of the invoice-credit form of value-added tax (VAT) is that some businesses— notably exporters—will pay more tax on their purchases than is due on their sales, and so can seek refunds of excess credits from government. While refunding is straightforward in principle, serious problems arise in practice, including opportunities for fraud and corruption, and denial of refunds by governments with cash shortages. This makes the refund process the “Achilles heel” of the VAT. This guide explains the meaning and circumstances for VAT refunds. It also describes general procedures for VAT refunds and refunds procedures to diplomats and international bodies.

Learning Outcomes

a) Describe the meaning and circumstances for VAT refunds
b) Explain the requirements for effecting VAT refunds
c) Describe VAT refunds procedures to diplomats and international bodies

Describe the meaning and circumstances for VAT refunds and explain the requirements for effecting VAT refunds

[Learning outcome a and b]

1. Meaning And Circumstances For VAT Refunds

A VAT refund is an amount of VAT that is payable by Tanzania Revenue Authority (TRA) to a taxable person where the total amount of input tax exceeds the total amount of output tax in a particular tax period, or a taxable person has paid an amount of VAT, in excess of the amount that should have been paid.

A taxable person will be entitled to a refund of VAT when in a particular prescribed accounting period when his tax liabilities are not exhausted by allowable deductions or where its returns for prescribed accounting periods regularly result in excess credits. The refund once is processed is paid to the taxpayer through Interbank Settlement System (TISS) or through his or her bank account.

A taxable person may apply for a refund where a person has over paid a net amount payable for a tax period, the application may be logged through form VAT ITX260.02E and considered to be effective if it meets minimum stated conditions provided under section 82 of the Value Added Tax Act, 2014 as stipulated below.

Taxpayers will be eligible to file VAT refund claims where:

- More than 50% of their turnover relates to zero-rated supplies
- More than 50% of their input VAT relates to purchases or imports that will be used to make zero-rated supplies;
- The credit amount that they have carried forward for 6 months exceeds Tshs.100,000 or
- Any other instance where the nature of the business results in excess input VAT credit, subject to the Commissioner's approval. If a registered person does not wish to file a claim, they can elect to carry forward the excess VAT credit for offset against future VAT liability. In addition, TRA has expressly authorized to utilize lodged VAT refund claims against the taxpayer's other tax liabilities upon Commissioner General Confirmation.

Note: The application for refund must be made not is made not more than three years after the end of the tax period to which the negative net amount relates (section 82(2) of the Value Added Tax Act, 2014

2. Requirements For Effecting VAT Refunds

A VAT refund, cannot be affected unless the applicant has submitted among others the following documents and or attachments:

1. Certificate of genuiness issued by an auditor who has been registered by NBAA and who is registered as a tax consultant with TRA.
2. A checklist of details of issues regarding the refund application must be properly filled and completed by the applicant.
3. For a case of Regularly Repayment traders the following documents are vital to be submitted;
   - ✓ Single Bill of Entry
   - ✓ Bill of Lading
   - ✓ Airway bill

- ✓ Road consignment note
- ✓ Landing certificate
- ✓ EFDs receipts/invoices

4. Brief working from the auditor as to how the claimed amount has been arrived at including the summary of purchases and sales.

Moreover, the speed of the VAT refund depends on proof of credibility of the taxpayer, where when the tax payer is credible, commissioner normally refund without undertaking an audit or investigation if the applicant's tax affairs (section 84(1)of the Value Added Tax Act, 2014). Alsos the commissioner is required that within 90 days of its receipt, make decision on the application and inform the applicant the decision by notice in writing stating the amount of the refund allowed and the period during which the refund should be made.

Where the Commissioner general is not satisfied that the refund should be allowed or is satisfied that the amount to be refunded is less than amount requested he shall give shall give the reason for such decision.

Section 84(2) of the Value Added Tax Act, 2014 grant applicant's rights to objection and appeal against the decision made by the Commissioner General. This section also provides the time, place and manner underlying filling of notice of objection.

Describe VAT refunds procedures to diplomats and international bodies [Learning outcome a and b]

3. VAT Refunds Procedures To Diplomats And International Bodies

Section 85 of the Value Added Tax Act, 2014 empower the Commissioner General within one tax period after receiving the application for refund to refund part or all of the input tax incurred on an acquisition or import by;

a) a public international organization, a non-profit organization, foreign government, or other person prescribed by regulations, to the extent that the person is entitled to exemption from value added tax under an international assistance agreement;
b) a person to the extent that such person is entitled to exemption for value added tax under the Vienna Convention on Diplomatic Relations or under any other international treaty or convention having force of law in United Republic, or under recognized principles of international law; or
c) a diplomatic or consular mission of a foreign country established in Mainland Tanzania, relating to transactions concluded for the official purposes of such mission.

Note:

A claim for a refund to Diplomats, International bodies and Non-profit organization shall be made in the form and manner prescribed in the regulations and shall be accompanied by supporting documentation as indicated in the preceding paragraph.

SECTION D

VALUE ADDED TAX

D4

STUDY GUIDE D4: ADMINISTRATIVE PROVISIONS UNDER VAT LAW

Get Through Intro

This Study Guide describes VAT returns and records as required under VAT ACT 2014. Also it explains consequences of not complying with these procedures. Further, it elucidates penalties and offence for failing to comply with VAT Act 2014.
Knowledge of computing VAT liabilities, statutory records, Electronic Fiscal Devices (EFDs) and payments of VAT on time is important in ensuring smooth compliance of the tax law. In addition, knowledge of when tax non- compliance occurs is helpful in determining the resultant consequences.

Learning Outcomes

a) Describe returns and notices under VAT
b) Describe documents, Records and accounts to be kept for VAT purposes
c) Describe the consequences of not meeting the filing and payment
d) State the VAT offences from non-compliance
e) Describe the electronic fiscal devices system, its benefits and the possible revenue risks involved

Describe returns and notices under VAT and describe documents, records and accounts to be kept for VAT purposes

[Learning outcome a and

1. Returns And Notices Under VAT

1.1 VAT Return

1.1.0 Meaning

Every taxable person is required to lodge to the Commissioner the VAT return for every prescribed accounting period. The return is a statement indicating, for a prescribed accounting period, the (1) values of supplies (sales and purchases) and imports, (2) their corresponding output and input taxes, and (3) the tax payable or refund claimed. In short, the VAT return indicates detailed computation, in statement format, of VAT payable/VAT refund claimed for a prescribed accounting period. Tax returns are forms which show all supplies of goods or services made by and to a taxable person, the importation of goods, tax deductions or credits and other business related information as VAT registration number. Nowadays the filling of VAT returns can be done online through the authority's website i.e. **www.tra.go.tz** and payment of VAT if any can be done through mobile and online banking to save time and penalties.

1.1.1 Time of Lodging Return

A taxable person shall lodge a value added tax return in the form and manner prescribed by the Minister on the 20th day of a month after the end of the tax period to which it relates, whether or not that person has a net amount of value added tax payable for that period. Where the 20th day falls on a Saturday, Sunday or a public holiday, the value added tax return shall be lodged on the first working day following a Saturday, Sunday or public holiday

1.2 Notice

The notices are means of communication made by a Commissioner General to taxable persons. They may communicate penalties, interests, prescribed period or in case of recovering unpaid taxes, demanding payments and communicating other information. However, taxpersons can also communicate with the Commissioners through notice, for instance sending the Commissioner General notice of appeal.

2. Documents, Records And Accounts To Be Kept For VAT Purposes

All VAT registered traders are required to keep the following records:

(i) Electronic fiscal receipts/Invoice: these are receipts issued by Electronic Fiscal Devices (EFDs). All supplies made by taxable persons are accompanied with electronic fiscal receipts given out to buyers and copies kept by the taxable persons. But, due to the introduction of EFDs, the copies are automatically kept in the machines for at least five years.

Tax invoice/receipts shall include the following information-

(i) the date on which it is issued;

(ii) the name, Taxpayer Identification Number and Value Added Tax Registration Number of the supplier;

(iii) the description, quantity, and other relevant specifications of the things supplied;

(iv) the total consideration payable for the supply and the amount of value added tax included in that consideration;

(v) if the value of the supply exceeds the minimum amount prescribed in the regulations, the name, address, Taxpayer Identification Number and value added tax registration number of the customer; and

(ii) Adjustment notes

Taxable persons should issue the adjustment notes when there is increasing or decreasing adjustment event of the previously accounted VAT. An adjustment note which is required to be issued shall include the following information-

(i) the date on which it is issued;

(ii) the name, Taxpayer's Identification Number and Value Added Tax Registration Number of the supplier;

(iii) the nature of the adjustment event and the supply to which it relates;

(iv) the effect on the amount of value added tax payable on the supply;

(v) if the effect on the value added tax payable on the supply exceeds, the minimum amount prescribed in the regulations, the name, Taxpayer's Identification Number and Value Added Tax Registration Number of the customer; and

(iii) Accounting records: complete accounting records may includes

- *VAT account*
  This account records, for each prescribed accounting period, total VAT on outputs and inputs together with the net difference to be paid to or reclaimed from the Commissioner General.
- *Sales Account/Journal*
  This keeps records of each supply made related to the appropriate tax invoice or any other invoice.
- *Purchases Account/Journal*
  This keeps records of each supply received related to the appropriate tax invoice, any other invoice or import document.
- *Drawings Account*
  This keeps records of all goods appropriate or taken into personal use or into the use of others.
- *Cash Account*
  This keeps records of each payment made or received showing the date, amount and the person making or receiving the payment.

(iv) VAT registration documents: Taxable persons should keep their Certificate of Registration, Taxpayer Identification Numbers and VAT registration numbers and indicate those numbers in any correspondence with TRA.

(v) VAT account: Each taxable person should keep VAT account showing how much input taxes were paid, output taxes were collected and VAT was paid to TRA in a particular month.

(vi) Other records and accounts

A taxable person shall keep record of all accounts, documents, returns, and other records that are required to be issued or given under VAT Act, or such other tax law, including

(a) customs documentation relating to imports and exports of goods by the person;
(b) records relating to supplies of imported services to the person, whether or not those supplies were taxable supplies;
(c) a value added tax account that records, for each tax period, all the output tax payable by the person in that period, or the input tax credit the person is allowed in that period, and all the increasing and decreasing adjustments that the person is required or entitled to make in that period; and
(d) Records showing the deposit of amounts paid to the Commissioner General under this Act.

The records referred to shall be maintained-

(a) for at least five years from the end of the tax period to which they relate; or
(b) until a later date on which the final decision is made in any audit, recovery proceedings, dispute, prosecution, or other proceedings under this Act relating to that tax period.

Describe the consequences of not meeting the filing and payment; State the VAT offences from non-compliance, describe the electronic fiscal devices system, its benefits and the possible revenue risks involved
[Learning outcome c, d and e]

3. Consequences of Not Meeting The Filing And Payment

Consequences of not meeting filing and payment requirement

Penalties and interest are two consequences of not meeting the filing and payment requirements.

(i) Penalty for failing to file tax return (s 77)

Section 77 of the Tax Administration Act, 2015 provides that, a person who fails to file a tax return (VAT return) or pay tax on due date as required by a tax law is liable for a penalty for each month or part of a month during which the failure continues. The penalty is higher of:-

(i) 2.5% of unpaid tax at starts of the month and
(ii) 5 currency points and 15 currency points per month for individual and entity respectively. **(1 point currency is equivalent to Tshs 15,000)**

(ii) Interest for failing to pay tax (s.76)

Where any amount of tax imposed under a tax law remains unpaid after the due date prescribed in a tax law, the interest at the statutory rate compounded monthly shall be payable to the Commissioner General.

Example

ABC is a registered taxpayer that did submit a return for June 2017 on 15th October 2017 with the payment of Tshs 6,000,000 as VAT payable.

Required

Calculate the penalties and interest payable for failing to submit the value added tax (VAT) return on the due date; (The prevailing rate of interest was 24 %)

ANSWER

(i) Penalty for the failure to file Return on or before the due date

- Due date: 20/7/2017
- Filling date: 15/10/2017.
- Duration of failure : 4 months
- VAT payable = Tshs. 6,000,000
- Penalty for each month or part of a month

  The greater of

  (i) 2.5% (Tshs 6,000,000-0) = Tshs 150,000

  (ii) 15 Currency point = Tshs 225,000

Penalty = 225,000 X 4 Months= Tshs 900,000

(ii) Interest for the late payment of VAT to be paid on the date of filling Return of Income

- Due date: 20/7/2017
- Filling date: 15/10/2017.
- Duration of failure : 4 months
- VAT payable = Tshs. 6,000,000

  Interest = 6,000,000*$(1+24\%/_{12})^4$-1 =494,593

4. EFD System, Its Benefits And The Possible Revenue Risks Involved

As part of improvement of tax administration and tax revenue through proper accounting records, taxable persons are required to issue electronic fiscal receipts through Electronic Fiscal Devices (EFDs) (The Value Added Tax (Electronic Fiscal Device) Regulation, 2010). The electronic fiscal devices are normally connected through a GPRS modem at Tanzania Revenue Authority enabling recording of all sales transactions at the authority servers.

The EFDs must be acquired by the taxable persons but the costs of first batch of the EFDs are provided by the government for free, where taxpayers are allowed to deduct the costs as input taxes (Value Added tax (Electronic Fiscal Devices) Section 28).

The authority categorizes EFDs into:

1. Electronic Tax Register (ETR): the device is used by retail businesses that issue receipts manually,
2. Electronic Fiscal Printer (EFP): the device is used by computerized retail outlets. It is connected to a computer network and stores sale transactions or details made in its fiscal memory,
3. Electronic Signature Device (ESD): the device is designed to authenticate by signing any personal computer (PC) produced financial document such as tax invoice. The device uses a special computer program to generate a unique number (Signature).

Definitions

'**Electronic Fiscal Device (EFD)**' means a machine designed for use in business for efficient management controls in areas of sales analysis and stock control system and which conforms to the requirements specified by the laws. Tanzania Revenue Authority, 2013

'**First batch**' is the first purchase of order of electronic fiscal devices by taxable persons not applicable of the subsequent purchase of the electronic fiscal devices. Value Added Tax (EFDs) Section 28(3)

Each EFD has the following features:

1. First, they have viable fiscal seals to prevent tampering with the EFDs, when any sign of tampering with seals is seen it should be promptly reported to the authority.
2. Second, all have fiscal memory to store data; once data is entered it cannot be altered, but when an error occurs a person should issue another fiscal receipt and make the error adjustment at the end of the month after providing the proof of the error.
3. Third, all have unique serial number within the fiscal memory and the number identifies the owner of an electronic fiscal device.
4. Fourth, all have unique specifications followed when operating their software and hardware.

The EFD offer the following benefits to both taxable persons and the authority:

1. Computerizing the tax auditing process as data are stored electronic; this results into spending little time on auditing using computers and software auditing techniques even on larger data.
2. With introduction of electronic signature devices, the authorities and taxable persons use less time when issuing tax documents as electronic fiscal receipts.
3. The availability of accounting records at taxable persons' place of businesses; EFDs and the authority servers may reduce disputes between officers and taxable persons during audit as the evidence can be easily compared. Furthermore, the EFDs issue automatic self-enforcing Z report daily after every 24 hours;
4. The Z-report is obtained by pressing a button on the device at the end of each business day; the report reports all transactions of the day and their total.
5. It might reduce tax evasion resulting from falsification of accounting records when the EFDs are used by taxable persons, because the data are irreversible.
6. They have in-built fiscal memory which cannot be erased by mechanical, chemical or electromagnetic interferences.
7. Transmits tax information to TRA system automatically. This will save a lot of administrative time and costs.
8. They issue fiscal receipt/invoice which is uniquely identifiable, enabling taxpayers to comply with tax laws.
9. They have at least 48 hours power backup, and it can use external battery in areas with no electricity supply. They therefore can work where there are frequent power cuts.
10. They save configured data and records on permanent fiscal memory automatically;
11. They have tax memory capacity that stores data for at least 5 years, which is a benefit to taxpayers because they are required to keep records at least for 5 years.

5. VAT Offences From Non-Compliance

To enforce compliance with the VAT legislations, section 90 of the Tax Administration Act provides lists of offences which are charged to a person as a consequence of non-compliance with the requirements of the VAT legislations as follows.

A person commits an offence if that

(a) fails to apply for registration as required under the Value Added Tax Act;
(b) fails to notify the Commissioner General of ceasing to be liable for value added tax as required under the Value Added Tax Act;
(c) fails to notify the Commissioner General of a change in circumstances as required under the Value Added Tax Act;
(d) fails to notify the Commissioner General the change in interest or ownership of property or control of business by reason of death, bankruptcy, winding-up or other legal process that vests in another person interest or ownership of property as required under the Value Added Tax
(e) Fails to notify the Commissioner General of a transfer as required under the Value Added Tax Act; or
(f) Holds himself out as a taxable person under the Value Added Tax Act, where that person is not.

The person who commits an offence under this section shall be liable, on conviction-

a. where the failure or holding out is made knowingly or recklessly, to a fine of not less than 100 currency points and not more than 200 currency points or imprisonment for a term of not less than one year and not more than two years, or to both; or
b. in any other case, to a fine of not less than 50 currency points and not more than 100 currency points or imprisonment for a term of not less than one month and not more than three months, or to both

Self-Examination Questions

Question 1

As part of improvement of tax administration and tax revenue through proper accounting records, the Value Added Tax (Electronic Fiscal Device) Regulation, 2010 requires taxable person to issue electronic fiscal receipts through Electronic Fiscal Devices (EFDs)

Required:

(i) Explain the advantages of introducing Electronic Fiscal Devices (EFDs) to different stakeholders in Tanzania.
(ii) Describe the challenges being faced in relation to Electronic Fiscal Devices (EFDs) adoption in Tanzania.
(iii) Advise the government on how it can improve the administration of Electronic Fiscal Devices (EFDs) in Tanzania.

Question 2

a. Implementation of the second phase of Electronic Fiscal Device (EFD) begun in year 2013. The second phase required non VAT registered traders administered under the Tax Administration Act, 2015 to use EFDs.

Required:

What groups are included in the implementation of the second phase of EFD?

b. The use of EFD in both phases is under the Law and the business or other person will be liable for the offence if they fail to comply with it.

Required:

(i) Give explanation on the offence and what penalty one will be charged if he/she fails to adhere to it.

(ii) What penalty is given to a person who fails to demand or report a denial of issuance of a fiscal receipt or fiscal invoice upon payment for goods or service under the law?

Question 3

Effective tax administration is a key machinery of tax revenue collections. The primary function of the tax administration is to scrutinize compliance and to enforce sanctions to offenders as provided in the rules and regulations.

In the light of TRA tax administration and policy on the use of Electronic Fiscal Devices (EFDs):

Required:

(i) Identify three (3) circumstances or practices under which electronic fiscal devices are said to be misused.

(ii) Describe the penalties for misuse of EFDs as provided under the Income Tax (Electronic Fiscal Devices) Regulations, 2012 and Tax Administration Act, 2015.

Question 4

Describe five offences under the Value Added Tax Act, 2014

Question 5

Haraka Co. Ltd deals with garments and was registered for VAT since July, 2013. The company accurately lodged the respective VAT returns up to October 2016. However, the returns from November 2016 to March 2017 were all submitted on 20th May 2017. The VAT due for each month were as follow:

Month	**Amount in TZS.**
November, 2016	8,000,000
December, 2016	5,000,000
January, 2017	1,500,000
February,2017	2,000,000
March, 2017	(1,200,000)

Required:

(i) Calculate the total penalty due.

(ii) Compute interest for failure to pay tax on time if the taxes were all paid on 20th May 2017. Interest rate is 10%

Answers to Self-Examination Questions

Answer to SEQ 1

(i) Advantages of EFDs

- Provides business security for traders as all information entered in to the machine stored in to a fiscal memory
- Cannot be erased or altered. Hence the trader can keep track of all business transactions.
- Enhance fairness in tax assessment as all tax information is transmitted to TRA system automatically and hence reduces objection or disputes.
- Minimize pilferages commonly practiced by unfaithful shop attendants.
- Easy to retrieve sales and stock reports (weekly, monthly).

To the User of EFD/Taxpayer

- Easy to operate by users as user can opt to use either Kiswahili or English language.
- Security of the business information as once stored in fiscal memory cannot be erased.
- Simplify refunds applications as information's are contained in fiscal documents.
- Modern way of keeping records as compared to manual records.
- Assurance that the tax on the receipt issued has been remitted to the Government.
- Access to genuine receipts every time a purchase is made.
- Enjoys the social services provided by the Government as a result of the collected taxes.

To the Government

- Fair bases for verification of self-assessments due to timely availability of accurate/reliable tax information.
- Minimizes tax disputes and tax arrears.
- Collection of more revenue due to timely availability of tax information of the taxpayers/EFD users.
- Assist other parties like EWURA to capture accurate data relating to fuel consumption.
- Custody for useful tax information that may enable easy access for statistical analysis and forecasting.

(ii) Challenges of EFDs

- Little or no culture, among Tanzanians of demanding fiscal receipts for every purchase made from their resellers.
- Resistances by Phase II traders to acquire and use EFDs.
- Reluctance by some traders to issue correct fiscal receipts and sometimes not issuing receipts for some sales, creating a potential for revenue losses to the government.
- Claiming of underserved VAT input tax by few dishonest traders using ghost fiscal receipts contrary to the law.
- Some EFD users delay in reporting the EFD problems to EFD suppliers contrary to EFD Regulations.

- Durability of EFD Machine.
- Some EFD suppliers delay in servicing of non-working EFDs on time contrary to EFD Regulations.

- Mode of operations/Network
- Telecommunication infrastructure constraints especially in remote areas.

- Lack of education

- Price of the device is high.

(iii) Government intervention

- Carrying out continuous surveillance and surprise visits in all high risk areas of non-issuance of receipts.
- Applying sanctions against all identified defaulters.
- Introduction of lottery (raffle) as one of the strategies to stimulate compliance.
- Conducting continuous training to all EFD operational staff on analysis of Z reports, information, audit and enforcement.

- Carrying out continuous tax educational programs to the general public, on the importance of demanding fiscal receipts and invoices upon purchase of goods and services from the eligible EFD users.
- Carrying out continuous sensitization programs to identified EFD phase II traders to acquire and use the EFDs.
- Carrying out continuous and rigorous EFD seminars to EFD users on proper usage and safe keeping of the device.
- Taking punitive measures against EFD users and suppliers who delay reporting and servicing malfunctioned EFDs.

Answer to SEQ 2

a) Implementation of the second phase of EFD shall include the following groups;
   i. Persons who are not VAT registered with a turnover ranging from TSHS 14 million and above per year;
   ii. Traders trading in the Region's prime areas, identified on the basis of rent payable.
   iii. Traders dealing with selected business sectors such as Spare Parts, Hardware, Mini Supermarkets, Petrol Stations, Mobile phone shops, Sub wholesale shops, Bar and Restaurants, Pharmaceutical Stores; Electronic Shops

b) Any person who does one of the following will be committing the offence:
   I. Fails to acquire and use an electronic fiscal device upon commencement of business operation or expiry of the period specified by the Commissioner.
   II. Fails to issue fiscal receipt or fiscal invoice upon receiving payment for sale of goods or service.
   III. Issues a fiscal receipt or fiscal invoice that is false or incorrect in any material particulars.
   IV. Uses electronic fiscal device in any manner that misleads the system or the Commissioner.
   V. Tempers with or causes electronic fiscal device to work improperly or in manner that does not give a correct or true document.

   Anybody who will commit an offence, shall be liable on conviction to a fine not less than 200 currency points and not more than 300 currency points or to imprisonment for a term not exceeding three years or to both.

   ii) A person who fails to demand or report a denial of issuance of a fiscal receipt or fiscal invoice upon payment for goods or service commits an offence and shall be liable on conviction to a less than 2 currency points and not more than 100 currency points.
   Note: one currency point is equal to Tsh 15,000/=

Answer to SEQ 3

(i) The following are circumstances or practices under which electronic fiscal devices (EFDs) are said to be MISUSED:
   - Fails to acquire or use an electronic fiscal devices, fails to issue fiscal receipt or invoice, issue fiscal receipts/invoice that is false or incorrect, use EFD that misleads the system or commissioner, temper with or cause EFD to work improperly or in a manner that does not give correct or true picture, failure to demand or report a denial of issuance of a fiscal receipt/invoice upon payment for goods or services.

(ii) Depending on the type of an offence, a person involved in above offences upon conviction shall be liable to:
   - a fine of not less than 200 currency points and not more than 300 currency points or imprisonment for a term not exceeding 3 years or both
   - a fine of twice the amount of tax evaded or imprisonment for term not exceeding three years
   - a fine not less than 2 currency points and not more than 100 currency points **(*Note: 1 currency point is equivalent to TShs 15,000/=*)**

Answer to SEQ 4

According to section 90(1) a person commits an offence if that person:

a) Fails to apply for registration as required under the Value Added Tax Act;
b) Fails to notify the Commissioner General of ceasing to be liable for value added tax as required under the Value Added Tax Act;
c) Fails to notify the Commissioner General of a change in circumstances as required under the Valued Added Tax Act;
d) Fails to notify the Commissioner General the change in interest or ownership of property or control of business by reason of death, bankruptcy, winding-up or other legal process that vests in another person interest or ownership of property as required under the Value Added Tax.
e) Fails to notify the Commissioner General of a transfer as required under the Value Added Tax Act; or
f) Holds himself out as a taxable person under the Value Added Tax Act, where that person is not.

(a) **Part (i)**
COMPUTATION FOR TOTAL PENALTY

The penalty is higher of:-

(i) 2.5% of unpaid tax at starts of the month and
(ii) 15 currency points per month for individual and entity respectively. **(1 point currency is equivalent to Tshs 15,000).**

PERIOD	**PERIOD DELAYED**	**PERNATY PER PERIOD**	**TOTAL**
November, 2016	6	225,000	1,350,000
December, 2016	5	225,000	1,125,000
January, 2017	4	225,000	900,000
February, 2017	3	225,000	675,000
March, 2017	2	225,000	450,000
Total			**4,500,000**

Therefore, Total penalty is TZS.4,500,000

Part (ii)

PERIOD	**FORMULAR**	**INTEREST**
November, 2016	$= 8,000,000\ [(1 + 0.01)^5 - 1]$	408,080.40
December, 2016	$= 5,000,000\ [(1 + 0.01)^4 - 1]$	203,020.05
January, 2017	$= 1,500,000[(1 + 0.01)^3 - 1]$	45,451.50
February, 2017	$= 2,000,000[(1 + 0.01)^2 - 1]$	20,000
March, 2017		NIL
Total		**676,551.95**

Therefore, Total interest accrued is TZS.676,551.95

SECTION E

TAX ADMINISTRATIONS

E1

STUDY GUIDE E1: SELF-ASSESSMENT FOR ENTITIES

Get Through Intro

In order to promote voluntary tax compliance, the TRA has implemented the self-assessment tax system (the SAS) on taxpayers. Under the SAS, entities with total income are required to disclose taxable income honestly, compute tax payable correctly, file tax return form and pay tax on a timely manner. The key feature of SAS is that tax return form is deemed the notice of assessment. Non submission of tax return form and late payment of taxes will attract monetary penalty and interest. This guide describes the self-assessments and consequences for non-compliances.

Learning Outcomes

a) Explain the Self-Assessment System and the process for making of self-assessment
b) Explain Tax payable on the assessment and due date for payment
c) Explain the procedures for payment of Income tax by quarterly installments
d) Calculate Interest for Under Estimating Tax Payable and failure to pay tax

Explain the Self-Assessment System and the process for making of self-assessment and Explain Tax payable on the assessment and due date for payment

[Learning outcome a and b]

1. Self-Assessment System And The Process For Making Of Self-Assessment

1.1 The Self-Assessment System

The Self-Assessment System applies where a taxpayer determines his own tax liability and pays the tax on specified due dates. Under this system an entity is initially required to file its own estimate of income, calculate tax at appropriate tax rate and pay the estimated annual tax by quarterly instalments. Within six months from the end of the year of income the entity shall file a return of income and audited accounts stating its actual income, tax on the income amount and actual tax payable on the assessment for the year of income. An entity shall pay the balance of the tax due or claim refund of overpaid tax on the date of filing the return. Under s.78 of the Tax Administration Act, 2015, an entity which fails to file a tax return or pay tax on due date as required by a tax law is liable for a penalty for each month or part of a month during which the failure continues. The penalty is higher of:-

(iii) 2.5% of unpaid tax at starts of the month and
(iv) 15 currency points per month.

1.2 The making of self-assessment

Where an entity files a return of income, an assessment shall be treated as made on the due date for filing the return. The assessment is of the income tax payable on the entity's total income under section 4(1) (a) and which has a domestic permanent establishment that has repatriated income, the tax payable on repatriated income under section 4(1) (b) of the Act and the amount of that tax still to be paid for the year of income as declared by the entity in the return (the "tax payable on the assessment").

Where an entity fails or is not required to file a return of income for a year of income then, until such time as a return shall be filed, an assessment shall be treated as made on the due date for filing the return that the income tax payable by the entity for the year shall be equal to the sum of any income tax withheld from payments derived by the entity.

2. Tax Payable On The Assessment And Due Date For Payment

Where an entity files a return of income it is treated that an assessment is made by the entity on the due date for filling the return. The return must show the income tax payable on the total income of the entity during the year of income less tax withheld from payments derived and income tax paid by instalment by the entity during the year of income. The balance of the tax payable will be the tax payable on the assessment.

Tax rates

(i) The income tax payable by an entity on its total income under section 4(1)(a) is calculated by applying the rates of income tax determined under paragraph 3 of the First Schedule for –

(a) a corporation, trust unapproved retirement fund or domestic permanent establishment but excluding a newly listed entity or perpetual loss making entities the tax rate of thirty percent;

(b) newly listed entities with Dar es Salaam Stock Exchange with at least thirty percent of shares issued to the public the tax rate is twenty five percent for the first three consecutive years after the listing;

(c) Perpetual loss making entities at the rate of 0.3percent of annual turnover.

(d) A corporation with a newly established plant for assembling motor vehicles, tractors, fishing boat or out boat engine and having a performance agreement with a government of URT for the first five years from commencement of production shall be taxed at a reduced corporate rate of **10%.**

(ii) The income tax payable on repatriated income of a domestic permanent establishment of the entity as calculated by applying ten percent tax rate.

Example

Where an entity has total income of TZS.800, 000,000 for a year of income inclusive of a non-final withholding payment on which withholding tax of TZS. 30,000,000 was withheld and instalment tax payment of TZS. 150,000,000 were made during the year of income, the tax payable is calculated as follows: -

Income tax rate is 30% of the chargeable income

Tax payable on the assessment is calculated as follows: -

Income Tax on Total income (30%) TZS. 240,000,000

Less: Tax paid by Instalments TZS 150,000,000

Less: Non – final W/Tax TZS 30,000,000

Tax payable on Assessment **TZS 60,000,000**

When entity is having unrelieved loss in the year of income and in two previous consecutive years of income, then the entity will be taxed at the rate of 0.3% on its turnover of that year of income notwithstanding the cause of such loss

Example:

Company ABX Ltd was incorporated 5 years ago. The summary of income statements for 5 years is as follows:- 6

year		Year	Year	Year	Year
	1	2	3	4	5
Gross Income (Turnover TZS.	500,000,000	700,000,000	400,000,000	450,000,000	300,000,000
Allowable deductions (Expenses)	460,000,000	650,000,000	600,000,000	550,000,000	400,000,000
Taxable Income/(Loss)	40,000,000	50,000,000	(200,000,000)	(100,000,000)	(100,000,000)

Calculation of tax payable in year 5 which is the 3rd year of perpetual unrelieved loss:

Turnover TZS 300,000,000

Tax payable at 0.3% TZS 900,000

However the unrelieved loss for year income 5 will be carried forward to year 6.

Explain the procedures for payment of Income tax by quarterly installments and Calculate Interest for Under Estimating Tax Payable and failure to pay tax

[Learning outcome c and d]

3.0 Payment of Income Tax by Quarterly Installments

A person who derives or expects to derive any chargeable income during a year of income from a business or investment or employment where the employer is not required to withhold income tax from the payments made shall pay income tax for the year of income by installments as provided for under Section 88 of the Act.

The tax installments shall be paid as follows:-

(a) In the case of a person whose year of income is a twelve months period beginning at the start of a calendar month, the tax shall be paid on or before the last day of the third, sixth, ninth and twelfth month of the year of income.

(b) In any other case, at the end of each three-months period commencing at the beginning of the year of income and a final installment on the last day of the year of income unless it coincides with the end of one of the three-months period.

3.1 Statement of Estimated Tax Payable

An entity, which is an instalment payer, shall file with the Commissioner an estimate of its income and tax payable for the year of income by the date for payment of the first installment. The tax estimate for the year of income shall be paid by quarterly instalments:

3.2 Calculation of each instalment of income tax payable

The amount of each instalment of income tax payable by an entity, which is an instalment payer for a year of income, is calculated according to the following formula:

(A – C)

B

Where:

A = is estimated tax payable at the time of the instalment.

B = is the number of instalments remaining for the year including the current instalment

C= is the sum of;

i. income tax paid during the year of income but prior to the due date for payment of the instalment; and

ii. Income tax withheld during the year prior to the due date.

Where an instalment shall be payable at a time when an entity's estimated tax payable for a year of income is TZS. 50,000/= or less or the amount of instalment is TZS. 12,500/= or less, the amount of the instalment shall be nil.

The instalments are payable on or before the last day of 3rd, 6th, 9th and 12th months of the year of income.

The income and tax estimates may be revised at any time during the year of income if circumstances change.

Example

M/S ABC Co. Ltd is a manufacturer of fruit concentrates. ABC Co. Ltd. Also has fixed Deposit Account, which earned the company estimated interest income of TZS. 16,000,000/= during the year of which only TZS 4,000,000 was paid and tax withheld of TZS 400,000 was paid in the first quarter. Income from the manufacturing business in the prior year was TZS.75,000,000/=. The company estimates its manufacturing income for the year of income as 80,000,000/=

The accounting period of ABC Co. Ltd. is 01 January – 31 December.

Solution

The instalment payment for 31st March is as follows: -

Estimated business income TZS. 80,000,000/=
Estimated Interest income TZS. 16,000,000/=
Estimated Total Income TZS. 96,000,000/=
Corporation Tax (30%) TZS 28,800,000/=
Tax withheld TZS. 400,000/=
Number of instalments 4

- 1st Instalment payment =(A-C)/B

A =28,800,000/=
B = 4
C = 400,000/=
= [28,800,000/= - 400,000/]/ 4
=7,100,000/=

1st Instalment tax payment is TZS 7,100,000/=

- 2nd Instalment payment = (A-C) /B

A=28,800,000/=
B= 3
C= 400,000/= + 7,100,000/=
= [28,800,000/= - 7,500,000/=]/3
= 7,100,000/=

2nd Instalment tax payment is TZS 7,100,100/=

3rd Instalment payable = $\frac{(A-C)}{B}$

A= 28,800,000
B= 2
C= 400,000 + 2 x 7,100,000
i.e. 14,600,000
= (A-C)/B
= 28,800,000 – 14,600,000 = 14,200,000/2
= 7,100,000

4th Instalment payable = $\frac{(A-C)}{B}$

A= 28,800,000
B= 1
C= 400,000 +(7,100,000X3) = 21,700,000
$=\frac{(A-C)}{B}$

=28,800,000 – 21,700,000
4rd Instalment tax is Shs. 7,100,000
4th Payment due **Shs. 7,100,000**

4.0 Computation of Interest for Under Estimating Tax Payable and failure to pay tax

4.1 Interest for Under Estimating Tax Payable

Under s.75 of the Tax Administration Act, if estimated income tax payable for a year of income is less than 80% of correct amount of final tax), the installment payer (taxpayer) shall be liable for interest for each month or part of a month (the period) from the date the first installment for the year of income is payable until the due date by which the person must file a return of income for that year of income. The rate of interest is the statutory rate compounded monthly on the difference between

(a) the total amount of income that would have been paid by way of installments during the year of income to the start of the period had the person's estimate or revised estimate equaled the correct amount; over

(b) the amount of income tax paid by installments during the year of income to the start of the period.".

The formula for calculating interest for under-estimation is given by:

$I = P [(1+ R)^N – 1]$,

where;

I = Interest charge,

P = difference between actual tax payable and estimated tax paid

R = monthly statutory rate and

N = number of periods from the first instalment up to the day the return on income is supposed to be filed.

Example

MaduhuLtdwhoseaccountingperiodendson31Decembereachyearestimatedthatin2017itwasgoingto make a total income of Tshs20,000,000. The company filed the statement of estimated tax payable on 5 May2017 and return on income on 30 August 2018 showing tax payable of Tshs 9,000,000 but all instalments were paid on time and the tax payable on assessment was paid on 30August 2018.

Required

(a) Ifthetaxratewas30%andstatutoryratewas10%, determine whether there is under-estimation of tax payable in instalments.

(b) If yes compute the interest for under estimation.

Answer

If estimated Income tax payable is less than 80% of the actual tax shown in the return; there is underestimation.

Solution

- 80% of correct tax i.e. 80% xTshs 9,000,000 = Tshs. 7,200,000.
- Income tax paid by installment = 30% x Tshs20,000,000= Tshs6,000,000
- Excess = Tshs 9,000,000 – Tshs 6,000,000 = Tshs. 3,000,000
- Date of 1st instalment = 31/3/2017
- Date of filing return of income 30/6/2015,
- Duration = 15 months (periods)

- BOT statutory rate 10%

Interest:
PV = Tshs. 3,000,000
n = 15 months
i = 15%/12 months
$I = 3,000,000*(1+15\%/_{12})^{15}-1$
=Tshs614,487

4.2 Calculate Interest for failing to pay tax.

Under s.75 of the Tax Administration Act, 2015, taxpayers who fail to pay tax on or before the date on which the tax is payable are liable for interest for each month or part of a month for which any of the tax is **outstanding** calculated as the statutory rate, compounded monthly, applied to the amount outstanding at the start of the period

The formula for calculating interest is given by: $I = P [(1 + R)^N-1]$,
Where I = Interest charge
P = Unpaid taxes
R = monthly interest charge rate
N = number of periods in which taxes were unpaid.
Malulu Ltd whose accounting period ends 31 December each year estimated that in2013it was going to make total income of Tshs. 20,000,000. The company filed the statement ofestimatedtaxpayableon5May2013and paid the first instalment on the same date
Required:
If the tax rate was 30% and statutory rate was 15%, compute the interest for failure to pay tax on time.
Workings:
Estimated tax payable 30% x Tshs.20,000,000= Tshs6,000,000,
The first instalment is Tshs1,500,000.
Interest for failure to pay tax = $P [(1 + R)^N– 1]$, where
P = unpaid taxes i.e. Tshs1,500,000,
R = monthly statutory rate, i.e. (15%)/12=1.25%and
N = number of periods in which failure continued = 2months.
Therefore the interest is Tshs.37,734.

Self-Examination Questions

Question 1

ABC Co. Ltd's main line of business is manufacturing. The company's 12 months accounting period runs from 1st September each year. For the year of income 20X6, the company furnished a statement of estimated income tax on 15st April 20X6, for the year of income of an income of Tshs 140 million. However on 16th June 20X6, the company paid the full income taxes shown on statement of estimated income tax payable for the year of income 20X6. On 20th May 20X7, the company furnished the return of income for the year declaring an income of Tshs 200 million.
Required: Calculate

i) Penalties for failing to file tax return if any payable under section 78 of the Tax administration Act, 2015.

ii) Interest payable on under-estimation of estimated tax under section 75 of the Tax administration Act, 2015.

iii) Compute interest for failing to pay tax (if any), under section 76 of the Tax administration Act, 2015.

BOT statutory rate 15%

Question 2

Muhidin & Co. Ltd is a company established in the United Republic of Tanzania since 1990s. Its accounting period starts on 1st October each year. During the year of income ended 30th September 2014, the company filed its statement of estimated tax payable on 28th February 2014 with taxable income amounting to TZS. 240,000,000/= and paid the 1st installment amount on that date while the 2nd and 3rd installments were paid on their respective due dates as per S.88 of the ITA (Cap. 332) (R.E. 2014). The company filed revised estimates with an income tax amounting to TZS.75,000,000 on 31st December 2014 and paid the amount due thereof. On 30th June 2015, the company filed its final tax return with taxable income of TZS. 300,000,000/=.

Required:

(i) What was the due date for filling the provisional returns for Muhidin & Co. Ltd as per S.89 of the ITA, Cap 332, (R.E. 2014)?

(ii) State the due date for filling the final return for Muhidin & Co. Ltd as per the provisions under the ITA, Cap. 332, (R.E. 2014).

(iii) Compute the amount of income tax paid by Muhidin & Co. Ltd on 1st installment and 4th installment.

(iv) Compute the amount of income tax paid by Muhidin & Co. Ltd on 30th June 2015 (ignore any interest and/or penalty thereof).

Ascertain the amount of penalty payable by Muhidin & Co. Ltd as per S.78 of the Tax Administration Act, 2015 (if any).

Question 3

Zuma Zuma Company Ltd is a company dealing with wholesale and retail business in Singida for the period of five years now. The company's financial year is January to December.

During the financial year 2016, it was discovered by the tax audit done by Tanzania Revenue Authority that the Company did not comply with the requirement of the law of filling tax return and tax payment. The following information was revealed:

(a) It submitted the provisional statement of estimated tax payable on 14/09/2016 and paid all the tax due on the same day.

(b) The taxable income calculated was supposed to be TZS.115,000,000.

(c) Other balance of tax was paid as required.

(d) The return on income (final accounts) was submitted on 30/09/2017.

(e) The Bank of Tanzania discounting rate at the time was 10%.

Required:

Calculate the penalties and interest to be paid, if any, as per tax laws in the country.

Question 4

The accounting period of the Great Co. Ltd ends on 31st December of each year. During the year of income 2017, the company fails to file/furnish the statement of estimated income on the due date. However, on 30/9/2017, the company files the estimated income of Tshs 100 million.

Unfortunately, the company also, delayed the submission of the final return of income which is submitted on 30/9/2018 showing an income tax amounting to Tshs. 40 million. The corporation tax rate is 30%.

Required:

Compute penalties if any payable under section 78 of the Tax Administration Act, 2015.

Answers to Self-Examination Questions

Answer to SEQ 1

(a) **Penalties for late submission of Statement of Estimated Income Tax Payable and Return of Income** (Section 78 of the Tax Administration Act, 2015)

(i) Penalty for the failure to file Statement of Estimated Tax Payable on or before the due date

- Due date: 30/11/20X5
- Filling date: 15/4/20X6.
- Months late: 5 Months
- Penalty for each month or part of a month

  The greater of

  (i) 2.5% (Tshs 42,000,000-0)= Tshs 1,050,000

  (ii) 15 Currency point = Tshs 225,000

Penalty = Tshs 1,050,000 X 5 Months= Tshs 5,250,000/=

(ii) Penalty for the failure to file Return of Income on or before the due date

- Due date: 28/2/20X7
- Filling date: 20/5/20X7.
- Duration of failure : 3 months
- Income tax payable = Tshs. 60,000,000
- Tax paid out at the start of month, May (installments = Tshs 42,000,000
- Penalty for each month or part of a month

  The greater of

(iii) 2.5% (Tshs 60,000,000-42,000,000)= Tshs 450,000

(iv) 15 Currency point = Tshs 225,000

Penalty = 450,000 X 3 Months= Tshs 1,350,000

(b) Interest payable for the under estimation of estimated income tax payable (Section 75 of the Tax Administration Act, 2015)

If estimated Income tax payable is less than 80% of the actual tax shown in the return; there is underestimation.

Answer

- 80% of correct tax i.e. 80% xTshs 60,000,000 = Tshs. 48,000,000.
- Income tax paid by installment = Tshs. 42,000,000
- Excess = Tshs 60,000,000 – Tshs 42,000,000 = Tshs. 18,000,000
- Date of 1st instalment = 30/11/20X5
- Date of filing return of income 28/2/20X7,
- Duration = 15 months (periods)
- BOT statutory rate 15%

Interest:
PV = Tshs. 18,000,000
n = 15 months
i = 15%/12 months
$I = 18,000,000*(1+15\%/_{12})^{15}-1$
=Tshs 3,686,925

(c) Interest payable for the late payment of taxes (Section 76 of the Tax Administration Act, 2015)
(i) Payment for quarterly installment taxes (Section 88 Of the Income Tax Act Cap 332

Tax payable= (A – C)/B

A- Estimated income tax payable for the year income under section 4(1)a & b of the Income Tax Act Cap 332 2004 R.E 2014
(Tshs 140 million 30% =Tshs 42,000,000
B- Number of installments remaining including the current installment
C- Income tax paid prior the due date for the payment of installment tax by the way of withholding or installment

- 1st installment
The due date for payment of the 1st installment is 30/11/20X6
Date paid 16/6/20X6.
Since it is paid after the due date, there is an interest under section 75
Amount of 1st installment = $(42,000,000-0)/_4$ = shs.10, 050,000
Duration of failure = 7 months
BOT interest rate 15%
Interest
$I = 10,050,000*(1+15\%/_{12})^{7}-1$
= 913,047

- 2nd installment
The due date for payment of the 2nd installment is 28/02/20X6
Date paid 16/6/20X6.
Since it is paid after the due date, there is an interest under section 75
Amount of 2nd installment = $(\text{Tshs } 42,000,000-\text{Tshs } 10,500,000)/_3$ = shs.10, 050,000
Duration of failure= 4 months
BOT interest rate 15%
Interest
$I = 10,050,000*(1+15\%/_{12})^{4}-1$
= 512,001

- 3rd installment

  The due date for payment of the 3rd installment is 30/05/20X6

  Date paid 16/6/20X6.

  Since it is paid after the due date, there is an interest under section 75

  Amount of 3rd installment = (Tshs 42,000,000-Tshs 21,000,000)/2 = shs.10, 050,000

  Duration of failure = 1 months

  BOT interest rate 15%

  Interest

  $I = 10{,}050{,}000*(1+15\%/_{12})^1-1$

  $= 125{,}625$

- 4th installment

  The due date for payment of the 4th installment is 31/08/20X6

  Date paid 16/6/20X6.

  No failure

(ii) Interest for the late payment of Income tax to be paid on the date of filling Return of Income

Due date for payment: 28/2/20X7

Date the tax is paid: 20/5/20X7

Since it is paid after the due date, there is an interest under section 75

Duration of failure = 3 months

Amount payable on 28/2/20X7 = Tshs. 60,000,000 – 42,000,000 = Tshs. 18,000,000.

$I = 18{,}000{,}000*(1+15\%/_{12})^3-1 = 683{,}473$

Answer to SEQ 2

(i) The due date for filling provisional return was 31st December 2013.

(ii) The due date for filling the final return was 31st March 2015.

(iii) Amount of Income tax paid on 1st instalment was as follows:

$$\textbf{First instalment} = \frac{A - C}{B}$$

A = income tax payable by the start of the period = TZS 240,000,000 x 30%
= TZS 72,000,000/=

C = income tax paid by the start of the period

B = No. of instalment = 4

$$1^{st}\text{ instalment} = \frac{72{,}000{,}000 - 0}{4}$$

Amount paid by Muhidin & Co. Ltd. on 1st instalment = TZS 18,000,000

4th instalment = $\frac{\text{Revised estimate – Income tax paid}}{\text{No. of remaining instalment}}$

Income tax payable on revised estimate = 75,000,000
Income tax paid before the last instalment = 18,000,000 x 3
= TZS 54,000,000
Fourth instalment = $\frac{\text{TZS 75,000,000 – TZS 54,000,000}}{1}$
= TZS 21,000,000/=

(iv) Income tax paid on 30th June 2015 by Muhidin & Co. Ltd.
Income tax payable = 300,000,000 x 30%
= 90,000,000
Income tax paid = 90,000,000 – 75,000,000
Therefore, the income tax paid on 30th June 2015 was TZS 15,000,000/=

(v) Penalty paid by Muhidin & Co. Ltd. As according to s.78 of Tax Administration Act 2015:

Penalty for late lodging of provisional returns: 2 months late
Penalty = 72,000,000 x 2.5% x 2
= 3,600,000 vs 15,000 x 15 x 2
= 3,600,000 vs 450,000 (whichever is higher)
= TZS 3,600,000/=

Penalty for late filling of return of income: 3 months late
Tax payable = 300,000,000 x 30%
= TZS 90,000,000
Tax paid = TZS 75,000,000
Penalty = (90,000,000 – 75,000,000) x 2.5% x 3 vs 15,000 x 15 x 3
= 1,125,000 vs 675,000 (whichever is higher)
= TZS 1,125,000/=

Answer to SEQ 3

Calculated income was Tshs. 115,000,000/=
Tax will be 115,000,000 x 30% = 34,500,000
Per each Quarter payment will be = Tshs. 8,625,000/=

(a) **Penalties for late submission provision and final return of**

(i) **Provision return**
In the 1st Quarter the company was supposed to submit the statement of provision of tax payable on March 16 but was submitted on 14/09/2016, months late = 6 months
Penalty for late submission of return is;

- The higher of 2.5% of the tax assessed or 15 currency point whichever is higher, times months failure continues
- Tshs. 34,500,000 x 2.5% = 862,500

Or 15,000 x15 =225,000
The higher is 862,500
Penalty for failure to file provision = Tshs.862,500 x 6
= Tshs.5,175,000

(ii) Final return

Return on Income was supposed to be submitted on end of June 2017

- Was submitted on 30/09/2017
- Months late was 3 months
- Penalty for late submission of return is;
- The higher of 2.5% of the tax assessed or 15 currency point whichever is higher, times months failure continues
  - 0×2.5%=0
  - Penalty on late submission will be 15 currency point times the months late

  (15 15,000)3= 675,000/=

(b) Interest payable for the late payment of taxes

(i) 1st installment tax

The company was supposed to pay 1st installment tax which was Tshs. 8,625,000 on the end of Month.

- But was paid on 14/09/2016
- Month late 6 months
- Interest on late payment
- $= 8,625,000 \times ((1+ \frac{0.1}{12})^6 - 1) = 440,335$

(ii) 2nd installment of tax

For 2nd instalment the company was supposed to pay tax due of Tshs. 8,625,000 on end of June but paid on 14/09/2016

- Month late equal to two months
- Interest of failure to pay tax will be
- $8,625,000 \times ((1+ \frac{0.1}{12})^3 - 1) = 217,427$

(iii) 3rd installment of tax

For 3rd installment the company was supposed to pay tax due, ofTsh. 8,625,000/= on 30/09/2016
Was paid on 14/09/2017 – no interest

Therefore

(i) Total Penalties are 5,175,000/ + 675,000/ = Ths 5,850,000/

(ii) Total Interest is 440,335 + 217,427 = Tsh 657,762

Hence the amount of penalty and interest to be payable to TRA will be TShs.6,507,762

Answer to SEQ 4

Year of income: 1/1/2017 to 31/12/2017
Due date for filing estimate: 31/3/2017
Date the estimate filed: 30/9/2017, (there is failure)

Due date for filing the return of income: 30/6/2018
Date the return filed: 30/9/2018 (there is failure as well)

Type of Failure and its penalty:
Failure to file statement of estimated income
Due date: 31/3/2017
End of failure: 30/9/2017
Duration: 6 months
Income tax payable on the income as per s. 4(1)(a) and (b)
= Tshs. 100 million x 30% =Tshs. 30 million
Income tax paid at the start of the month = NIL

Penalty:
= (30 million-0) x 2.5% = 750,000 or 15 points currency (1 currency =Tshs 15,000) ,whichever is greater.
The greater (penalty) is Tshs. 750,000

Tshs 750,000 is imposed for each month of failure i.e 6 months
The penalty amount is 750,000 x 6 = Tshs 4,500,000

Failure to file the return of income:
Due date: 30/6/2018
End of failure: 30/9/2018
Duration: 3 months
Income tax payable Tshs. 40million.
Tax paid out of it at te start of month,- NIL
Penalty:
Tshs. (40 million – 30 million) x 2.5% =Tshs. 250,000
Compare with 15 currency points (1 currency =Tshs 15,000), take the greater.
The greater (penalty) is Tshs. 250,000
Tshs 250,000 is imposed for each month of failure i.e 3 months

Penalty = Tshs. 250,000*3 =750,000

STUDY GUIDE E2: SETTLEMENT OF TAX DISPUTES

Get Through Intro

Taxpayers and the tax authority may disagree on the amount of tax assessed. The disagreement may be on interpretation of tax laws, biased decisions, flawed evidence etc. which may lead to higher tax liabilities than taxpayers themselves think. To avoid damaging taxpayers and the tax authority's relationship, the Tax Revenue Appeals Act, Cap.408 allows taxpayers to appeal against any tax assessment made by the Tanzania Revenue Authority (section 16 (1)). Consequently, that assessment is known as disputed assessment. This Study Guide deals with procedures to follow when taxpayers dispute Tanzania Revenue Authority's decision. It is important to know how tax disputes are dealt with in order to have an equitable, efficient and reliable tax system.

Learning Outcomes

a) Explain causes of tax disputes and measures to avoid tax disputes
b) Explain Handling of Tax objections in Tanzania
c) Explain Tax Revenue Appeals system in Tanzania
d) Explain finality of assessment

Explain causes of tax disputes and measures to avoid tax disputes and explain Handling of Tax objections in Tanzania

[Learning outcome a and b]

1. Causes Of Tax Disputes

Taxpayers and the tax authority may disagree on the amount of tax assessed. The disagreement may be on interpretation of tax laws, biased decisions, flawed evidence etc. which may lead to higher tax liabilities than taxpayers themselves think. Other causes includes:-

(i) It can be the parties have not established or fully understood of the relevant facts,
(ii) One or both party(ies) have made assumptions about particular facts,there are differences of opinion between the parties about how the law applies to the relevant facts;
(iii) The parties have not discussed or fully understood their respective positions.
(iv) Fiscal deficit creates a need to squeeze more from the existing tax base through invasive audits and investigations, or introduce higher or new taxes.
(v) Lack of ethical taxpaying due to growing inequality
(vi) Improved systems and technologies with tax authorities
(vii) Gaps between IFRS and Tax Laws

2. Handling Of Tax Objections In Tanzania

Section 51(1) of the Tax Administration Act, provides that, a person who is aggrieved by a tax decision made by the Commissioner General, may object the decision by filling an objection to the Commissioner General, within 30 days from the date of service of the tax decision.

A valid notice of objection must fulfill the following conditions:

(a) It must be in writing to the commissioner (not verbal communication)(section 51(4)
(b) The objection must be filed and received by the commissioner within 30 days from the date of service of the tax decision (section 51(1).
(c) It must state the grounds in which objection is made. (section 51(4))
(d) The person objecting must pay the amount of tax which is not in dispute or one third of the tax assessed whichever is greater, within a period of thirty days from the date of service of tax decision, pending the final determination of the objection.[sec.51(5)].

Definition

The tax deemed not in dispute means:-

(a) The amount that ought to be charged where the assessment or tax decision is amended in accordance with the objection; and
(b) The whole of the duty or tax assessed on imports.

Relief to the general requirements

(i) **Extension of time to file an objection –section 51(2)**

A person aggrieved by a tax decision and who wishes to make an objection has a time limit of thirty days from the date of service of the tax decision. Where there are reasonable grounds, a taxpayer can apply for an extension of time to file an objection

(ii) **Reduction or waiver of tax deposit –section 51(6)**
The Commissioner General may accept the valid notice of objection without payment of any tax at all or a lesser amount as is reasonable where there is good reason s warranting reduction or waiver of tax payable, until the objection is finally determined (section 51(6).

Object able tax decisions (Section 50(1)

Tax decisions a taxpayer can object against include assessments or other decisions or omissions on matter left to the discretion, judgment, direction, opinion, approval, consent, satisfaction or determination of the Commissioner General under the tax law that directly affects a person

Tax decisions for which there is no right of objection [section 50(2)

a) A practice note or a decision or omission to issue, refuse or revoke a practice not;
b) A decision or omission that affects a person as a tax officer or employee or agent of the Authority

Decisions on objections (section 52)

(i) The commissioner General may, upon admission of the objection, make a decision by determining the objection or call for any evidence or any other information as may appear necessary for the determination of the objection and may, in that respects-
    (a) Amend the assessments in accordance with the objection and any further evidence that has been received
    (b) Refuse to amend the assessment.

(ii) Where the Commissioner General agrees to amend the assessment in accordance with the objection, he shall serve a notice of the final assessments to the objector.

Where the Commissioner General-
(a) Intends to amend the assessments in accordance with the objection and any further evidence; or
(b) Decides to refuse to amend the assessment

He shall serve the objector with a notice setting out the reasons for the intention or decision.

(iii) The taxpayer has thirty days to respond to the proposal. After receipt of such further submissions the CG will then determine the objection.

Test yourself 1

List the qualities of a valid notice of objection

Explain Tax Revenue Appeals system in Tanzania and explain finality of assessment.

[Learning outcome c and d]

3. Tax Revenue Appeals System In Tanzania

Section 53(1) of the Tax administration Act provides that a person who is aggrieved by an objection decision or other decision or omission of the Commissioner General, shall appeal to the Board in accordance with the provisions of the Tax Revenue Appeals Act

3.1 Appellant Machineries And Tax Appeals System In Tanzania

When the commissioner general and the objecting taxpayers fail to agree over the concerning issues the taxpayers can follow the appeal system. But, no appeal can be made when the commissioner general has amended the assessment as proposed by the notice of objection or as proposed by objectors (section 16 (2)). In any other case, the taxpayers may appeal first to the board, then to the tribunal and finally to the court of appeal. In total, these three institutions are known as appellant machineries.

The power and procedures of the revenue appeals board and tribunal resemble those of the court system. They have power to take evidence on oath, resolve any complaint or appeal by mediation, reconciliation or arbitration, issue warrants of arrest for failure to comply with summons, order payment of appeal costs, dismiss any matter before it, and adjourn the hearing of any proceedings before it (section 17(1)). Likewise, proceedings in the tax revenue appeals board and tribunal follow the civil case procedure hearing (section 18). The following section explains in detail each of these appellate machineries.

3.2 Tax Revenue Appeals Board

Tax revenue appeals board consists of a ministerial appointee chairperson; who is the principal legal officer or has adequate knowledge of taxation and two vice-chairpersons; one from Tanzania Zanzibar subject to the consultation with the minister of finance in the Revolutionary Government of Zanzibar (section 4(4)). In addition, it consists of four other members appointed by the minister from each region specifically to hear and consider appeals from their respective regions (section 4). Also it has ministerial appointee secretary of the board who must be a senior public officer to run all administrative and judicial activities (section 6).

The board has the sole original jurisdiction in all civil nature cases for the tax laws governed by the Tanzania Revenue Authority (section 7). So taxpayers can only appeal to the tax revenue appeals board when:

(a) the Commissioner General declines to admit the notice of objection but after payment of tax deposit as required and the board's decision on admittance of the notice of objection is final (section 12(8)).

(b) The commission refuses to make tax refunds (section 14 (1b)). The commissioner general is required to pay the refund not in dispute awaiting the appeal board decision (section 14 (3)).

(c) There is disagreement over the calculation of refund, drawback or repayment (section 14 (1) (a)).

(d) When the commissioner and taxpayers disagree over VAT registration i.e. whether liable or not liable for registration (section 14 (1)(c)

(e) When taxpayers disagree over payment of any taxes as required by the commissioner general (section 14 (2)).

Nevertheless, the appeal to the tax revenue appeals board can only be accepted by the board when:

(a) The commissioner general is served with notice of appeal not more than 30 days from the date when the final assessment was served to tax objectors (section 16 (3)(a)). However, the board can accept the delayed appeal when the appellant was not in Tanzania, sick or other reasons which

may prevent the appellant to file or inform the other party on time (section 16(5));

(b) The notice of appeal must be filed to the board not more than 45 days after the date when the final assessment was served to tax objectors (section 16 (3) (b)).

(c) The notice should give all details relating to the tax assessment and further correspondences made between the commissioner and the taxpayer.

3.3 Revenue Appeals Tribunal

Revenue appeals tribunal is the second level of appeals. The tax revenue appeals tribunal comprises of the presidential appointee chairperson following consultation with the Chief Justice; who should be a judge of the High Court (section 8(2)(a) and section 8(3)(a)).

The chairperson should be assisted by two presidential appointee vice chairpersons; one of from Tanzania Zanzibar following a consultation with President of Zanzibar and four other ministerial appointee members (section 8(2)(b and c). A member should have knowledge of, and experience in, taxation, commercial or financial matters. Furthermore, the tribunal share has the registrar who is a senior lawyer to perform its administrative and judicial roles (section 10). In addition to supervising the work of the tax revenue appeals board, the tribunal has sole jurisdiction in all appeals arising from the decision of the tax revenue appeals board (section 11). Consequently, the revenue appeals tribunal has power over those appeals against the tax revenue appeals board's decision raised not more than 30 days since the date of the tax revenue appeals board' decision. Also the appellant should inform the commissioner general about the appeal within 15 days from the date of the decision of the board (section 16 (4). However, the tribunal can accept the delayed appeal when the appellant was not in Tanzania, sick or for other reasons which may prevent the appellant to file or inform the other party on time (section 16(5)).

3.4 Differences between Tax Revenue Appeals Board and Tax Revenue Appeals Tribunal.

	Taxes Revenue Appeals Board	Tax Revenue Appeals Tribunal
1.	It is stipulated under section 4(1) through 7 of the Tax Revenue Appeals Act	It is stipulated under section 8(1) through 11 of the Tax Revenue Appeals Act.
2.	The chairman of the Board is appointed by the minister responsible for finance.	The Chairman of the Board is appointed by the 'President after consultation with the Chief Justice.
3.	It has two vice-chairmen appointed by the minister responsible for finance one of whom shall be from Tanzanian Zanzibar	It has two vice chairmen appointed by the President, one of whom shall be from Tanzania Zanzibar.
4.	It encompasses four members appointed by the minister responsible for finance from each region for the purpose of hearing any appeal originating in the region from which they are appointed	It encompasses four members appointed by the minister disregarding regionalism.
5.	The chairman of the board must be a Principal Legal Officer or a person having adequate knowledge of taxation.	The chairman must be a Judge of the High Court.
6.	Where appointment relates to a person from Tanzania Zanzibar, the minister responsible	Where an appointment relates to a person from Tanzania Zanzibar, the appointing

	for finance shall consult the minister responsible for finance in the revolutionary government of Zanzibar	authority shall consult the President of Zanzibar
7.	The law does not stipulate cessation as shown under the Tribunal in section 9(1)(d)	The office of the chairman, vice-chairman or member of the tribunal shall become vacant upon ceasation to be a Judge and in the case of a vice-chairman and member, ceasation to practice on disciplinary grounds by law to make disciplinary measures against a person possessing qualifications in relation to which such vice-chairman or a member was qualified to be appointed as such.
8.	It has a secretary appointed by the minister responsible for finance who is a senior public officer	It has a registrar appointed by the minister responsible for finance who is a public officer ranked as senior lawyer.
9.	It has sole jurisdiction in all proceedings of a civil nature in respect of the disputes arising from revenue laws administered by TRA.	It has sole jurisdiction in all appeals arising from the decision of the Board on disputes on which original jurisdiction is conferred on the Board.
-	Any person who is aggrieved by the decision of the board may appeal to the Tribunal.	Any person who is aggrieved by the decision of the Tribunal may appeal to the Court of Appeal.

3.5 Powers of the Board and the Tribunal (section 17)

The following are the powers of the Board and the Tribunal:

(a) to take evidence on oath;
(b) to resolve any complaint or appeal by mediation, reconciliation or arbitration;
(c) to issue warrants of arrest for failure to comply with summons;
(d) to order payment of costs in relation to any matter referred to the Board or the Tribunal
(e) to dismiss any matter before it;
(f) To adjourn the hearing of any proceedings before it

3.6 Appeal to the Court of Appeal

Finally, if the appellant is still not satisfied with the tribunal's decision, the appellant can appeal to the court of appeal (s.25 (1)). But the appeal to the court of appeal is limited to the matter of interpretation of laws only (s.25 (2)).

Test yourself 3

Briefly explain the power and procedures of the revenue appeals board and tribunal.

4. Finality Of An Assessment

Circumstances under which the assessment will be treated as final and conclusive as per the Tax Revenue Appeals Act 408.

(i) the assessment is issued but no objection is raised by the taxpayer within 30 days of the assessment;
(ii) an objection is raised by the taxpayer and

- the assessment is amended in complete agreement with the objection;
- the assessment is amended in the light of the objection and the taxpayer agrees with it;

(iii) the Commissioner rejects it totally and issues a confirming notice and the taxpayer does not appeal;

(iv) the taxpayer appeals against the confirming notice or non-agreed amended assessment and the dispute is decided on appeal and the taxpayer agrees;

(v) The taxpayer appeals further to Tribunal or Court of Appeal and the dispute is finally decided (whether agreed or not).

Answers to Test Yourself

Answer to TY 1

A valid notice of objection should contain the following qualities otherwise the commissioner general may not admit it:

(a) It should be in writing;
(b) It should be addressed to the Commissioner General;
(c) It should contain a statement in a precise form, stating grounds in respect of which the objection to an assessment is made;
(d) Unless the amount is reduced or waived by the commissioner general the notice of objection should be accompanied by a payment of a tax deposit of the higher of:
   i. the amount of tax which is not in dispute or
   ii. 1/3 of the assessed tax in the disputed assessment.

Answer to TY 2

The power and procedures of the revenue appeals board and tribunal resemble those of the court system. They have power to take evidence on oath, resolve any complaint or appeal by mediation, reconciliation or arbitration, issue warrants of arrest for failure to comply with summons, order payment of appeal costs, dismiss any matter before it, and adjourn the hearing of any proceedings before it (section 17(1)). Likewise, proceedings in the tax revenue appeals board and tribunal follow the civil case procedure hearing (section 18).

Self-Examination Questions

Question 1

(i) Briefly explain the issues a taxpayer can object or appeal against and
(ii) Outline the full procedure provided for by the Tax Administration Act, 2015 and Tax Revenue Appeals Act, Cap 408 for handling tax disputes in Tanzania.

Question 2

An effective tax disputes resolutions system is the only alternative for a country like Tanzania. The country requires a tax disputes resolutions system that will make taxpayers have faith and confidence in it.

Required:
What are the shortcomings in handling tax disputes in Tanzania?

Question 3
Explain the sole original jurisdiction of Tax Revenue Appeals Board and Tax Revenue Appeals Tribunal as provided under Section 7 and 11 of the Tax Revenue Appeals Act Cap 408 R.E 2006

Question 4
The Tanzania Revenue Appeals Act Cap. 408 provides procedures for the legislation governing the hearing and determination of tax appeals, primarily when there is disagreement between Tanzania Revenue Authority and taxpayers.
On 1st January 2018, AAA Co. Ltd, a government pension fund company received a tax assessment of TZS.200,000,000 for not paying taxes since its formation. The Managing Director, Ms. Pamela, has strongly disagreed with TRA's assessment on the ground that AAA Co. Ltd, as a government entity, is exempted from paying corporate income tax under the second schedule of the Income Tax Act Cap. 332. So, she wants to appeal against the tax assessment.
Required:
Briefly examine the tax appeals machinery in Tanzania through which AAA Co. Ltd can follow in appealing against the tax assessment issued by the Tanzania Revenue Authority.

Question 5
Where a notice of objection has been raised on an assessment issued by the Commissioner General, describe the five circumstances under which the assessment will be treated as final and conclusive as per the Tax Revenue Appeals Act Cap 408 R.E 2006.

Question 6
State two merits and two demerits of an administrative tribunal system over the court system as immediate machinery of solving the tax disputes

Answers to Self-Examination Questions

Answer to SEQ 1

(i) Issues a taxpayer can object or appeal against
(a) Decision by Commissioner General on assessment of taxes due.
(b) the calculation by the Commissioner-General of the amount due for refund, drawback or repayment of any tax, duty, levy or charge;
(c) a refusal by the Commissioner-General to make any refund or repayment;
(d) the decision by the Commissioner-General to register, or refusal to register, any trader for the purpose of the Value Added Tax

(ii) Full procedure provided for by the Tax Administration Act, 2015 and Tax Revenue Appeals Act, Cap 408 for handling tax disputes in Tanzania
- ✓ The taxpayer who is aggrieved by the tax decision made by the Commissioner general, may object the decision by filling an objection in writing to the Commissioner General within 30 days from the date of service of the tax decision, and a notice of objection shall contain a statement in

precise form, of grounds in respect of which the objection is made. Objection cannot entertain unless the taxpayer has paid the amount of tax which is not in dispute or one third of the assessed tax, whichever amount is greater.

- ✓ If the Tax payer is not satisfied with the decision of the commissioner on objection; he may appeal to the Tax Revenue Appeal Board. Such an appeal must be lodged within 45 days of the date of service of the Commissioner's General decision on the objection and the taxpayer must serve a notice of intention to appeal to the Commissioner General within 30 days of the date of service of the decision of the commissioner.
- ✓ If a Taxpayer is not satisfied with the decision of the Tax Revenue Appeal Board; he may appeal against such a decision to the Tax Revenue Appeal Tribunal. Such Appeal be lodged with the Tribunal within 30 days of the decision of the Board; and the person intending to appeal must serve the other party to the appeal with a notice of intention to appeal within 15 days of lodging the appeal.
- ✓ A person not satisfied with the decision of the Tax Revenue Appeals Tribunal may appeal against such a decision to the Tanzania Court of Appeal. Should the appeal be lodged with the Court of Appeal then the Appeals Court Rules will apply. Appeal to the Court of Appeal shall lie on matters involving questions of law only

Answer to SEQ 2

(i) Time set by the Act to deal with the objection and appeals
- For the tax payer , stipulated time is too short for him/her to get prepared
- Commissioner general has no specified time to deal with objection , so it may take long time or may misuse the power
- For appeals to tribunal , time set for both parties is not favorable

(ii) Amount payable by the taxpayer so that the commissioner may admit his objection is not fair, i.e tax not in dispute or 1/3 of amount assessed whichever is greater. For imports tax not in dispute is the total tax assessed on such imports

(iii) Appeal to the court of Appeals is based on matters involving questions of law only this deprives the right of aggrieved party in case of disagreement of facts.

(iv) The Tax Tribunal may not admit any fresh evidence provided by an appellant.

(v) Composition of the Tax Revenue Appeals Board and Tribunal not necessary tax professionals.

Answer to SEQ 3

Student is required to explain the role of TRAB and TRAT as provided under S.7 and S.11 of the Tax Revenue Appeals Act

(i) TRAB- Shall have sole original jurisdiction in all proceedings of a civil nature in respect of disputes arising from revenue laws administered by the Tanzania Revenue Authority.

(ii) TRAT – Shall have sole jurisdiction in all appeals arising from decision of the Board on disputes on which original jurisdiction is conferred on the Board

Answer to SEQ 4

Tax appeal machinery

(i) **Tax revenue board**

This is the first level of appeals, tax revenue appeals board consists of a ministerial appointee chairperson; who is the principal legal officer or has adequate knowledge of taxation and two vice-chairpersons; one from Tanzania Zanzibar subject to the consultation with the minister of

finance in the Revolutionary Government of Zanzibar (section 4(4)). The appeal to the tax revenue appeals board can only be accepted by the board when the commissioner general is served with notice of appeal not more than 30 days from the date when the final assessment was served to tax objectors (section 16 (3)(a)), in addition to that, the notice of appeal must be filed to the board not more than 45 days after the date when the final assessment was served to tax objectors (section 16 (3)(b)). Lastly, the notice should give all details relating to the tax assessment and further correspondences made between the commissioner and the taxpayer.

(ii) **Tax Appeal Tribunal:**

This is the second level of appeals. The tax revenue appeals tribunal comprises of the presidential appointee chairperson following consultation with the Chief Justice; who should be a judge of the High Court (section 8(2)(a) and section 8(3)(a)). In addition to supervising the work of the tax revenue appeals board, the tribunal has sole jurisdiction in all appeals arising from he decision of the tax revenue appeals board (section 11). Consequently, the revenue appeals tribunal has power over those appeals against the tax revenue appeals boards decision raised not more than 30 days since the date of the tax revenue appeals board' decision.

(iii) **High Court of Appeal:**

This is the final level for appeals and therefore is used if the appellant is still not satisfied with the tribunal's decision, the appellant can appeal to the court of appeals (s.25 (1)). But the appeals to the court of appeal is limited to the matter of interpretation of laws only (s.25 (2)).

Answer to SEQ 5

Finality of an assessment would arise if:

(i) the assessment is issued but no objection is raised by the taxpayer within 30 days of the assessment;

(ii) an objection is raised by the taxpayer and

- the assessment is amended in complete agreement with the objection;
- the assessment is amended in the light of the objection and the taxpayer agrees with it;

(iii) the Commissioner rejects it totally and issues a confirming notice and the taxpayer does not appeal;

(iv) the taxpayer appeals against the confirming notice or non-agreed amended assessment and the dispute is decided on appeal and the taxpayer agrees;

(v) The taxpayer appeals further to Tribunal or Court of Appeal and the dispute is finally decided (whether agreed or not).

Answer to SEQ 6

Merits and demerits of an administrative tribunal system over the court system as an immediate machinery to solve the disputes:

(i) Merits of administrative tribunal system

- It is less formal, hence less complicated, for example, it does not consider some of formalities or procedures which apply under the court system
- Takes less time compared to court system
- Appellant can be represented by any person, not necessarily an advocate
- The hearing can be heard by Chairman or Vice Chairman

(ii) Demerits

- Independence of the Board or Tribunal may be impaired (e.g. by political interest) because they are appointed by President or Minister of Finance
- Board or Tribunal may lack necessary technical expertise in taxation matters and law
- The Board is limited to devil cases only. Some cases need to be transferred to court
- The position of the Board or Tribunal in the legal hierarchy does not exist in Tanzania, therefore, their decision is sometimes questionable