UNIVERSITY OF NAIROBI

SCHOOL OF LAW

INCOME TAX IN THE EAST AFRICAN COMMUNITY: A CASE FOR HARMONISATION AND CONSOLIDATION OF POLICY AND LAW WITH A FOCUS ON CORPORATE INCOME TAXATION

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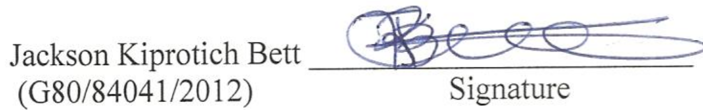
DECLARATION

BY CANDIDATE:

I, JACKSON KIPROTICH BETT, do hereby declare that this thesis is my original work and that it has not been submitted for a Doctorate degree or any other degree or award of any other University.



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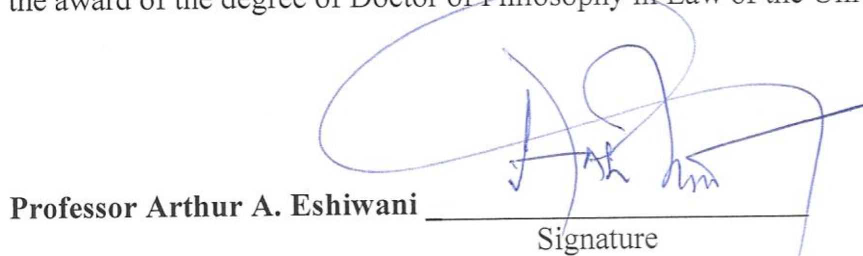

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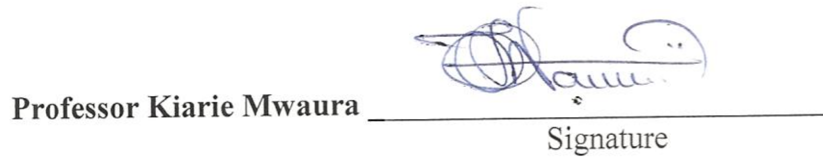

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ABSTRACT

This study seeks to make a case for a harmonised and consolidated corporate income tax law in the East African Community (EAC) as a step towards removing the problems caused by heterogeneity in corporate income taxation within its Common Market and the attainment of the progressive integration levels.

It is the argument of this thesis that the policy and legal differentiation of the income taxes is counterproductive and contrary to the tenets of regional (economic) integration as it causes fiscal distortions, trade diversion, revenue erosion, harmful tax competition, double taxation and other effects. It looks at corporate income tax policy harmonisation as an antecedent to a harmonised corporate income tax law and the Corporate Income Tax (CIT) is pursued as an illustration of the would be bigger picture of harmonising the entire income taxation laws of the member states.

This analysis is considered against the backdrop of the historical antecedents to integration covered by the EAC of 1967-1977. Comparative parallels from the European Union (EU) and North American Free Trade Area (NAFTA) regions which support tax harmonisation are also analysed to provide some insightful lessons for the EAC initiative. Consequently, the thesis proposes the adoption an EAC Common Consolidated Corporate Tax Base (CCCTB) as the first tool of harmonisation of CIT bases in order to overcome some of the challenges of heterogeneity. In a nutshell, the study advocates for a radical move from the current state of heterogeneity in

income taxation to a harmonised regime as exemplified in the study of corporate income tax systems within the East African region.

ABBREVIATIONS AND ACRONYMS

ACTS	African Centre for Technology Studies
ASYCUDA	Automated System for Customs Data
CARICOM	Caribbean Community
CBT	Central Bank of Tanzania
CCTB	Common Consolidated Tax Base
CCCTB	Common Consolidated Corporate Tax Base
CG	Commissioner General
CIA	Central Intelligence Agency
CIF	Cost Insurance Freight
CFC	Controlled Foreign Corporations
CLE	Council for Legal Education
CET	Common External Tariff
CGT	Capital Gains Tax
CIT	Corporate Income Taxation/Common Internal Tariff (as the case may be)
CMP	Common Market Protocol
COMESA	Common Market for Eastern and Southern Africa
CPA	Certified Public Accountant
CPI	Corruption Perception Index
CUP	Comparable Uncontrolled Price
DTT/ DTA	Double Taxation Treaty/Agreement
DTD	Domestic Tax Department
EABC	East African Business Council
EACA	East African Court of Appeal
EACB	East African Currency Board
EAC	East African Community
EAC 1	East African Community (1967-1977)
EAC 2	East African Community (as re-established in 1999)
EACITA	East African Community Income Tax Authority.

EACJ	East African Court of Justice
EACSO	East African Common Services Organisation
EADB	East African Development Bank
EAF	East African Federation
EAHC	East African High Commission
EAITMA	East African Income Tax and Management Act
EALS	East African Law Society
EAMU	East African Monetary Union
EARA	East African Revenue Authorities
EC	European Commission
ECCAS	Economic Community for Central African States
ECJ	European Court of Justice
ECOFIN	Economic and Finance Ministers of the EU member states
ECOWAS	Economic Community of West African States
EEC	European Economic Community
EFTA	European Free Trade Association
EMCS	Excise Movement and Control System
EPZ	Export Processing Zone
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross National Product
GST	Goods and Services Tax
HOSP	Home Ownership Savings Plan
IBEACO	Imperial British East Africa Company
IBFD	International Bureau of Fiscal Documentation
IFRS	International Financial Reporting Standards
IGAD	International Governmental Authority on Development
IMF	International Monetary Fund
IT	Information Technology/Income Tax (as per text)
ITA	Income Tax Act

ITAS	Integrated Tax Administration System (Uganda)
ITAX	Integrated Taxation Management-System (Tanzania)
IUCEA	Inter-University Council for East Africa
LSK	Law Society of Kenya
KRA	Kenya Revenue Authority
MFN	Most Favoured Nation
MNEs	Multinational Enterprises
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MTC	Model Tax Convention
NAFTA	North America Free Trade Area
NTBs	Non-Trade Barriers
NT	National Treatment
OECD	Organization for Economic Cooperation and Development
PAYE	Pay-As-You-Earn System
PIN	Personal Identification Number
PIT	Personal Income Tax
PWC	Price Waterhouse Coopers
RA	Revenue Authority
RRA	Rwanda Revenue Authority
SACU	South African Customs Union
SADC	Southern Africa Development Cooperation
SAPs	Structural Adjustment Programmes
SEZ	Special Economic Zones
SME	Small and Medium Enterprises
TI	Transparency International
TIN	Tax Identification Number
TJN	Tax Justice Network- Africa
TRA	Tanzania Revenue Authority
UNCTAD	United Nations Conference on Trade and Development
URA	Uganda Revenue Authority

VAT	Value Added Tax
WT/WHT	Withholding Tax

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CHAPTER ONE

INTRODUCTION: THE CHALLENGE OF INCOME TAX HARMONISATION IN THE EAC

1.1. Introduction

As the economies of African countries continue to grow due to the heightened global interest on Africa as an investment destination, the East African Community[1] is not reaping the maximum benefits from this economic boom because of significant fiscal barriers within its single market. One of these barriers is the need to comply with five heterogeneous income taxation regimes.[2] Unfortunately, the disparity exits notwithstanding the EAC Treaty provisions that require the member states to harmonise their tax policies so as to remove tax distortions and enhance efficient allocation of resources within the Community. Similarly, the Protocol establishing the EAC Common Market also requires the Member States to harmonise their tax policies and laws with the aim of removing tax distortions and promotion of investment within the community.[3] Even though there has been significant harmonisation of customs,[4] the same cannot be said for income taxes generally and corporate income tax specifically.

[1] The East African Community (EAC) is a regional bloc in Africa legally established by the EAC Treaty of 1999. The founding members of the Community are the Republic of Kenya, the Republic of Uganda and the United Republic of Tanzania (see Preamble). In the year 2007, Rwanda and Burundi joined the Community. The EAC region has a population of over 150 million people thus presenting a large market and attractive investment destination for foreign companies. The successive integration levels of the EAC (as described by the Treaty) are Customs Union, Common Market, Monetary Union and Political Federation.

[2] For instance, each member state has its own set of laws for determining taxable profit, own set of negotiated tax treaties, separate accounting rules and arrangements for the collection and administration of tax.

[3] The Protocol on the Establishment of the East Africa Community Common Market, 'Article 32.'

[4] This could be explained by the existence of explicit provisions under Article 75 of the EAC Treaty, the Protocol on the EAC Customs Union and the enactment of the East African Customs and Management Act, 2004, providing the legal framework for harmonisation.

Consequently and against both the spirit and letter of these constitutive instruments, there is at present notable and distinct heterogeneity in the corporate income taxation laws and policies of the EAC Member States. This differentiation in corporate income taxation laws and policies hampers the intended cohesion and integration efforts of the region. In fact, the differentiation in taxation is one of the historical problems experienced by the pre-1977 EAC due to lack of proper framework for harmonisation, skewed distribution of gains and losses among the member states and the mismanagement of the transfer tax system.[5] Yet, the region was expected to integrate into a Political Federation by the year 2015. If such a Federation is intended, then a tax federation towards full economic integration should be prioritized. It is hoped that fiscal integration will act as a catalyst to the attainment of the EAC common market, a pre-condition to the realisation of the political federation.

Indeed, insufficient and half-hearted harmonised CIT laws and taxation procedures within the region constitute an unwelcome barrier to positive future progress in regional economic integration. The heterogeneity in taxation between countries has already presented numerous challenges hence hindering the realization of full benefits of the EAC single market.

For instance, the need to comply with a multiplicity of different rules by the multinational corporations (MNCs) entails a considerable compliance cost and represents itself a significant barrier to cross-border economic activity. In addition, whereas investment should be located where it is most productive and not where taxes are low, current state of heterogeneity in the EAC corporate taxes has permitted the investors to base their investment location decisions on

[5] These problems are discussed in Chapter Two. They range from economic, political, and demographic to social problems encountered by EAC 1 leading to its eventual collapse.

tax considerations. This has resulted in harmful tax competition practices where the member states reduce corporate taxes to the lowest levels with the intention of attracting more FDI.[6] Indeed, recent studies[7] show that the EAC member states lost up to US$2.8 billion a year from their uncoordinated tax incentives and exemptions. With proper coordination of corporate income tax laws and policies, the EAC would prevent this massive loss of revenue.

Another challenge caused by maintenance of heterogeneous corporate income tax systems and the lack of coordination is the problem of double taxation. This problem is associated with companies that operate in more than one EAC member state, such as Kenya Commercial Bank and Uchumi Supermarkets. Consequently, a business that is trading through a branch will have the branch pay tax in its country of operation and the same income will also be taxed on the head office located in another country. On the other hand, in the case of withholding taxes, if income or expenditure is subject to withholding tax in one country and also taxable in another country, the tax paid is not accepted as tax settlement in the regime of the second country.

A related problem arises when subsidiaries of a company that operates in different countries are treated as independent entities in each country for tax purposes. This treatment essentially allows the multinational firms through tax planning to shift profits to countries with lower tax rates resulting in revenue loss which affects the collective economic progress and welfare of the EAC.

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[6] See Tax Justice Network Africa and Action Aid International Report 2012, *Tax competition in East Africa: A race to the bottom,* p.5., the report shows that, investment incentives particularly tax incentives are not an important factor in attracting foreign investment. More important factors include good quality infrastructure, low administrative costs of setting up and running businesses, political stability and predictable macroeconomic policy.

[7] *Ibid.*, TJNA Report 2012, p.4.

Overall, the heterogeneity in corporate income taxes within a single market such as the EAC as stated above distorts investment, complicates the tax system and may further give rise to conflicts between taxpayers and tax authorities as well as between tax authorities of different countries.[8] This is further compounded by the fact that the EAC founding members, that is, Kenya, Uganda and Tanzania, share a common historical Anglo-Saxon tax design and administration. But, Rwanda's and Burundi's (tax) administrations have been strongly influenced by the French tradition.[9] The historical ideological inclinations have further deepened the disparity in tax regimes generally and corporate income taxes in particular. In order to reap the full benefits of the EAC common market, fiscal coordination on both direct and indirect taxes is required.

At the international level, efforts to coordinate corporate taxation have been subject of intense debate. Within the European Union (EU), significant steps have been taken with the proposals for a consolidated common corporate tax base (CCCTB). This proposal was revised in 2015 and is yet to be adopted by the EU. On the other hand, the NAFTA region has embarked on gradual coordination of their tax systems.

This study seeks to make a case for harmonised and consolidated corporate income tax policy and legislation as a step towards removing the problems caused by heterogeneity in taxation within the Common Market of the EAC and the attainment of the third and fourth integrative

[8] For instance, Uganda's failure to ratify the East African Double Taxation Treaty (DTT) has been and continues to cause double taxation problems and competition for tax between the governmental revenue authorities of the member countries.

[9] These differential origins and administrative orientations pose a major challenge to regional tax practices and tax harmonisation may very well be the solution. The findings from this study will, hopefully inform the respective Member States of the economic and opportunity costs of different corporate income tax legislation and policy regimes thus justifying the need for adoption of mechanisms towards harmonisation of the regional corporate income tax policies and laws.

steps. In terms of focus for illustration of the harmonisation desire, the study looks at corporate income tax harmonisation as an antecedent to a harmonised corporate income tax law.[10]

The broad philosophy behind harmonisation as advocated by this thesis is: regional integration and/or cooperation while the narrow context is the removal of trade distorting taxes which borrows from the integration argument. This ideal is what was intended by the framers of Article 83 (2) (e) of the EAC Treaty and Article 32 of the Common Market Protocol. The twin provisions jointly advocate for general tax harmonisation within the EAC. However in practical terms, the application of different CIT structures within the region offends harmonisation to the extent that the EAC Member States lack a coordinated approach. This falls short of the philosophy of harmonisation.

1.1.1. Contrasting heterogeneity-vs-harmonisation within the context of the present study

Heterogeneity refers to the existence of different systems. It is the nature of opposition, or contrariety of qualities. It is diverse in kind or nature; composed of diverse parts, or resulting from different causes. In general, a heterogeneous entity is composed of dissimilar parts, hence the constituents are of a different kind that can be distinguished from one another. The parts or constituents are connected, and of a conglomerate mass, and viewed in respect to parts of which it is made up.[11]

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[10] Policy harmonisation as a precursor to legal harmonisation is based on the reasoning that any sound law must be preceded by a suitable underlying policy framework in order to foresee and circumvent any implementation challenges.

[11] Ludek K. et al, Policy autonomy, coordination or harmonization in the persistently heterogeneous European Union? , Working Paper no 95 Welfare Wealth Work for Europe, Available at: http://www.foreurope.eu/fileadmin/documents/pdf/Workingpapers/WWWforEurope_WPS_no095_MS79.pdf. (Accessed on 15th December 2015). See Wikipedia definition available at:

On the other hand, harmonisation refers to the coordination, organisation, management, synchronization or bringing together of disparate systems. To harmonise is to make such disparate systems work together without undue hitches.[12]

In the context of the present study, heterogeneity refers to disparities in the corporate income tax systems of the EAC Member States. This situation contradicts the tenets of integration as envisaged by the EAC Member States in the constitutive instruments of the regional body. The study advocates for harmonisation in order to bring together the disparate corporate income tax systems of the EAC Member States for purposes of achieving the objectives of the Community.

1.1.2 Why corporate income taxation?

Essentially, corporate tax is a tax levied on a corporation's profits. Since corporations are legal entities separate from their shareholders, they are taxed as if they were persons. Corporate tax for corporations is therefore the equivalent of income tax for natural persons.[13] Corporate bodies liable for corporate tax include limited companies, trusts and co-operatives.[14]

Corporate tax has not had a separate historical development in the EAC because all along, it has been considered as part of income tax. The legal regime under examination in this study is therefore the income tax legislations of the EAC member states. Income tax laws in the EAC have focused on income derived from business (which includes business done by corporate

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http://www.edurite.com/kbase/difference-between-homogenous-and-heterogenous (accessed on 31st July 2013).

[12] *Ibid.*

[13] Schreiber U., *International Company Taxation*, *Springer Texts in Business and Economics*, 2012, p. 20. Available at: http://link.springer.com/chapter/10.1007/978-3-642-36306-1_1.

[14] Kenya Revenue Authority, *Income Tax at a glance*, p. 2. Available at: http://www.kra.go.ke/incometax/pdf/incometaxataglance.pdf.

bodies), employment income, rent income, dividends, interests and pensions among others.[15] These taxes include pay as you earn (PAYE), withholding tax and corporate tax.[16]

The choice of CIT as distinct from other income taxes such as individual, partnerships, trusts, farming, cooperatives and withholding is mainly for illustrative purposes. Other than the illustration of the mechanisms of tax harmonisation in the EAC, other considerations include firstly, the substantial contribution that it makes to the EAC tax revenue kitty. The CIT emerges as a dominant source of public revenue for the EAC Member States which are tax regimes. In Kenya, for example, the corporate tax rate is 30% for residents and 35% for non residents, while EPZ companies pay 25% corporate tax after the first ten (10) year tax holiday. Newly-listed companies at the NSE pay a corporate tax rate of 27%. On the average, the income tax in the EAC contributes between 20-30% of the annual revenue.[17] This sample of statistics show that the contribution of CIT to the EAC tax revenue kitty is substantial and therefore worth academic analysis as attempted by this thesis in respect of the entire EAC region. The disparity of corporate income tax systems of the EAC is addressed in detail in chapter three as well as in Appendix 3 of the study. As stated above, the disparity has had deleterious effects on the economies of the EAC member states. The effects of heterogeneity are covered in detail in chapter four of the study.

Secondly, the revenue losses resulting from profit shifting and tax avoidance by the MNEs are huge as discussed in chapter four of this thesis. Tax avoidance is one of the negative effects of

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[15] Isaac Tarus, '*The Political Economy of Post-Colonial Taxation in Kenya, 1973 -1995(Historical Research Letter, 2013)* p. 60.

[16] *Ibid*., p. 61.

[17] Mutua J., *A Citizen's Handbook on Taxation in Kenya,* Institute of Economic Affairs, 2012, ISBN No. 978-9966-1561-6-7.

heterogeneity in CIT practice within the EAC as indeed any other region. The thesis therefore contends for harmonisation of CIT systems as a panacea to the problem of tax avoidance.

Thirdly, the issue of transfer pricing (TP) poses a challenge to tax administration within the EAC. Harmonisation would deal with the challenges posed by TP in so far as uniform rules, such as the Arms-length principle would be applied for corporate goods sold within the region.

Fourthly, as Musgrave has pointed out, "*business income taxes present more difficulties for the harmonisation process…not only because they are heavily involved in all the economic aims of the harmonisation, but also because they are imposed on internationally mobile factors*."[18] This thesis appreciates the complexity of CIT as envisaged by Musgrave thus providing a sound basis for academic inquiry within the regional context of the EAC.

Fifthly, comparatively speaking, the EU has had a near successful attempt with the CCCTB in so far as the imposition of CIT within the region is concerned. This provides a frame of reference for the EAC region to make a similar but localized attempt for her CIT systems. The harmonised structure could be modeled along the EU or NAFTA examples.

1.2. Background to the study

Cooperation within the East African Community (EAC) is not a new phenomenon even though it has regained renewed momentum in recent times. The re-energized drive towards regional integration within the EAC has been recognized by the political leadership among the partner

[18] Musgrave P.B., "*Harmonisation of Direct Business Taxes: A Case Study*", in C.S Shoup, *Fiscal Harmonisation in the Common Market*, Vol II, Practice (1967 Columbia university Press) p. 216.

States.[19] Kenya's President H.E. Uhuru Muigai Kenyatta, while previously serving as the Finance Minister, stated in the 2011/12 Budget:

> With regard to deepening regional trade and expanding market for our products, we will continue to position Kenya through appropriate economic policy and reforms to reap the benefits from regional integration with opportunities accorded by the East Africa Community Common Market Protocol and the wider Common Market for Eastern and Southern Africa market.[20] We are fully committed to the implementation of the provisions of the Common Market Protocol and we are in support of the ongoing negotiations of the East African Monetary Union Protocol to ensure that the exercise comes to a logical conclusion for the benefit of the East African people.[21]

Kenya, Tanzania and Uganda have enjoyed a long history of co-operation under successive regional integration arrangements which can be traced back to the construction of the Uganda Railway in 1885.[22] This was followed by the creation of the East African Common Market which started in 1900 with a customs arrangement between Uganda and Kenya (then, British East Africa) on one hand and Tanganyika (then German East Africa) on the other.[23]

This period saw increasing measures to integrate and interlink the three countries through the introduction of an East African Common Currency Board[24] and a common currency (that is, the

[19] Kenya, Uganda, Tanzania, Rwanda & Burundi.
[20] Hereinafter referred to as 'COMESA', established by Article 1 of the COMESA Treaty.
[21] Para. 43 of the Republic of Kenya Budget Statement for the Fiscal Year 2011/2012 (1st July – 30th June 2012), by Hon. Uhuru Muigai Kenyatta, E.G.H., the then Minister for Finance, 8th June 2011, available at: www.treasury.go.ke/oldwebsite/index.php?option=com_docman. (accessed on 17th May 2012). This quote reaffirmed Kenya's commitment to regional integration "for the benefit of the East African people", Kenyans included. These sentiments were echoed by the Ugandan 2011/12 Budget Speech at para. 5. See also para. 1 of the Rwandan 2011/12 Budget. In the vein of this collective thinking, this thesis argues for regional tax harmonisation generally and unified income tax legislation in particular as catalysts to integration.
[22] Tulya M., '*Revival of the East African Co-operation and its Institutional Framework',* in *Perspectives on Regional Integration and Cooperation in East Africa: Proceedings of the 1st Ministerial Seminar on East African Cooperation* Arusha, 25-26 March 1999, EAC Secretariat, Arusha: EAC Secretariat, 2000, p. 21.
[23] *Ibid.,* p.4.
[24] The board was established in 1905. The East African shilling was the currency in British East Africa from 1921 to 1966. It was produced by the East African Currency Board, which had been established by the British colonial administration.

East African Shilling),[25] a Joint Income Tax Board and the establishment of a Governor's Conference which was consolidated into an East African High Commission (EAHC) in 1948.[26] On taxation matters, a common income tax code,[27] a common customs union code, a common excise duty code, similar sales tax code and an institutional framework for the management of taxes in the region were developed.[28] The economic cooperation fostered under the colonial rule had different objectives as compared to the present times. The colonial era cooperation was primarily tailored to enhance efficiency, through central (colonial) administration of customs, excise and revenue authorities. It never was a genuine promotion of the economic harmonisation, being sought by this study.

In 1961, there was the formation of the East African Common Services Organisation (EACSO) intended to review the structures of regional cooperation. The major aim of EACSO was to centralise the administration of East Africa's customs, excise and revenue authorities, currency,

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[25] The use of a common currency in the region dates back to 1850, when Indian, Greek and European merchants on the Kenyan Coast and Eritrea traded using the silver bullion coins known as Maria Theresa thalers. This one lasted until 1905, when the Indian rupee was made the official currency of the region. The rupee was phased out after Kenya became a crown colony in 1920 and was replaced with the shilling in 1923. It became the official currency in Kenya, Uganda, Tanganyika, Zanzibar, Pemba and British Somaliland. The shilling, which had an Arabic inscription, was also used in Yemen and the Persian Gulf. The currency board's main function was to maintain the shilling at par with the shilling in the United Kingdom. The board, with its headquarters in London, had commissioners in each of the countries it operated who reported to the Secretary of State for the Colonies under the advisory of the Bank of England. The board shifted from London to East Africa in 1960.

[26] The E.A. Governors conference was established in 1926. See the Preamble of the Treaty establishing the EAC. Also see, Mukandala R., '*Political Cooperation*,' in *Perspectives on Regional Integration and Cooperation in East Africa: Proceedings of the 1st Ministerial Seminar on East African Cooperation*, p. 88.

[27] Managed through the East Africa Income Tax Board established in 1940. This function was later transferred to the East Africa Common Services Organisation (EACSO) in 1961. See *East Africa Integration: Dynamics of Equity in Trade, Education, Media and Labour, Society For Intra-National Development, Regional Office for Eastern Africa.* Available at: www.sidint.net/docs/EA_integration_report_2nd_ed.pdf, (accessed on 25th June 2011).

[28] See the preamble of the Treaty establishing the EAC, 1999. Available at: www.mea.gov.in/Portal/.../east-african-community-april-2011.pdf, (accessed on 12th June 2012).

land, sea and air transport, telecommunication and education.[29] From its birth, EACSO was faced by serious problems, predominantly trade imbalances and unequal distribution of the resultant benefits.[30] From the inception of Customs Union in 1919, Uganda had a grievance against Kenya over customs matters.[31] Uganda was later joined by Tanganyika in making "*persistent claims*" over the unfair advantage given to Kenya within the East Africa[32]. The Armitage Smith report[33] recommended that "*Tanganyika should … cease to deplete her revenue and impoverish her citizens by protecting the products of her neighbours.*"[34] The Customs Union costs implications saw Tanzania extend tax refunds to Kenya and Uganda.

In the early 1950s, the Customs Union was distinctly divided, on the one hand, between Tanganyika and Uganda who wanted it dismantled and on the other hand, Kenya which preferred continuity. Tanganyika and Uganda increasingly felt that "*the customs union was designed for the exclusive benefit of Kenya*."[35] Attempts were made to address the imbalances by signing the Kampala Agreement in 1964. The Agreement sought to decrease trade deficits and industrial imbalances between Kenya on the one hand and Uganda and Tanzania on the other. Additionally, it advocated for industrial policies of allocating new industries to Tanzania and Uganda so as to increase production in the two countries, thereby reducing imports from Kenya. The Agreement was never implemented partly because Kenya refused to ratify it by insisting

[29] Nyirabu M., '*Lessons from the East African Community of 1967-1977*', in Ahmed Mohiddin (ed.) *Deepening Regional Integration of the East African Community,* (Addis Ababa, DPMF Book Series 2005) p. 24.
[30] *Ibid.*
[31] Hazlewood E. A., *Economic Integration: The East African Experience* (Heinemann Publishers 1975) p. 23.
[32] *Ibid.*
[33] Report by Sir Sydney Armitage-Smith on a *Financial Mission to Tanganyika*, as quoted in Hazlewood, ibid.
[34] *Ibid.*
[35] *Ibid.,* p.24. Hazlewood concludes that an understanding had been reached that if the integration scheme were to survive, radical adjustments had to be introduced in the manner benefits were distributed amongst the EAC States.

inter alia that one single currency be maintained in EA, a condition that was unacceptable to her sister countries.[36]

The failure of the Kampala Agreement saw the establishment of the Phillip Commission in 1965 which proposed the maintenance of a common tariff against non-EA origin goods entering the region.[37] However, unlike in the past, customs duty was to be paid to the consuming state rather than to the port of entry, which was in Kenya.[38] The Commission's work led to the signing of the Treaty for the East African Cooperation on 1st December 1967 in Kampala, Uganda. It also provided for the harmonisation of economic policy, establishment of common institutions and a Common Market.[39] As described in detail in the next chapter, the EAC collapsed in 1977 as a result of the political differences and the divergences in the municipal economic policies, including generally speaking the heterogeneous tax policies of the Member States.[40]

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36 Nyaribu M., *ibid.,* p. 25.

37 *Ibid.* p. 25.

38 *Ibid*,, p.26. With respect to industrialisation, the commission recommended the maintenance of the licensing scheme created under the Kampala Agreement with incentives whereby Tanzania was unequivocally granted the authority to establish three industries, while Uganda and Kenya were to establish two industries and one industry, respectively. It also recommended the creation of the East African Development Bank (EADB) with the key aim of lending investments funds to the three states with special bias in favour of Uganda and Tanzania.

39 Nyirabu. *M., ibid.,* p. 26.

40 Ingrid D., *The East African Community and Common Market,(*Longman, London, 1970, ISBN 0582645255), p.48. He argues that the main challenge was the mismanagement of the transfer tax system that had been introduced to deal with economic imbalance within the EAC. Also see, Kayunga S.S, '*Deepening Political Integration of the EAC Countries: The Uganda Case*,' in Ahmed Mohiddin (ed.), *op cit*., pp. 152-153. See also Mukandala, p. 96 (arguing that the reasons behind the collapse of the EAC in 1977 may be summarised as: background factors which inhibited the realisation of potential gains from regional cooperation; the inadequate institutional structures created in support of regional arrangements; un-equal distribution of gains arising from regional cooperation; the asymmetrical interdependence that characterised economic relations between the Member States and between Africa and the rest of the world; and ideological differences and political volatility).

In 1984 the three countries signed the Mediation Agreement for the Division of Assets and Liabilities of the former Community.[41] Under the Agreement, the parties agreed to explore areas of future cooperation and to work out concrete arrangements for such cooperation.[42] Subsequent meetings of the three Heads of State led to the signing of the Agreement for the Establishment of the Permanent Tripartite Commission for East African Co-operation on 30th November 1993. Full East African Co-operation operations started on 14th March 1996 when the Secretariat of the Permanent Tripartite Commission was launched at the headquarters of the EAC in Arusha, Tanzania. Considering the need to consolidate regional co-operation, the East African Heads of State, at their 2nd Summit in Arusha on 29th April 1997, directed the Permanent Tripartite Commission to start the process of upgrading the Agreement establishing the Permanent Tripartite Commission for East African Co-operation into a Treaty. The Treaty for Establishment of the EAC was signed on 30th November 1999 and entered into force on 7th July 2000 following its ratification by the original three Member States, being Kenya, Uganda and Tanzania. The Republic of Rwanda and Burundi acceded to the EAC Treaty on 18th June 2007 and became full members of the EAC with effect from 1st July 2007.[43]

1.3. A contemporary perspective to the study

The EAC Member States depend on taxation as a key source of public revenue, to finance their both recurrent and developmental budgetary requirements.[44] Income tax forms a critical

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[41] Available at: *www.kenyalaw.org:8181/exist/rest//db/.../No.%207%20of%201987.pdf.* (Accessed on 10th March 2011).
[42] Article 14: 02 of the EAC Mediation Agreement (1984).
[43] See preamble of Treaty establishing the EAC, 1999.
[44] See, for example Part 7 of Kenya's current (2011/12) Budget Statement (*supra*) entitled 'Fiscal Projection for 2011/12' which projects that out of the total revenue target of Ksh. 787.6 billion (i.e. 24.7 % of Kenya's GDP), about 70 % i.e. Ksh. 713.6 billion is to be financed through ordinary revenue, meaning taxes, while a (comparatively) paltry Ksh. 75.9 billion is expected to flow from Appropriations in Aid (AiA). Compare this

component of this allocation. For instance, the collection of income tax in Kenya has increased over time from Ksh. 7 billion in 1991/92 financial year to Ksh. 216 billion in 2009/10 financial year. This according to the Institute of Economic Affairs represented 40% of the total tax revenue.[45] The other EAC Member States have recorded similar trends on income tax contribution. For instance, Uganda's income tax collection accounted for 28% of total tax collection in the year 2012 and Rwanda's at 31%.[46] On the other hand, in order to ameliorate the tax burden incumbent upon investors in the region, both local and foreign, these countries have often resorted to tax incentives which have been sporadic and, therefore less economically beneficial in the long run.

Article 5(2) of the EAC Treaty declares that, "… *the Member States undertake to establish among themselves and in accordance with the provisions of this Treaty, a Customs Union, a Common Market, subsequently a Monetary union and ultimately a Political Federation*…. ". The roadmap towards the establishment of the Federation began with the signing of the Customs Union Protocol,[47] the Common Market Protocol,[48] and the fifth round of negotiations on a

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to para. 84 of Uganda's 2011/12 Budget which confirms that out of a resource envelope of Ushs. 9,840 billion, Ushs. 6,170 is expected to flow from tax revenues. Sol Picciotto in his book, *International Business Taxation A Study in the Internationalization of Business Regulation*(CUP, Electronic Edition 2013), p. xi argues that *"taxation is the point of most direct interaction between government and citizens, the state and the economy. Yet the technical complexities of taxation often make informed debate difficult."*This explains the nexus between taxation and governance which supports the dependence of tax regimes like the EAC Partner States on citizen taxation.

[45] Mutua J., *A Citizen's Handbook on Taxation in Kenya,* Institute of Economic Affairs, 2012, ISBN No. 978-9966-1561-6-7, p. 23.

[46] Akiza N.B., *Direct Tax revenue and its Contribution to Uganda's Economic Growth*, Makerere University, 2013. p.2. Available at: www.statistics.gov.hk/wsc/CPO30-P4-s.pdf. (Accessed on 25th June 2014).

[47] Available at: www.eac.int/customs/. The EAC Customs Union Protocol came into force on 1st January 2005. The Customs Union has four major elements: the establishment of a Common External Tariff, the establishment of Rules of Origin, the internal elimination of tariffs for goods meeting the EAC Rules of Origin criteria and the elimination of Not Tariff Barriers.

[48] The EAC Common Market Protocol *was* signed on 20th November 2010. Available at: www.eac.int/commonmarket/. (Accessed on 25th June 2014).

common currency for the EAC commenced in October 2011.[49] These negotiations culminated in the signing of the EAC Monetary Union Protocol on the 30th November 2013.[50] Article 83 of the EAC Treaty provides for monetary and fiscal policy harmonization. Member States are required to harmonise their tax laws and policies with a view of removing tax distortions, in order to achieve a more efficient allocation of resources within the EAC.[51] It is expected that harmonisation of tax policies would eliminate fiscal barriers and reduce trade imbalances hence enhancing economic growth within the EAC.

The date 1st July 2010 marked the commencement of the operationalisation of the EAC Common Market following the completion of the ratification of the Common Market Protocol. The Protocol opens the door for free movement of goods, labour and persons, rights of residence and free movement of services and capital as agreed by the Member States.[52]

To operationalise the Common Market Protocol, Member States are required to, enact relevant legislation to domesticate provisions of the Protocol into their domestic laws, undertake a review of domestic laws with a view to causing necessary amendments to ensure consistency with the

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[49] See the editorial, *Daily Nation,* 1st November 2011, p. 27. The Protocol establishing the Common Market set a goal of a Common Currency in 2012 and a Political Federation by 2015. These two are yet to be realised. Although, the Heads of State of the EAC during their 15th Extra-Ordinary Summit on 30th November 2013 signed the East African Monetary Union Protocol.

[50] It had been anticipated that Common Market framework would be in place in 2012.

[51] In addition, the Member States undertook to adopt policy measures in accordance with an agreed macro-economic policy framework. They also sought to, remove all exchange restrictions on imports and exports within the Community; maintain free market determined exchange rates and enhance the levels of their international reserves; adjust their fiscal policies and net domestic credit to the government to ensure monetary stability and the achievement of sustained economic growth; liberalise their financial sectors by freeing and deregulating interest rates with a view to achieving positive real interest rates in order to promote savings for investment within the Community and to enhance competition and efficiency in their financial systems.

[52] Article 2 (4) of the Protocol in accordance with the provisions of Articles 76 and 104 of the EAC Treaty, 1999. The Protocol was signed by the member states on 30th November 2009.

EAC Treaty and the Common Market Protocol, and to commence the implementation of the Protocol by discharging the obligations arising therefrom by removing any existing restrictions on freedoms and rights enshrined in the Protocol.[53] The Protocol is premised on the maintenance of a Common External Tariff regime, dismantling of the internal tariffs on cross-border trade and elimination of charges of equivalent effect which mostly manifest themselves as other forms of taxes. Additionally, it provides for national treatment in order to remove discriminatory treatment and the removal of subsidies which may be in the form of indirect taxation.

Whereas the EAC has made significant progress towards harmonisation of customs, to the contrary, income taxes, especially corporate, have not been harmonised.[54] For instance, the non-resident corporation tax in Kenya is 37.5% while in Tanzania the rate is 30%.[55] This is compounded by lack of in-built mechanisms in the Common Market Protocol to explicitly provide for income tax harmonisation. Indeed, one is left to wonder the scope of taxes intended to be harmonised under Article 83 (2) (e) of the Treaty as well as Article 32 of the Common Market Protocol. Further, income tax legislations differ significantly, for instance in terms of the objectives of taxation, tax bases, rules of tax payment and the applicable tax rates. This study is premised on the notion that if the differentials in national taxes are not addressed, Member States will continue to compete in taxing rights that may harm other Member States and erode the

53 Article 47 of the EAC Common Market Protocol.

54 Article 32 of the EAC Common Market Protocol provides for harmonisation of tax policy and laws to remove distortions and facilitate free movement of goods, services and capital and to promote investment.

55 For a comprehensive analysis of differences on income taxes, see, Price Waterhouse Coopers (PWC) Report, *Doing Business in Kenya: Know Your Taxes, East Africa Tax Guide* 2011/2012. Available at: www.pwc.com/en_RW/rw/.../east-african-tax-guide-2011-2012.pdf. See also, Deloitte Report, *Step By Step Income Tax in East Africa*, 2012. Available at:www.deloitte.com/assets/Dcom.../Deloitte_IncomeTax2012.pdf. See also, Deloitte Report, International Tax, Kenya Highlights 2014. Available at: www.deloitte.com/.../Tax/dttl-tax-kenyahighlights-2014.pdf. (Accessed on 25th June 2013).

overall tax base of the Community. Harmful tax practices and double taxation pose an obstacle to these freedoms as well as the co-operation and trade with third parties.

This study seeks to examine and analyse the tax systems of different member countries of the EAC in order to identify the impact of maintaining a heterogeneous tax regime that may have a negative effect on the operation of the Common Market. In particular, focus is on corporate income tax harmonisation as a process towards realising the full objectives of the EAC Common Market.[56]

Presently, the Member States of the EAC even pursue different policies on taxation depending on their sovereign needs. However, the key purpose of taxation is revenue collection to finance various governmental projects. The need to attract foreign direct investment (FDI) is another justification for maintaining particular rates of taxes. Equitable distribution of economic benefits can also justify taxation. The existence of different tax laws indicates that the respective policies pursued by each Member State also differ.[57]

The constitutive instruments of the EAC are examined in the thesis in so far as they are relevant and insightful in the study of income tax law and policy harmonisation within the framework of EAC integration. Relevant national laws are also considered in order to identify the heterogeneity in income taxation regimes and propose solutions thereto.

[56] The choice of focus on corporate income taxes has been informed by the comparative study on EU's CCCTB which is a model of harmonization of corporate income taxes.
[57] This study shall examine the different policies pursued in order to ascertain whether the convergence of policies could support the proposed harmonisation of income tax laws especially corporate.

A sneak preview of prevailing tax rates show that income tax rates in the EAC are distinct although there are a few areas of convergence. If left unaddressed, the differences would potentially harm the economic integrative initiatives in the EAC.[58] Without concrete measures for harmonisation, the differences will affect the integration process especially in the operationalisation of the Common Market, Monetary Union and ultimately the Political Federation of the EAC. Other problems further occasioned by the marked heterogeneity are analysed in Chapter Four and include revenue loss, trade distortion, harmful tax competition and double taxation.

Indeed, during the EAC Heads of State's 15th Ordinary Meeting of 30th November 2013 in Uganda, the Summit approved and signed the Protocol on the establishment of the East African Monetary Union (EAMU) and directed that:[59]

> All Partner States should conclude the ratification process of the EAMU Protocol by July 2014; the Council of Ministers should implement the roadmap to single currency as indicated in the Schedule on the EAMU Protocol; the following institutions necessary for the implementation of the EAMU be established, firstly, the EA Monetary Institute, secondly the EA Statistics Bureau to be responsible for statistics, thirdly, the EA Surveillance, Compliance and Enforcement Commission to be responsible for surveillance, compliance and enforcement of the Protocol and, the EA Financial Services Commission to be responsible for financial services.

It was further resolved that the Council of Ministers be given the mandate to develop the bills for the establishment of the institutions provided in the Protocol for consideration by the East African Legislative Assembly (EALA) as provided for in the road-map. Lastly, the summit directed that the Council of Ministers should be charged with the responsibility of appraising the Summit on the progress made on implementation of the roadmap to a single currency at every

[58] For a comprehensive overview of income taxes, see chapter three and Appendix 4 of this thesis.

[59] Communication from the EAC Secretariat, Kampala, Uganda following the 15th Ordinary summit meeting held at the Speke hotel in Uganda on the 30th November 2013, available at: www.**eac**.int/news/index.php?...com. The Protocol is available at: www.**eac**.int/legal/index.php?option.

Ordinary Summit. In addition, the Summit agreed that the Sectoral Council on Finance and Economic Affairs be given the responsibility of implementation of the Monetary Union Protocol.[60]

The above developments evidence the acceleration of efforts towards establishing the EA Federation. However, the key question is whether the Monetary Union can survive the current competitive corporate income tax laws and policies prevailing in the EAC. Income tax harmonisation, as suggested in this study, is expected to aid in the expeditious realisation of an EAC Tax Federation and, ultimately, serve as a catalyst for the intended Political Federation of the EAC.

1.4. Statement of the problem

Despite the long history of cooperation within the EAC, the five Member States still operate their own national corporate income taxes with limited coordination between them. Indeed, this heterogeneity of corporate income tax legislation, policy and practice in the EAC is counterproductive and inimical to the tenets of regional economic integration as it has lead to a number of challenges, yet the region is required to operate as a single market. One such problem relates to the behaviour of governments which may find themselves competing to attract mobile forms of investment by offering lower corporate tax rates or special regimes favouring certain business activities. For instance it is estimated that in the year 2012, the member states of the EAC lost up to US$2.8 billion on revenue foregone from tax incentives and exemptions.[61]

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[60] *Ibid.*

[61] Tax Justice Network Africa and Action Aid International Report 2012, *Tax competition in East Africa: a race to the bottom,* p. 4.

A second concern relates to the behaviour of companies, which can exploit differences between tax rules and tax rates in different countries to reduce their tax burden. The interactions between the heterogeneous corporate income taxes present numerous opportunities for firms to benefit from tax planning for example through the manipulation of transfer prices for transactions between affiliated companies with the effect of shifting profits from high-tax to low-tax jurisdictions, and intra-group borrowing and lending, with the effect that interest payments are deducted against corporate tax at a high tax rate in one country and taxed at a lower rate when received in another country.[62] These opportunities for tax evasion/avoidance result in lost revenues thereby hindering the collective economic progress of the EAC.

Another challenge caused by maintenance of heterogeneous corporate income tax systems and the lack of coordination is double taxation. This problem is associated with companies that operate in more than one EAC member state. Currently, a business that is trading through a branch will have the branch pay tax in its country of operation and the same income will also be taxed on the head office which is in another country and in the case of withholding taxes, if income or expenditure is subject to withholding tax in one country and is also taxable in another country, what is paid will not be accepted as tax settlement in the regime of the second country.

Further, the need to comply with a multiplicity of different rules by the multinational corporations entails a considerable compliance cost and represents itself a significant barrier to cross-border economic activity yet the EAC is expected to operate as a single market. In addition, the heterogeneity of corporate income taxes affects the real behaviour of companies to

[62] Lohse, T. and N. Riedel. *The impact of transfer pricing regulations on profit shifting within European multinationals*, FZID discussion papers, 2012, No. 61, p. 24.

the extent that investment is attracted to certain locations by the promise of low tax charges rather than by low production costs which results in inefficiency in production.

Under Article 83 (2) (e) of the EAC Treaty[63], the Partner States, in the spirit of monetary and fiscal policy harmonisation, undertake to harmonise their tax policies with a view to removing tax distortions in order to bring about a more efficient allocation of resources within the Community. This treaty provision is skeletal, bare and merely encouraging EAC Partner States to harmonise tax policies.

Sadly, the insufficiencies resulting from the legal and practical character of Article 83(2) (e) are not cured by Article 32 of the Common Market Protocol[64] under which the Partner States undertake to progressively harmonise their tax policies and laws with a view to attaining the objectives already stated.

The two legal provisions, even when interpreted jointly, do not point the EAC Partner States to any suitable mechanism, timeline or appropriate path of tax harmonisation taking into account existing disparities in taxation generally, the relative stages of economic development, the preconditions for free movement of goods and services including capital and investment promotion in the region. The problem posed by the lacunae in the EAC constitutive laws has left the EAC to continue applying heterogeneous corporate income tax systems at the expense of the

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[63] It provides that the Partner States undertake to "(e) *harmonise their tax policies with a view to removing tax distortions in order to bring about a more efficient allocation of resources within the Community*."

[64] It provides that "*The Partner States undertake to progressively harmonize their tax policies and laws to remove tax distortions in order to facilitate the free movement of goods, services and capital and to promote investment within the Community*."

very “tax harmonisation” declared by both the Treaty and Protocol.[65] The perils of heterogeneity as pointed out above and in chapter four of this thesis, have persisted from 7th July 2000 when the Treaty was ratified and almost six (6) years later since the ratification of the EAC Common Market Protocol on 1st July 2010.

The problems occasioned by the deficiencies of Articles 83(2) (e) and 32 as discussed above can be comparatively analysed both within the internal context of the EAC and external context of the EU and NAFTA. These experiences offer poignant lessons for the EAC on how to harmonise corporate income taxes. In particular, regarding the EU, the CCCTB proposal provides a coordinated framework for corporate base taxation within the EU.[66] However, the NAFTA tax harmonisation experience is less ideal than the EU’s as the region is still at a crossroads on the tax integration approach to pursue. Nonetheless, the crucial learning point for the EAC from NAFTA’s experience revolves around balancing between gradual harmonisation and sustaining political sovereignty at the same time. On the other hand, the harmonisation of customs within the EAC has been made possible since it is explicitly provided for in Article 75 of the Treaty as supplemented by the Protocol on the establishment of the Customs Union and further, through the enactment of the *EAC Customs Management and Coordination Act, 2004*.[67]

It is proposed in this study that the challenges of heterogeneity in CIT can be overcome by undertaking amendments to Article 83 of the Treaty, the enactment of the EAC Protocol on

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[65] See an overview of income tax systems in the EAC in Appendix 4 of this study. Also see Price Waterhouse Coopers, *Doing business: Know your taxes, East Africa Guide 2013/14*, p.4-44. Available at: https://www.pwc.com/...east-africa-tax-guide-2013-2014.pdf. (Accessed on 25th June 2014).

[66] The CCCTB works on the legal basis of EU Council Directives and regulates the taxation of specified revenues such as dividends, interest and royalty payments.

[67] The enactment and implementation of the statute has led to the implementation of the EAC Common External Tariff (CET) regime for custom taxes. Comparatively-speaking, the same cannot be said for CIT.

corporate income taxes and, further, the enactment of an EAC statute on corporate income taxes to provide for CCCTB *inter alia*. The alternative would be the amendment of the Common Market Protocol to elaborate on the income tax harmonisation process. These changes should explicitly provide for harmonisation of EAC corporate income taxes.

1.5. Justifications for the study

The EAC and, in particular, its political leaders, have taken on regional integration with renewed vigour and hope.[68] This study seeks to juxtapose itself within the current wave of regional integration in order to contribute some focus, insight and impetus into the issue of regional income tax harmonisation as a catalyst to economic integration. The proposals for reforms to have an elaborate legal framework for harmonisation of income taxes in general and corporate income taxes in particular shall be beneficial to the EAC in elimination of trade distorting fiscal barriers, harmful tax competition, double taxation and other effects of heterogeneity. The amendment of the Treaty and enactment of new EAC laws on income tax harmonisation as recommended in this study will therefore provide long lasting legal foundations for the envisaged reforms.

At the specific level of taxation, the advantages of corporate income tax harmonisation that the region seeks to reap therefrom include boosting the single market, preventing revenue erosion,

[68] For example, a press release from the EAC Secretariat in Arusha (24th May 2012) indicates that the Secretary General of the EAC Amb. Dr. Richard Sezibera reaffirmed that negotiations for the EAC-EU Economic Partnership Agreement (EPA) are on course and hailed the talks as "the first time in history that the EAC Member States were negotiating terms of reciprocal trade arrangement with Europe as a bloc". In June 2011, Former President of Kenya H.E.Mwai Kibaki attended a joint EAC-SADC-COMESA meeting in South Africa. Para. 28 of the Rwandan 2011/12 Budget confirms that the Rwandese Government received an EAC-COMESA grant to compensate a revenue gap/shortfall.

preventing tax evasion especially of the cross-border type, preventing double taxation,[69] ensuring coordination in the incentive and investment structures of the region, elimination of harmful tax competition and increasing revenue mobilisation to correct the imbalances of an imperfect market. These reasons provide policy, legal and economic justifications for income tax harmonisation generally and corporate income tax harmonisation, in particular, hence the essence of the study.

On the other hand, the negative effects of the current scheme of tax heterogeneity within the EAC including lack of equity, tax competition, conflict of jurisdiction, misallocation of resources, tax evasion, can be overcome as argued in this thesis through harmonisation and consolidation of relevant laws and policies.

With regard to the comparative study of the European Union (EU) which is discussed under Chapter Five of this thesis, the need to change the structure of taxation systems in Europe has increased with the pressure on fiscal revenues facing the ageing population and excessive deficits.[70] Moreover, as the number of the EU Member States has grown, the differences in fiscal and tax policies in the Union have became even more significant. Highly divergent direct tax rates across the EU have raised questions about the limits of national sovereignty over direct taxes and the need to harmonise corporate taxes.[71] Assuming that the reasons and underlying

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[69] Kenya has concluded nine (9) DTTs with other countries (to the exclusion of the EAC members). These are UK, Germany, Norway, Sweden, Denmark, India, Canada, Zambia, France and UAE. DTTs with Netherlands and Mauritius in the pipeline.

[70] Charles E. Mclure, Jr., *'Harmonising Corporate Income Taxes in the US and the EU: Legislative, Judicial, Soft Law and Cooperative Approaches*', Columbia Journal of European Law, Vol 14, No. 3, 2008, p. 350.

[71] *Ibid*., p.377. The existence of 27 national corporate tax systems based on separate accounting and the arm's length standard (SA/ALS) poses serious obstacles to the creation of a single market within the European Union (EU). These include complexity, in the need to document and monitor transfer prices, the possibility

rationales for tax harmonisation in the EU can be extrapolated to the EA scenario, then the EU and additionally, NAFTA[72] experiences may justify the EA's attempts at income tax harmonisation.

Against the foregoing background, and considering the lack of specific literature on the subject of EAC income tax harmonisation, it is the goal of this study to inform the East African drive towards corporate income tax harmonisation taking advantage of the EU and North American Free Trade Area (NAFTA) experiences which are quite instructive. Hopefully, regional policy makers, legislature, academics and the general citizenry will find the study useful considering the existing gap in the literature that this study seeks to fill. This study is intended to address the issue of harmonisation of corporate income tax and to further make proposals for the enactment of the relevant consolidated law and policy in the EAC. The study intends to provide antecedent tax conditions for prospective new members to the EAC. Having expressed the desire to join the EAC, South Sudan, Somalia, Ethiopia and DRC would be required to structure their respective taxation policies and laws as a preconditioned requirement before joining the Community.

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of double taxation, and the general inability to offset losses incurred in one Member State against income earned in another. To overcome these obstacles, the European Commission has suggested that EU Member States consider adopting a Common Consolidated Corporate Tax Base (CCCTB). See Charles E.Mclure, Jr., 'Harmonising Corporate Income Taxes in the US and the EU: Legislative, Judicial, Soft Law And Cooperative Approaches', *Columbia Journal of European Law*, Vol 14, No. 3, 2008, p. 377. Available at, www.lawlib.wlu.edu/CLJC/index.aspx?mainid (accessed on 20th March 2011).

[72] NAFTA stands for the 'North American Free Trade Agreement' [cited as NAFTA Dec. 8-17, 1992, U.S.-Mex. - Can., 32 I.L.M. 605 (1993); hereinafter 'NAFTA']. Currently in NAFTA, there is tension between, on the one hand a desire to reap economic benefits through integration and the desire to maintain sovereign control of tax policy. Three possible approaches have been identified, first is the maintenance of the status quo of coordination of cross-border tax activities through bilateral tax treaties, secondly through measures to undertake comprehensive tax integration through harmonisation and adoption of NAFTA wide formulary approach towards taxing the profits of business entities, and thirdly by pursuing a policy of gradualism through slowly harmonising their tax regimes while coordinating their tax policies. See, Arthur Cockfield, 'Tax Integration under NAFTA: Resolving the Conflict Between Economic and Sovereignty Interests' (1998) 34 *Stan. J. Int'l L.* 39-73. Available at: www.post.queensu.ca/~ac24/StanJIntlLawArticle.pdf. (accessed on 20th March 2011).

1.6. Conceptual and theoretical framework of the study

1.6.1. Introduction

According to Adam Smith,

> The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax and would remove his stock to some other country where he could either carry on his business in peace or enjoy his fortune at more ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left. Logically, as stock cultivates land and it also employs, a tax which tended to drive away stock from any particular country would so far tend to dry up every source of revenue both to the sovereign and to the society. The move will not only affect the profits of stock, but also the rent of land and the wages of labour which may be diminished by its removal.[73]

Adam Smith has aptly emphasised the perils of fiscal disparities in a single market area. These include locative distortions, trade and investment imbalance, revenue loss and imbalances in regional development and as argued in this thesis, contrary to the objectives of the Community as set out in Article 5 of the EAC Treaty. Conformity is achieved through harmonisation in order to eliminate harmful tax competition and provide a favourable environment for investment. The latter only results in increased tax burden, which inhibits regional investment and economic growth. This study is premised on two main concepts which are distinctly opposite, tax competition and tax harmonisation. The current practice of income tax systems in the EAC signifies tax heterogeneity while the ideal situation in a fully operational common market is a harmonised income tax framework. As the EAC states seek to form a political federation, key steps must be taken to change it from the current system of tax competition to a harmonised framework. These broad concepts are discussed next.

[73] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 2 vol 1. Everyman's Library (London: Dent and Sons, 1904) p. 68.

1.6.2. Conceptual framework

The tax systems in the Member States of the EAC differ in many aspects. For instance, there is substantial difference in the types of taxes (direct or indirect), the set of taxpayers, the types of assessable or taxable property, the bases of the taxes, tax exemptions, tax allowances and procedures. The phrase 'tax harmonisation' has wide interpretation depending on the context. It can refer to the pursuit of similar tax rates or to the standardisation of the methodology, definitions and administrative practices, including rules and procedures.[74] It can also refer to the pursuit of similar tax structures, for example, whether the proportion of direct to indirect taxes is similar in the countries under consideration.[75] Further, it may be interpreted to mean the similarity of fiscal policy, including the expenditure side thereof. Overall, tax harmonisation refers to the pursuit of uniformity. It can also refer to harmonised tax policies or simply one tax policy or law for the region.[76]

Based on the implementation of the Common External Tarriff (CET), tax harmonisation in the EAC refers to the pursuit of similarity of tax bases, structures and also rates. The most practical concept of tax harmonisation, however, is one that encompasses relevant elements of all the aforementioned definitions. Tax harmony has several characteristics: first, to ensure that 'like' is compared with 'like' across borders. Critical to tax harmony are the concepts/processes of tax administration and collection, including rules, procedures, methodologies and definitions of applicable terms.

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[74] Musgrave P., *Fiscal Coordination and Competition in an International Setting* (University of California, Santa Cruz Dept. of Economics 1989) p. 67.

[75] CARICOM Secretariat, *Caribbean Trade and Investment Report 2000: Dynamic Interface of Regionalism and Globalisation* (Kingston: Ian Randle Publishers, 2000) p. 26.

[76] Amos C. Peters, *Exploring Caribbean Tax Structure and Harmonisation Strategies*, Economic Intelligence and Policy Unit CARICOM Secretariat, Georgetown, Guyana, May 2010 bulletin, p. 4.

The second element of tax harmony is *similar tax structures*. This entails identifying the methodology of how taxes are uniformly applied across the region. Making the definitions and methodologies uniform and consistent across the region is critical to ensuring that both regional and international economic agents, be they investors or consumers, can make simple and accurate comparisons of tax matters within and outside the Common Market. The third element of tax harmony is the harmonisation of tax rates. Any efforts at tax harmonisation within a single market should be aimed at ensuring some form of uniformity of tax rates.[77]

The uniformity of tax rates entails a situation where countries agree to apply or pursue exactly the same tax rate, for instance, on corporations. Minimum and maximum tax rates refer to the scenario where harmonisation is achieved through the enactment of tax floors and ceilings below or above which national governments should apply. On the other hand, tax bands are a combination of the minimum and maximum tax rates where either is agreed upon regionally. [78] In contrast, tax competition allows governments to freely compete for tax bases and represents the exact opposite of a uniform tax rate because there is absolutely no constraint on national governments. In terms of corporate income tax, the uniformity should reflect common accounting rules and the methods of arriving at the common tax base and rate.

To successfully undertake tax harmonisation measures, the EAC Member States can progressively utilise the relevant parts of the abovementioned methods in order to attain the twin objectives of removal of barriers to trade and ultimately attaining the third and fourth integrative

[77] Uniformity of rates, can take a number of forms namely: a uniform tax rate, minimum tax rates, maximum tax rates, tax bands, and tax competition.

[78] These three elements restrict the behaviour of national governments to particular regional limits but, at the same time, allow for some discretion and variance in the rates across the countries involved.

steps as provided in the EAC Treaty.[79] Tax policy is also essential in the East African Common Market as Member States need to work together on tax administration. This can be achieved through coordination, cooperation and convergence of their respective tax policies. In corporate income tax terms, this means that a uniform formula of computing the corporate tax base ought to be adopted. Thereafter, the harmonisation could extend to the tax rates.

1.6.3. Theoretical framework

Regional income tax reform is an interdisciplinary study that uses economic analysis in its pursuit for legal solutions. Both economic and legal theories are therefore considered herein. At a basic and foundational level, three main economic theories justify taxation and its attendant laws and policies. These are comprehensive income theory, optimal theory of taxation and public choice theory.[80] At an enhanced level of analysis and in the context of this study, three theories explain and justify tax harmonisation. These are equilisation or real harmonisation theory, differentiation theory and competition theory. In terms of legal jurisprudence, the thesis draws insight from legal positivism. A closer examination of these harmonisation theories will suffice.

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[79] The third integrative step is the establishment of a Monetary Union while the fourth and the last step is the establishment of an EAC Federation.

[80] See, Nicos C. *How Crises Shaped Economic Ideas and Policies*, Springer-Verlag, 2015, ISBN: 978-3-319-16870-8, Available at: http://link.springer.com/book/10.1007/978-3-319-16871-5. (Accessed on 20th May 2015). The first is comprehensive income theory whose proponents are English classical economist John Stuart Mill, French political economist Jean Babtiste and Swiss philosopher, Jean Rousseau. This theory provides that taxes should be made on all sum of a person's annual consumption and expenditure and the increment in that persons net worth in a given year. This includes income in kind, freedom from pressure. it is based on Haig-Simons definition of comprehensive income. The second is the optimal taxation theory whose proponents are English philosophers Thomas Hobbes and John Locke, and Dutch Jurist, Hugo Grotius. This theory posits that a tax system should be chosen to maximize a social welfare function subject to a set of constraints. It treats social planner as a utilitarian, that is parliament. It considers social welfare function based on the utilities of individuals in the society. The third is Public choice theory whose proponents are French physiocrats Francois Quesney and Jacques Turgot. The theory posits that taxpayers should be involved in determination of the use of the revenue earned from taxation.

1.6.3.1. Tax harmonisation theories

Tax harmonisation theories occupy the heart of the theoretical grid of the present study. Here, the **equalisation or real harmonisation theory** is considered first. According to this theory, tax law and policy is passed from the national/domestic to the regional level. The Member States of the region agree to a single tax system comprised of single rates.[81] The advantage of this 'real' harmonisation approach is the abolition of all market distortions and maximum efficiency in capital allocation. However, handing over the tax policy to the regional authority is hardly reconcilable with the sovereignty interests of Member States since tax legislation is traditionally seen as a national/domestic or municipal matter to be jealously guarded by a Member State.[82] As far as the EAC scenario is concerned, by analogy, the successful implementation of the Common External Tariffs (CET) in the EAC Customs Union exemplifies this form of harmonisation.

Within the context of this study, the classification of the degree of harmonisation was guided by the study by Velayos, *et al,*[83] who have considered the taxonomical approach for tax harmonisation in a single market. One of the main objectives of this study is to examine the effects of maintaining different corporate income tax systems in a Common Market and to assess whether those challenges could be resolved through a legal process. It is proposed in the study that explicit provisions should be made in the constitutive instruments of the EAC for harmonisation of Income taxes. Harmonisation of both tax base and rates would be the ultimate objective of this process since it is intended that the roadmap to political Federation of the EAC

[81] Joseph Jason, *Fiscal harmonisation in the Caribbean: A case study of the Value Added Tax*, Caribbean Centre for monetary studies conference held in Barbados, 31st October – 3rd November 2006, p, 7. Available at: www.ccmf-uwi.org/files/publications/conference/907.pdf. (Accessed on 20th June 2013).

[82] Arguments abound against the cession of state sovereignty.

[83] Velayos, F., Barreix, A. and Villela, L. (2007). *Regional Integration and Tax Harmonisation: Issues and Recent Experiences*. Inter-American Development Bank, January 2007, p. 32.

should be preceded by a convergence of income tax laws and policies. Equalisation or real harmonisation theory is therefore useful in determining the extent of harmonisation necessary for full operationalisation of the EAC Common market aimed at making the EAC a single market. The Velayos scale is therefore useful in establishing the various policy levels for harmonisation process as discussed in detail in chapter five herein.[84]

Secondly, the **differentials or coordination theory** is based on the view that the tax systems of each country functions as an instrument of policy for attaining its major economic objectives. Therefore, different tax systems in the Member States should be kept with the maximum welfare of the union as the sum of the members' welfare.[85] The inter-country effects of the different tax systems such as cross-border taxation should be eliminated through coordination among the Member States. The advantage is that the tax policy is left to Member States rather than being imposed by the region. Further, the approach appreciates the different economic and social circumstances in each member state, which may justify different tax systems.[86]

The second theory accepts differences among Member States and subsequently is contradictory to the general tenets of regional integration, the single market concept and the economic analysis of the impact of direct taxation differences among Member States. This is because it is based on the doubtful basis that the benefit to the EAC is the sum of the Member States' welfare. Consequently, social and economic circumstances in the respective Member States have to be

[84] See part 5.2.2 below.
[85]Ramsey F.P., *A Contribution to the Theory of Taxation*, the Economic Journal, Vol. 37, No. 145. Mar, *1927*, pp. 47-61. Available at: *www.uib.es/depart/deaweb.../ramsey.pdf*. This argument sounds utilitarian and resonates with the optimal taxation school which favours utilitarianism over equity, the only technical difference being the domestic/municipal nature of the latter theory.
[86] *Ibid.*

considered not only for taxation but rather for all aspects of the Common Markets. However, the necessary coordination among the Member States aimed at the elimination of the cross-border effects of different tax systems may be much more difficult to achieve than harmonising all the tax systems. This thesis argues for the elimination of tax distortions caused by heterogeneous corporate income taxes through the harmonisation process. This theory is therefore useful since the member states are allowed to progressively eliminate distortions caused by heterogeneity, the ultimate objective being the harmonisation of the rates. As suggested in the study, the CCCTB harmonisation along the EU lines is one such utility of this theory since it would allow the member states to harmonise their corporate tax bases and once fully harmonised, the structures, administrative processes and ultimately the rate harmonisation will be agreed upon.

Thirdly and finally, the **competitive theory** provides for fiscal sovereignty in all aspects of taxation with the assumption that imposed tax harmonisation is not necessary since a single market competition among the Member States will lead in the long term to approximation of taxes. The major advantage with this theory is that national sovereignty is maintained since tax policy formulation is confined to the individual member state.

There are, however, a number of counter-arguments against the competitive approach, the main critique being the fear that it will take much too long for taxes to be approximated and, moreover, due to open membership of the Community, additional Member States (like Rwanda and Burundi who have joined the EAC at its post-inception stage), the process will become less likely to work at all. Furthermore, the competition approach presupposes absolute mobility of capital within the region and zero transfer costs. This is, however, only (or virtually) true for

money investment like buying shares or giving credit. All other assets are more or less immobile and subsequently necessitate a certain amount of transfer costs. On the other hand, in the absence of a minimal level for tax rates, tax competition would be likely to drive direct taxes to a very low level as has been observed in the EU.[87]

Hansson and Olofsdotter have developed a key theoretical concept of new economical model,[88] distinguished into welfare and economic arguments. They apply to the question of whether tax competition or harmonisation is to be pursued by the EAC member states or not.

The new economy geography model is a contemporary analysis of corporate tax competition which takes into account the different characteristics of nations and how they relate to tax rates. The main argument in this thesis is that since the EAC has constituted itself into a single market, geographic barriers ought to be dismantled, a step away from tax competition towards a fiscally integrated regime. Baldwin and Krugman,[89] show that integration increases the importance of the agglomeration forces and leads to a concentration of production in certain countries or regions. The theory contends that further integration tends to elevate the importance of agglomeration forces and consequently decrease tax competition as observed by Hansson and Olofsdotter.[90]

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[87] Corporate tax rates might reach such a low level that the incentive to shield income from personal taxation through incorporation would be unacceptably high leading to a 'race to the bottom.' Due to the high mobility of money, capital income taxes would probably even be driven to a zero level.

[88] Hansson, A. and Olofsdotter, K. (2004). *Integration and Tax Competition: An Empirical Study for OECD countries*. Department of Economics, Lund University, Sweden. April 2004, p. 23.

[89] Baldwin, R. and Krugman, P. (2004). *Agglomeration, Integration and Tax Harmonisation in the EU*. European Economic Review, 48 (2004) 1-23, P.8. Available at, www.elsevier.com/framework_aboutus/pdfs/agglomeration.pdf, (accessed on 16th May 2012).

[90] *Ibid.*

Zodrow and Mieszkowski[91] have developed the basic theoretical model of corporate income tax competition and the efficient provision of public local goods. According to this model, taxes are assumed to be source-based and the provision of social goods is financed through the tax levied on capital and labour. If a higher marginal tax is placed on the mobile factors of production then an outflow of capital occurs, thereby reducing the tax base and decreasing public spending. A lower tax rate on capital therefore implies a sub-optimal supply of the public good. This shows that the continued application of competitive regimes of corporate taxation within the EAC continues to yield a negative relationship between factor mobility and tax rates applicable.

An extensive body of literature supports the view that tax competition may lead to inefficiently low tax rates and sub-optimal levels of public spending,[92] which would imply grave concerns for regions such as the EU that are showing a rapid decline in corporate tax rates. The EAC should borrow from the EU experience so as to preserve their corporate tax environment from the effects of harmful tax competition. Janeba's[93] perspective is useful as it views tax competition as an uncooperative game with respect to both corporate tax rates and effect of double taxation. According to Janeba, since the non-cooperative game playing equilibrium yields an inefficient allocation of global capital stock, any moves towards cooperating and coordinating taxes can be welfare-improving for both countries. This finding is useful to the present study which seeks to determine the correlation between corporate income tax competition and economic neutrality in the EAC common market. Whilst public finance models of taxation typically argue that tax

[91] Mieszkowski, P. and Zodrow, G. (1986) Pigou Tibeout, *Property Taxation and the Under-provision of Local Public Goods*. Journal of Urban Economics 19, p. 365.
[92] Tanzi and Bovenberg. *Is there a need for harmonising capital income taxes within European Countries?*, (1990) in Zodrow, G . (2003). *Tax Competition and Co-ordination in the European Union.* International Tax and Public Finance Journal, Nov 2003, 10 (6), p. 34.
[93] Janeba, (1993). *Corporate Tax Harmonisation and Competition in Federal Countries: Some Lessons for the European Community*? National Tax Journal, 26, 441-461, p.450.

competition has a negative effect as it will damage the social provision, other research,[94] is quick to argue that it can help economies grow faster and that, in fact, lower tax rates have not implied lower tax revenues.[95] The present study however contends that the lowering of tax rates, a feature associated with tax competition has and continues to deny the EAC member states the much needed revenue and therefore advocating for corporate income tax harmonisation.

Cano[96] argues that, in fact, harmonisation is not a singular concept but rather there exist two forms of tax harmonisation, that is, uniformity and compatibility. In his opinion, compatibility is most relevant at the early stages of economic integration when tax harmonisation is just beginning. Other efforts to break down the classification of harmonisation into sub groups which better explain the situation include the work of James[97] who establishes a scale from 'no harmonisation' to 'standardisation'. Velayos, et al[98] have formulated a scale of harmonisation which proves particularly useful in this study. This is based on standardisation, compatibility, coordination, cooperation and convergence respectively.[99] This study advances the Velayos argument that the EAC should carefully design an appropriate mechanism to allow the gradual departure from the current regime favouring harmful income tax competition to a fiscally integrated regime as has been achieved through common external tariffs under EAC harmonised customs regime.

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[94] Mitchell, D. (2004). *The Economics of Tax Competition: Harmonisation vs. Liberalization.* 2004 Index of Economic Freedom. Chapter 2. Retrieved on16.04.12, available at: www.heritage.org/index/chapters/pdf/Index2004_Chap2.pdf, (accessed on 16th April 2012).
[95] *Ibid.*
[96] Gonzalez Cano, J. (1996). Armonizacion tributaria del Mercosur. Bueons Aires: Instituto Universitario de Finanzas Publicas Argentinas, p. 12.
[97] James, S. (2000). *Can we harmonise our views on European tax harmonisation?,* International Fiscal Documentation Bulletin, June, p. 9.
[98] Velayos, F., Barreix, A. and Villela, L. (2007). *Regional Integration and Tax Harmonisation: Issues and Recent Experiences.* Inter-American Development Bank, January 2007, p. 22.
[99] This classification is explained in chapter six of this study.

1.6.3.2. Tax harmonisation within the framework of economic integration

The question can be posed: does close economic integration, especially in the face of the growing mobility of capital, both physical and human, require harmonisation of income taxes? Many observers believe that it does.[100] It is often argued that the nations of the EU, in particular, must agree on common tax rates if they are to avoid a 'race to the bottom' that will undermine their relatively generous welfare states. The logic seems straightforward: other things being equal, producers will shift to whichever country that has the lowest tax rates, and, absent any coordination of tax-settings, the attempt to attract or hold on to employment will lead to a competition that drives tax rates ever lower. In order to avoid the pitfalls of this 'race to the bottom' phenomenon, it is important for neighbouring countries, trade partners or countries who share the same tax base and/or whose trade and tax practices are affected by more or less the same citizens to integrate and harmonise their tax policies and legislation.

Simply put, rather than the EAC Member States each lowering their domestic tax rates to attract foreign investment through incentives in a "race to the bottom", it is more economically plausible for them to harmonise their taxes and harness the benefits accruing from a unified and consolidated tax policy and legislation. Negotiating more coordinated corporate income tax systems through harmonisation would yield several benefits for the member states including the reduction of competition, reduction of economic distortions, reduction of tax evasion and

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100 OECD (1998), *Harmful Tax Competition: An Emerging Global Issue; available at:* www.oecd.org/dataoecd/33/0/1904176.pdf, (accessed on 28th March 2012). 'There are concerns that harmful preferential tax regimes that drive tax rate levies on income from the mobile activities significantly below rates in other countries have the potential to cause harm by distorting financial and indirectly, real investment flows, undermining the integrity and fairness of tax structures and the potential to cause undesired shifts of part of tax burden to less mobile bases, such as labour, property and consumption, for more analysis, see p. 16. However, the harmful taxes argument does not enjoy support throughout the OECD where it was first championed as there are those who have poured cold water on it.' See, for instance, Michael Littlewood, "*Tax Competition: Harmful to Whom?*" Michigan Journal of Int'l Law, 2004-5.

avoidance and the reduction of administration and compliance cost. The predictability of tax burdens for foreign investors, and increased trade and revenue will therefore be realised.[101]

But things are not necessarily equal in real life. As far as the EU is concerned, countries with generous welfare policies tend to be those that have long been wealthy; such nations capitalize on the advantages of an established base of infrastructure and accumulated experience. In short, they offer favourable external economies and the EAC should not go this direction. Within limits, this presumably allows them to hold on to the mobile factors of production even while levying higher tax rates than less advanced nations. On the other hand, should the tax rate get too high, the results could be catastrophic: not only will capital move (capital flight), but also because that movement undermines agglomeration of economies and this may be irreversible in the long run. Hence, still, it is important for countries to conglomerate or agglomerate their tax structures and jointly constitute themselves into some sort of 'tax havens'[102] by creating a favourable regional tax environment to attract investment inflows.

1.6.3.3. Which harmonisation theories inform the present study?

Bearing in mind the three theories on tax harmonisation have been considered above. This study advocates for law reforms in the EAC to specifically provide for harmonisation of corporate

[101] TJN-A Report, *Ibid.,* p. 3.

[102] Tiley, J., *Revenue Law*, Oxford: Hart Publishing, Oxford, 2005. ISBN-10: 1841135364. According to Tiley (p. 1093), a tax haven is simply a place with a favourable tax climate. *Wikipedia* adds that it is a state, country or territory where certain taxes are levied at a low rate or not at all. Individuals and/or corporate entities can find it attractive to establish shell subsidiaries or move themselves to areas with reduced or nil taxation levels relative to typical international taxation. This creates a situation of tax competition among governments. Different jurisdictions tend to be havens for different types of taxes, and for different categories of people and/or companies. States that are sovereign or self-governing under international law have theoretically unlimited powers to enact tax laws affecting their territories, unless limited by previous international treaties. There are several definitions of tax havens especially following the evasion-avoidance debate. Notable examples of tax havens include the Channel Islands, the Isle of Man, the Bahamas, Cayman Islands and Liechtenstein.

income taxes.[103] This is occasioned by the failure of the current Treaty provisions to clearly define the scope of harmonisation and thereby allowing the Member States to continue with harmful competitive corporate income tax practices. The Common Market Protocol has also failed to elaborate the Treaty provisions on matters relating to harmonisation of corporate income taxes hence the need for regional law reforms.

This thesis therefore conceptually hinges upon the equalisation and differentiation theories. This is because the competition theory which is applicable at the moment has not been effective in dealing with the adverse effects of heterogeneity in corporate income taxes. It therefore seems to contend against harmonisation. In addition, if the EAC wishes to completely remove fiscal barriers to trade, then the equalisation approach will be useful in abolishing market distortions and maximizing efficiency in capital allocation. On the other hand, the competitive approach will entrench locative distortions thus affecting the functioning of the Common Market that provides for various forms of freedom. Considering the current prevailing economic conditions of the EAC member states, it would be appropriate in the meantime to adopt the differentiation theory that would give the individual countries the leeway to levy different tax rates albeit in a coordinated manner. The member states can agree to harmonise the tax bases and procedure in the first instance and rate harmonisation gradually (through tax bands, minimum or maximum rates). In the run up to the establishment of a political Federation, it is expected that the member states would have completed harmonisation of both corporate bases and rates in line with equilisation theory. With further analysis of these theories, they can inform harmonisation efforts towards a consolidated corporate income policy and legislation in the EAC. The harmonisation

[103] The provisions to be amended are chiefly Article 83 (2) (e) of the EAC Treaty and Article 32 of the Common Market Protocol.

design formulated by Velayos *et al*[104] is relevant to this study in so far as it informs the policy and the stages of EAC corporate income tax harmonisation.

1.6.3.4. Applicable legal theory

The legal theory applicable to this thesis is Legal Positivism.[105] Legal positivists argue that the proper matter of jurisprudence is positive law, that is, law simply and strictly so called or law set by political superiors to political inferiors.[106] Bentham and Austin contributed to analytical jurisprudence through the imperative theory of law which defines the concepts of sovereignty[107] and command. Kelsen, on his part, extended the positivist thesis by crafting a pure theory of law devoid of morals, ethics, politics, economics or even metaphysical allurements. However, the direct application of a pure theory of law to the present discourse is doubtful.

Hart, another positivist, suggested a dual system consisting of two types of rules: primary and secondary. The former lays down standards of behaviour and constitute rules of obligation while the latter, being mainly procedural, remedial and including sanctions[108], are ancillary to the primary rules.

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104 Velayos, *ibid.*, p. 18.

105 Positivism embraces the fundamental concepts of law upon which the theoretical framework of this thesis is hinged.

106 These views are contained in Bentham, *Of Laws in General*, ed. H.L.A. Hart (The Athlone Press, 1970) and Austin, *The Province of Jurisprudence Determined,* edition of Robert Campbell, published in 1885. The relevant exerps from Benthams and Austins work are contained in *Lloyds' Introduction to Jurisprudence, (infra).*

107 Refer to the definition of sovereignty by Bentham in Freeman, M.D.A., *Lloyds' Introduction to Jurisprudence* (London, Sweet & Maxwell, 2008), p. 299.

108 Lloyds (*Ibid.),* p. 268. For Kelsen, the essence of law is an organization of force which rests upon a coercive order designed to bring about a desired social conduct. Sanctions, then, become the key characteristic of law, not because of any supposed psychological effectiveness but because that coercion ought to be applied by officials where breaches (of law) are committed.

The positivist orientation of this thesis is found in the framework or structure of analysis adopted generally. In Bentham terms, the study is expository[109] as it discusses the state if the law as it is before making recommendations on the law as it ought to be. In a nutshell, the thesis uses the term 'heterogeneity' to describe the state of the law is it is while the term 'harmonisation' is used to describe the law as it ought to be. The thesis analyses the effects of heterogeneity and proposes harmonisation as a possible solution.[110]

In order to understand heterogeneity within the context of this study and also positive jurisprudence, Chapter Four of the study discuses the negative effects of having many different CIT systems operating alongside each other. On the other hand, Chapter Three outlines the national CIT profiles of the EAC Member States while Chapter Six gives recommendations on the state of the law as it ought to be.

The dichotomy between primary and secondary rules, as propounded by Hart, can be seen in the broad array of laws, rules and codes that form the pillars of the EAC CIT legal framework. This can be seen in the treaties, protocols, codes, national constitutions and statutes that govern CIT in the EAC region. As a matter of legal reform, a consolidated income tax law (incorporating harmonised CCCTB) would serve as the primary rule in corporate income taxation in the EAC.

Suffice it to state that the legal positivist theory is linked to the economic theories discussed above. First, the equalisation theory explains the source of regional law to be municipal or domestic systems which, according to Bentham and Austin, refer to the idea of sovereignty or a

[109] See Lloyds, *ibid.,* p. 250.

[110] See parts 1.4.and 1.7 herein.

sovereign who decrees laws in the form of commands.[111] The sovereignty idea is central to legal positivism. This thesis has been concerned with how the EAC member states may cede their national sovereignties to a regional body as far as CIT imposition is concerned. Nonetheless, the solution put forward by Bentham and Austin is having a distinct sovereign at the helm of the regional body to issue and implement a consolidated law.[112]

Secondly, the differentiation or coordination theory helps to justify the general utilitarian nature of positive law[113] in the sense that a harmonised CIT law and/or policy, at least with regard to CCCTB, will enhance Member States' welfare. The differentiation theory aims to preserve the welfare and interests of the member states in so far as the same contributes to the overall welfare of the regional body. The argument is that once the EAC comes up with a consolidated CIT Law, then the effects of heterogeneity can be overcome.[114]

1.7. Research formulation for the study

1.7.1 Research methodology

Research methodology refers to the general approach the researcher takes in carrying out a research project.[115] This study substantially relied on secondary data in its inquiry. The analysis of the general standard-setting initiatives of the EAC is based on secondary data. Background information on the chequered history of the EAC was reviewed in addition to useful historical

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[111] Under the public choice theory of taxation, this sovereign is Parliament (at least in the representative democracies of the EAC Member States). There is need for one sovereign, in Austinian and Benthamite terms, who enacts the consolidated CIT law for purposes of harmonisation.
[112] Refer to the Legislative Reforms recommended under part 6.2.1 of Chapter six.
[113] As propounded by Bentham.
[114] See Ramsey F.P., *A Contribution to the Theory of Taxation*, the Economic Journal, Vol. 37, No. 145. Mar, *1927*, pp. 47-61.
[115] Leedy, P. D., & Ormrod, J. E. *Practical research: Planning and design*. Upper Saddle River, N.J: Merrill Prentice Hall, 2001, p. 14.

government reports on the benefits of economic integration. Numerous books, journal articles, government reports, treaties, conventions, EAC Income Tax Laws and periodicals were reviewed. This information was obtained from the Jomo Kenyatta Memorial Library of the University of Nairobi at the Africana section, the Kenya National Archives, the KRA library, the Ministry of EAC library, Nairobi and the EAC library in Arusha. Additionally, repositories and databases from online sources were also reviewed extensively. The notable limitation, however, was the fact that there have been limited written works on EA corporate income tax law and policies. This is further compounded by the lack of fieldwork and grassroots connection between the EAC summit and the citizenry, for instance there has been no referendum to determine the legal and policy options available for the EAC.[116]

Bearing in mind this limitation, the study sought to explore the use of qualitative research in order to corroborate the secondary literature reviewed and possibly find new information on the subject.[117] Punch, describes qualitative research as exploratory research where the data is not in the form of numbers as is the case with quantitative research.[118]

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[116] For instance, on the approval of the Common Market and Monetary union of the EAC. Indeed, the EAC has been criticised for lacking the tenets of transnational representation because it has largely been seen as a Heads-of-States affair, and, as earlier observed, this was one of the vexing reasons for the collapse of the 1967-1977 EAC (EAC 1). On the latter point, see Wanjala, S.C., "Salient Features of a Treaty on Eastern Cooperation" (paper presented at EALS conference on constitutionalism in Mombasa, 1996).

[117] On qualitative research generally, see, Mason, J. *Qualitative Researching*, Sage Publications, London, 2nd Ed, 2002. ISBN 0 7619 7427 X. Available at: www.sxf.uevora.pt/wp-content/uploads/2013/03/Mason_2002.pdf (accessed on 20th September 2016).

[118] Punch, K.F. *Introduction to social research: Quantitative and qualitative approaches*. Sage Publications, Thousand Oaks, CA. 1998, p. 4. He explains that qualitative research involves the studied use and collection of a variety of empirical materials involving case study, personal experience, introspective, life story, interview, observational, historical and interactional approaches that describes routine and problematic moments and meanings in people's lives.

Qualitative research is a holistic approach that involves discovery and is suitable where the subject under investigation is new or exploratory in nature.[119] The objectives for the study are set out in part 1.7.2 below and include the identification of the effects of heterogeneity of income taxes and the assessment of whether corporate income tax harmonisation is necessary for the operationalisation of the EAC Common Market among others. Those objectives together with the research questions set out in part 1.7.3 are exploratory in nature hence the need to adopt the qualitative research method. Further, the desire to develop and uncover the underlying rationale for the present heterogeneous corporate income tax regimes and to dive deeper into the legal reforms for the development of a consolidated legal regime of income tax in the EAC underscores the exploratory nature of the study, hence the use of qualitative research method. Quantitative research on the other hand is suitable in explaining phenomena by collecting numerical data that are analysed using mathematically based methods and in particular statistics.[120] This is not the case in the present study.

This method was deployed to test the hypothesis using the exploratory qualitative research in order to explore the complex nature of heterogeneous CIT systems and its attendant effects on the established EAC single market. The qualitative data collection method applicable was sampling through interview and the use of structured questionnaire administered to a target sample population chosen on the basis of their involvement in income tax and the EAC

[119] Cohen, L. and Manion, L., *Research Methods in Education*, London, Routledge, 6th ed, 2007. Qualitative research method is useful in describing and exploring how and why the phenomena occur. It provides an understanding and description of people's personal experiences of phenomena.
[120] Creswell, J. W. *Research design: Qualitative and quantitative approaches*. Thousand Oaks, CA: SAGE Publications, 1994. ISBN 0803952546. Also See Mugenda, R*esearch Methods: Quantitative and Qualitative Approaches* (Nairobi: ACTS, 1999).

integration processes. The method used was purposive snowball sampling based on referrals from the initial target interviewees.[121]

The interviewees/ respondents were drawn from the revenue authorities of all the EAC member states, the EAC Secretariat in Arusha, Tanzania, audit firms with presence in all the EAC member states, the ministry of the EA cooperation in Kenya and the relevant officers from the Kenyan treasury.

The interview responses generated data that was analysed and included in the various chapters of the research and also annexed in appendix 2 of the study.[122] From the research, it was noted that published primary findings on the necessity of corporate income tax harmonisation in the EAC is lacking or limited and therefore, it is ventured that this study pioneers such primary data in this subject.

It is instructive to note that the sampling method used was based on the need to get insights from people thought to have knowledge or information into the research topic.[123] This method was adopted because of the unique nature of the study that explores CIT harmonisation in the EAC that is only visualized and yet to be implemented. The first interviewees were from the ministry of the EAC integration in Nairobi. The respondents here made referrals to officers in other institutions including the EAC secretariat in Arusha, Kenya Revenue Authority and the Kenyan treasury. On the other hand, the respondents at the Audit firm, PWC triggered referrals at the

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[121] On purposive sampling method, see generally, Palys, T. *Purposive sampling* in L.M. Given (Ed.), the Sage Encyclopaedia of qualitative research methods, 2008, vol. 2, Sage Los Angelos, pp. 697-698. Available at: www.sfu.ca/~palyspurposivesampling.pdf., (accessed on 20th September 2016).
[122] See Appendix 2, summary of data findings from interview/ questionnaire responses annexed herein.
[123] *Ibid.*

KPMG and Deloitte EA audit firms. These series of referrals enabled the researcher to obtain relevant data informing and or corroborating the literature on the heterogeneous CIT profiles in the EAC, the effects of the heterogeneity and the need to have a harmonised CIT regime. The difficulty encountered with this research was mainly in the novelty of the subject and the challenge of identification of suitable respondents who would trigger the referrals.

The other qualitative research method applied was the correlational study design which correlated two main variables, that is, heterogeneity and harmonisation.[124] This approach enabled the researcher to analyse these broad competing variables and their effects in the EAC integration process and hence the proposals made herein.

While the present study substantially used secondary data, the comparative study of the EU and NAFTA models further proved useful to give poignant lessons for the EAC. The comparative method has been hailed in many social science researches including those concerning law and policy such as the present study. According to Donald Denoon:

> There is only one analytical method in social science research, i.e., the comparative method. The common justifications for the comparative method include the following: (a) it improves taxonomies and typologies for categorizing knowledge. The comparative method helps in clarifying and analyzing both similar and dissimilar experiences and also aids the study, interpretation and understanding of various concepts, doctrines, ideas and experiences; (b) it refines the conceptual grid. The comparative method helps researchers to undertake a study of the inter-relational behavior between various phenomena. In the process, the general notions and abstract ideas find clarification and even demystification; (c) it provides some perspective on one's own context from the knowledge of what occurs elsewhere and so avoids ethnocentrism; (d) it helps in discovering general relationships among variable factors, e.g., what difference a particular law makes, if any; (e) it also helps evaluate the performance of systems, agencies, and institutions, and isolates factors that account for success or failure; (f) it helps explore the scope and limits of generalization from one context to another; and (g) it provides conceptual frameworks to assist with policy analysis, both for predicting outcomes and for advocating reform.[125]

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[124] On the correlational study design, see, Kothari, *Research Methodology: Methods and Techniques* (New Delhi: New Age, 2004), p. 130. The author notes that the objective of correlation analysis is to determine 5tha amount of correlation between two or more variables.

[125] As quoted in M.E. Turpel, *Aboriginal People and the Canadian Charter: Interpretive Monopolies and Cultural Differences*, (1989-90) 6 Canadian Human Rights Yearbook 3. See also Chebii *J. Comparative Law: Its*

The present study adopts Denoon's analytical frame. As far as the harmonisation of (income) taxation laws and policies is concerned, these objectives of comparative research are fulfilled by the EU, NAFTA and EAC experiences as was established in the subsequent chapters. As such, the objectives, research questions and hypotheses of the study are interconnected by one major hypothesis: that through law and policy reform, the EAC can shift from the current heterogenous CIT systems to a harmonised regime in order to prevent the negative effects of heterogeneity.

1.7.2. Objectives of the study

The following objectives constituted the broad and specific purposes of the study:

1) Identifying the effect of heterogeneity on corporate income tax laws of the EAC Member States in the context of the EAC Common Market and the Monetary Union.
2) Assessing whether corporate income tax harmonisation is necessary for the operationalisation of the EAC Common Market and the Monetary Union.
3) Establishing whether the administrative problems caused by heterogeneity in corporate income tax systems can be addressed through adoption of a harmonised tax policy.
4) Drawing comparative parallels with (other) tax harmonisation initiatives applied by the EU[126] and NAFTA[127] and making appropriate recommendations thereto.

Characteristics, Relevance and Value in Legal Scholarship' [2004] 2 (I) *UNLJ* 77. The latter defines comparative law as *"the comparison of the spirit or style of different legal systems, or of comparable legal institutions or of the solutions of comparable legal problems in different systems."*

[126] Other than being a success story on tax harmonisation efforts, the EU has been chosen for its involvement in African trade through the ACP-EU Cotonou Agreement which sets out the development, trade and political co-operation framework between the EU and the African, Caribbean and Pacific States.

[127] On NAFTA tax harmonisation, see, for instance, Arthur Cockfield, (1998), *Tax Integration under NAFTA: Resolving the Conflict between Economic and Sovereignty Interests,* Stanford Journal of International Law, 34, 39-73.

5) Making proposals for harmonised EAC corporate income tax law, policy and an appropriate institutional framework for collection, administration and its management.
6) Assessing whether a CCCTB regime can apply to the EAC region?

1.7.3. Research Questions

The main research question was, ‘What are the negative effects of the current heterogeneous corporate income tax systems of the EAC to the economic integration?’ The following questions were also interrogated to inform the analytical framework of the study:

1) What are the current national corporate income tax profiles of the heterogeneous and disparate tax systems obtaining in the EAC Member States?
2) What are the negative effects of the current income tax heterogeneity in the EAC?
3) Is a harmonised corporate income tax law and policy the solution to the problems caused by heterogeneous CIT regimes in the EAC?
4) Can regional law reform towards a harmonised corporate income tax system in the EAC spearhead and/or enhance regional (economic) integration?
5) Can the EU and NAFTA experiences inform the EAC law and policy reform towards a harmonised CIT regime?

1.7.4. Hypotheses

The study hinged upon the following hypotheses which were tested:

(a) That heterogeneous national corporate income tax legislation in the EAC Member States is counterproductive and inimical to regional integration as it causes distortion of economic neutrality through harmful corporate income tax competition.

(b) That corporate income tax harmonisation is necessary for the full operation of the EAC Common Market and a case for such harmonisation can be made by overcoming the negative effects of income tax heterogeneity.

(c) That corporate income tax harmonisation within the EAC/EAF can be attained by EAC law reform through the enactment of a consolidated income tax law based on a harmonised tax policy.

1.8. Delimitations and limitations of the study

This study is thematically, ideologically and conceptually delimited to the topical issue of corporate income tax harmonisation within the EAC. Special emphasis is, however, attached to the harmonisation of the different and divergent individual corporate income tax legislations as a precursor to the full operationalisation of the Common Market and enhanced economic integration in the EAC. It was established that published materials specifically relevant to this issue are limited. In fact, the writer had to rely on electronic/online materials most of which discuss and analyse the EU and NAFTA experiences rather than the EAC. Therefore, the background research was limited by a dearth of specifically relevant published material. It is hoped that the study will pioneer some thoughts on the EAC corporate income tax harmonisation process.

Secondly, the fluid and dynamic nature of the EAC integration process means that developments on the regional front may directly impinge upon some relevant aspects of this research. An example is where a resolution by the EAC Summit would cause a radical departure from the present scenario, the admission of a new member into the EAC for instance the Republic of

South Sudan[128] and similarly, if a Member State decides to change the course of its taxation policy and law, the same that could substantially affect the findings of the study.[129]

The fact that income tax harmonisation is quite a novel concept in the Community (it is only visualized) limited the understanding of the interviewees and consequently, some of the responses to the questionnaires touched on customs harmonisation which is only relevant to the study by analogy. Despite these limitations, the researcher got a clearer understanding of the subject from a wide range of literature reviewed on the subject.

1.9. Literature review

As we saw in the conceptual and theoretical framework above, the key issues relevant to this study are tax competition, corporate income tax heterogeneity and tax harmonisation. These issues are relevant to the research questions of the study which interrogate the possible solutions to the problem of heterogeneity. The following review of literature seeks to establish a forerunner discussion on these issues so as to identify the effects of tax heterogeneity and propose legal reforms including the possibility of a harmonised EAC CIT regime.

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[128] The EAC Summit meeting in Arusha 2nd March 2016 resolved to admit Republic of South Sudan as a new EAC member.

[129] In fact, the dynamism of the EAC was acknowledged by Kenya's Minister for Finance during the reading of Kenya's 2011/2012 Budget Statement in his bold reference to "*deepening regional trade and expanding market"* and, also, "*ongoing negotiations of the East African Monetary Union Protocol*". The discovery of oil in Kenya could ,for instance, change the government policy on treatment of taxes on minerals and oil products. Further, Relations between Tanzania and Rwanda have been tense since May 2013, when the then Tanzanian President, Jakaya Kikwete, called on countries taking part in the Great Lakes peace talks to open discussions with all the rebel groups involved, including the *Forces démocratiques de liberation du Rwanda* (FDLR), an anti-Rwandan-government militia. The Rwandan President, Paul Kagame, called the remarks "utter nonsense". The dispute deteriorated, with Tanzania expelling Rwandan refugees, and Rwanda increasing trade barriers against Tanzania. A meeting between the Presidents of the two countries in September 2013 signalled a truce, but deep-rooted tensions mean that it could escalate again at short notice which regresses the EAC integration.

The basic theme in Baldwin and Krugman [130] is to show the measured, cautious and careful manner in which tax harmonisation ought to proceed. The two authors argue that consideration of agglomeration (which is a variant of integration) reverses standard theoretical propositions in international tax competition. They show that greater economic integration may lead to a 'race to the top' rather than a 'race to the bottom' in the design of tax structures. Also, a drastic move (split the difference) towards tax harmonisation may harm member nations, a result that may explain why real-world tax harmonisation is rare. The key is that industrial concentration creates what Baldwin and Krugman call 'agglomeration rent', the dominant region can thus charge a higher tax rate without losing capital. The size of such rent is a bell-shaped function of the level of integration, so that the tax gap first widens before narrowing as integration increases.

The point of convergence between this, otherwise credible, piece by Baldwin and Krugman and the present study lies in the fact that this thesis seeks to argue that income tax harmonisation is an imperative for the EAC so as to prevent the numerous effects of heterogeneity of income taxes and further as a catalyst to the EAC integration. The scope of the present study is however beyond the agglomeration initiatives under Baldwin and Krugman as it interrogates the heterogeneous corporate tax profiles of the EAC, effects of the heterogeneous corporate tax systems, the viability of consolidated EAC corporate income tax framework and the lessons that can be drawn from other regional blocs such as the EU and the NAFTA.

[130] Richard E. Baldwin and Paul Krugman*, Agglomeration, Integration and Tax Harmonisation. European* Economic Review 48 (2004). Available at: www.sciencedirect.com, (accessed on 10th June 2011).

On the other hand, Cockfield's article[131] seeks to enlighten the reader on the main economic and sovereignty interests surrounding taxation of cross-border flows in North America which is not in any formal integration of the EAC-type. Part II of the article identifies the main economic concerns arising from the interaction of the American, Canadian and Mexican tax regimes. Part III reviews the factors that have triggered tax integration initiatives in Europe, and discusses sovereignty concerns that the United States, Canada, and Mexico (collectively called the "NAFTA Member States") may have with respect to tax integration initiatives under NAFTA. Part IV reviews possible tax integration initiatives and considers the resulting constraints that might hamstring domestic tax policy-making. Cockfield's article concludes that a gradual heightening of tax policy coordination among the NAFTA Member States is desirable in light of the current economic and political environment in North America.

This article proved very relevant to Chapter Five of this thesis in so far as it gave an overview of the NAFTA tax harmonisation experience including its underlying factors. For East Africa to learn from NAFTA's experience, Cockfield's article remains relevant and instructive. However, its point of divergence from the present study is the basic fact that the present thesis focuses on East Africa which is affected by different geo-political and fiscal factors compared to those identified by Cockfield in the NAFTA experience. In addition, the present study points the EAC to the most appropriate mechanism of harmonisation of its CIT through the adoption of the EAC CCCTB. Other proposals for reform include the amendment of the EAC Treaty, enactment of the EAC Protocol on harmonisation of the CIT as well as the enactment of the EAC legislation on CIT *inter alia*.

[131] Cockfield, Arthur, *NAFTA Tax Law and Policy: Resolving the Clash between Economic and Sovereign Interests*, (1998) 34 Stan. J. Int'l L. 39-73.

An OECD Report of 1998 addresses harmful tax practices within OECD. This is in the form of tax havens and harmful preferential tax regimes in OECD Member countries, non-Member countries and their dependencies.[132] It focuses on geographically mobile activities, such as financial and other service activities. The Report highlights the factors to be used in identifying harmful tax practices and goes on to make wide-ranging recommendations to counteract such practices.[133]

The report highlights how tax havens and harmful preferential tax regimes, collectively referred to as 'harmful tax practices' affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally.[134] Such harmful tax competition diminishes global welfare and undermines taxpayer confidence in the integrity of tax systems.[135] The report recognises the distinction between acceptable and harmful preferential tax regimes and carefully analyses the features of both residence and source country tax systems that may lead to the damaging impact of harmful preferential tax regimes.

The Report also finds that there are limitations on unilateral or bilateral responses to a problem that is inherently multilateral and identifies ways in which governments can best establish a common framework within which countries could operate individually and collectively to limit the problems of harmful tax practices by fiscally sovereign territories.[136]This report is useful in

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[132] OECD, '*Harmful Tax Competition; An Emerging Global Issue*' , OECD Centre for Tax Policy Administration (1998), p.6, Available at: http://www.oecd.org/document. (Accessed on 25th June 2012).
[133] *Ibid.*
[134] *Ibid.,* p. 8.
[135] *Ibid.*
[136] *Ibid.*, p 9.

the present study since it is intended that the EAC should undertake reform of its legal, institutional and policy framework so as to avoid harmful tax competition that has caused deleterious effects on the EAC drive towards full economic integration under a single market.

An article published by Tax Justice Network-Africa and Action Aid International[137] analyzes the wide range of tax incentives provided by Governments in East Africa Community to businesses to attract greater levels of foreign direct investment (FDI) into their countries. Such include corporate income tax holidays, notably in export processing zones (EPZs), and reductions from the standard rate for taxes such as import duties and VAT.[138] It is opined that the tax incentives are detrimental to the countries and are not necessary.[139] The article suggests that the incentives are unwarranted and calls for review or its reduction. It is noted that the East African Governments are well aware that these tax incentives present a serious level of revenue losses and are formally committed to reviewing, rationalizing and reducing them although little has been done towards this end. The Article argues that unless reviewed, the region may experience increasing tax competition,[140] which has encouraged illicit trade, complicated operational systems for companies wishing to carry out businesses in East Africa and has slowed Governments integration process. The authors note that East Africa Community has one significant initiative for promoting tax coordination in East Africa which is 'The Draft Code against Harmful Tax Competition'. This initiative is intended to freeze the current provision of tax incentives so that additional harmful incentives are not introduced.

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[137] Tax Justice Network-Africa and Action Aid International, '*Tax Competition in East Africa: A Race to the Bottom?*' (April 2012) . Available at: www.actionaid.org/sites/files/actionaid/eac_report.pdf.
[138] *Ibid*., p.4.
[139] *Ibid*., p 4.
[140] *Ibid*., p.5.

The GTZ report of 2009 on Tax Harmonisation in the EAC[141] which was a product of a consultancy by the EAC to examine the broad spectrum of harmonisation of customs, VAT, excise and income taxes reviews the national tax systems of the EAC, the policy structures and procedures. The report concludes by proposing reforms on the VAT, excise and income taxation. It also makes recommendations on the harmonisation of tax administration and procedures, transparency in its administration and the requirement of information exchange by the revenue authorities of the member states. Finally, it recommends the strategic sequencing of harmonisation of the remaining taxes beginning with VAT, Excise taxes and lastly on the income taxes. This report examines harmonisation of taxes in the EAC generally while the present study considers income tax harmonisation generally with some focus on corporate income taxes. It is hoped that the present study generates primary literature on the harmonsation of corporate income taxes in the EAC.

Mintz[142] examines the proposals for European tax harmonisation and discusses four main proposals. First, is the *home state taxation* approach (following the residency principle), which is based on mutual recognition where a government would levy a tax on income allocated to its jurisdictions according to the tax base determined by the country of residence. Corporations could choose between the consolidated system and the prevalent system. Secondly, the Common Consolidated Corporate Tax Base (CCCTB) approach, where the governments would use a European-wide consolidated tax base with factors used to allocate income. Companies could choose to use the CCCTB or the existing system.

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[141] Petersen et al, *Tax Study on Tax Harmonisation in the EAC, GTZ/EAC Report*, 2009.

[142] Jack Mintz., *Corporate Tax Harmonisation in Europe: It's All about Compliance, International Tax and Public Finance*, 11, 221–234, 2004, Kluwer Academic Publishers p. 226.

Thirdly, the EU corporate income tax administered at the EU level which entails a single system with a consolidated common base that would be levied at the EU level on pan-European companies with revenues going to the EU. Fourthly, he suggests the use of a compulsory harmonised corporation tax base where all companies would have to use a common tax base administered by each of the national governments. He concludes that the primary focus of corporate tax consolidation among the Member States of a Federation is to reduce compliance and administrative burdens within the EU. Therefore, in the context of the EAC, these suggestions are useful in the harmonisation of company taxation.

Giovannini, Malinvaud and Mayer[143] contend that the current structure of taxes on capital income across the European Community (EC)[144] countries can be exploited by corporations to reduce their tax burdens. Skilled individuals can indulge in tax avoidance, too, through transfer pricing. This article provides a primer on capital income taxes and describes strategies which avoid the tax burden. From a policy perspective, the question for the EU is how to avoid the resultant massive tax evasion. Giovannini *et al* argue that there is no need to harmonise if the right taxation principle is adopted.

The authors contrast two principles: the 'territorial principle', according to which taxes are levied on domestic investment irrespective of the country of residence of the beneficiary, and the 'worldwide principle', according to which taxes are levied on domestic savings irrespective of where they are invested. It is shown by the authors that the worldwide principle involves much fewer distortions than the territorial principle. A strict application of this principle would

[143]Giovannini, Malinvaud and Mayer "*National Tax Systems versus the European Capital Market*", Economic Policy Review, Vol. 4, No. 9, Europe 1992 (Oct., 1989), 345-386 p. 362.
[144] Precursor to the current EU.

effectively solve the problem of tax evasion in Europe, without requiring full harmonisation of the tax systems. Its full implementation would require the abolition of withholding taxes, the elimination of tax deferrals which are quite pervasive throughout Europe. While the concern of Giovannini *et al* is how to avoid tax evasion in the EU,[145] and perhaps elsewhere, the concern of the instant study is to argue for tax harmonisation within the EAC region.

On the other hand, Graetz and Warren, Jr.[146] argue that in recent years, the European Court of Justice (ECJ) has invalidated many municipal income tax law provisions of the EU Member States as violating European constitutional Treaty guarantees of the freedom of movement for goods, services, persons and capital. These decisions have not, however, been matched by significant EU income tax legislation, because no EU political institution has the power to enact such legislation without the unanimous consent of the Member States.

The two authors describe how the developing European Court of Justice (ECJ) jurisprudence threatens the ability of Member States to use tax incentives to stimulate their domestic economies and to resolve problems of international double taxation. They also compare the ECJ jurisprudence with the resolution of related issues in international taxation and the United States (US) taxation of inter-state commerce. In addition, the two authors consider the potential responses of both the EU and the US to these developments. They conclude that the ECJ approach is ultimately incoherent because it is a quest for an unattainable goal in the absence of harmonised income tax bases and rates, that is, to eliminate discrimination based on both the

[145] The three authors seem to argue for the elimination of the problem of tax evasion through the application of the worldwide principle hence downplaying tax harmonisation.
[146] Warren, A. C. and Graetz, M. J., "*Income Tax Discrimination and the Political and Economic Integration of Europe*", The Yale Law Journal, Vol. 115, No. 6 (Apr., 2006), 1186-1255, p.1196.

origin and the destination of economic activity. Thus, Graetz and Warren's concern is jurisprudential in tenor and effect because their focus is on the ECJ's approach to tax discrimination. This insight by the two authors is thus narrower in scope than the present thesis which examines the entire terrain and negative effects of the differentiated and disparate national tax profiles of the EAC Member States.

Chetcuti[147] writing within the context of the defunct European Commission (EC) contends that tax harmonisation, once looked upon by some observers as an Eurocratic idiosyncrasy, has gradually and quietly moved to a central place in the EU. Taxes claim between a half and a third of national income in the Member States of the EC and carry a weight which cannot be overlooked. In the context of the minimisation of the overall tax burden of the EC, the several fiscal divergences between Member States give rise to several important legal and economic implications for Member States and have made a case for a drive for the approximation[148] of taxation systems.

The author confirms that a joint statement was issued,[149] calling for 'rapid progress towards tax harmonisation in Europe'. This statement was followed by press conferences at which it was suggested that the national veto over tax reforms should be abolished. This proved a catalyst for public disagreement. With the setting up of a single European currency, that is, the Euro, coupled with other pressures for greater integration, tax harmonisation, in the authors' view, merits careful consideration. He acknowledges that the views on the meaning of tax

[147]Chetcuti J. P., "*The Process of Corporate Tax Harmonisation in the EC*" Available at: www.cc-advocates.com/publications/.../eu-tax-harmonisation, (accessed on 10th June 2012).
[148] The author (*ibid.*) uses this word contextually as a variant of harmonisation.
[149] On December 1st, 1998, by France and Germany.

harmonisation and what form it should take are numerous and dissimilar. He then explores the meaning, causes and implications of tax harmonisation and its role as a medium for the achievement of what he calls the "internal market." In so far as Chetcuti's article is pro-harmonisation, it remains directly relevant and analytically congruent to the hypotheses of this study. The point of departure remains the fact that while he addresses the EC/EU situation, the present study explores the EAC scenario, of course, predicated upon the EU experience.

Gammie, *et al*'s commission report[150] argues that the adoption of International Financial Reporting Standards (IFRS) within the EU from 1st January 2005 offered a unique opportunity to advance the cause of a common consolidated corporate tax base (CCCTB) for Member States.[151] The report argues that the commission and many commentators have long recognized the need for a CCCTB to resolve the issues and costs that over twenty five (25) different company tax systems present for European businesses.[152] A major problem, however, has always been to find a suitable starting point for developing a CCCTB. In recent years, the ECJ has made it clear to Member States on many occasions that while they retain competence in the direct tax field, they can only exercise their competence in a manner that is compatible with Community law. As a result, Member States have been forced to make major changes in their tax systems to adopt a 'Community perspective' in place of a 'national perspective' to their cross-border tax rules such as transfer pricing.[153] As the report notes, however, Member States have tended to respond unilaterally to ECJ decisions and often in a manner that is detrimental to European business by

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[150] Gammie M, '*Report of CEPS Task Force: Achieving a Common Consolidated Corporate Tax Base in the EU.'* (2006) (CEPS).
[151] This argument is consistent with the basic premise of the comprehensive income or equity school of Haig-Simons.
[152] Gammie, *ibid.,* p. 28.
[153] *Ibid.*

further complicating domestic tax systems. There is no guarantee, therefore, that ECJ's action will over time bring about greater uniformity in company tax systems or make a CCCTB easier to achieve.

Cano[154] argues that there are two tax harmonisation mechanisms: uniformity and compatibility. The second, in his opinion, is the one to be applied at the early stages of economic integration, when tax harmonisation is also incipient. Whereas Cano's arguments are important for the present study, these strategies would be vital in any efforts to harmonise personal or corporate taxes. His position masks some confusion in the analysis of the aims and instruments of harmonisation, i.e. the fact that integration is at an incipient stage does not mean that the degree of tax harmonisation, in terms of the obligations assumed or the sovereignty ceded or transferred by the Member State, should be equally weak or pursued reluctantly.

On the contrary, Martin Jimenez[155] analyses the relationship between these aims and instruments when he examines the role of "soft law" in the EU scheme of tax harmonisation, but he does not do so in order to establish a classification of tax harmonisation or levels of action. Nor does he seek to analyse the relationship between phases of integration, degrees of harmonisation and the instruments most commonly used to attain each level. The present study analyses the utility of the various diverse instruments in ensuring progressive integration until full harmonisation is attained.

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[154] Gonzalez Cano, J. 1996. *Harmonisation tributaries del Mercosur*. Buenos Aires: Instituto Universitario de Finanzas Públicas Argentinas, p. 33.
[155] Martin Jimenez, A. 1999. *Toward Corporate Tax Harmonisation in the EU*, Boston: Kluwer. 2006. P. 299. "Loopholes in the EU Savings Directive," *IBFD Bulletin*. December.

Caamano and Calderon,[156] in agreement with Jimenez, note that developments in the international context foster greater sophistication in the instruments available to the authorities in their efforts to bring tax policies closer thereby avoiding distortions or simply in response to an aggressive environment. Though they provide an interesting description of the examples of what they call "tax coordination," they failed to either define the term or establish its distinctive features relative to other mechanisms for approximating or harmonising taxes.

The contrasting view according to James[157] is a classification of the degrees of harmonisation, which in his view range from "no harmonisation" to complete "standardisation." His analysis is based on the notion that the first step towards harmonisation is to define a common set of taxes. That is, it is important to start by harmonising the objects of taxation. James' analysis is interesting because he classifies tax harmonisation in the form of a scale. But he does not address the possible relationships between the degrees of integration and the instruments available to policymakers to attain the intended harmonisation. His review of the degrees of harmonisation describes the results obtained and fails to explain the methodology used even though the guiding criterion seems to be the degree of standardisation attained. In sum, his main concern is a different one: whether the coexistence of various types of taxes, such as local taxes and other harmonised taxes, is justified. In other words, whether there is a rational constraint to tax uniformity.

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[156] Caamano, M. A. and J. M. Calderon (2002). *Globalización Económica Poder Tributario: Hacia un nuevo Derecho Tributario? Revista Española de Derecho Financieroy Tributario* 114, p. 116.

[157] James, S. 2000. '*Can We Harmonise Our Views on European Tax Harmonisation*?' International Fiscal Documentation Bulletin. June. p. 265.

Barreix and Villela[158] assert that other than the four classic features of taxation, (sufficiency, efficiency, simplicity and equity), the aspect of coordinability is important for an efficient tax system in a single market. They defined it as the ability of a tax jurisdiction to coordinate with the fiscal jurisdictions of its main economic partners. The two authors have formulated five various degrees of harmonisation of taxes. The first is standardisation. According to them, this entails having the same tax or equalising the tax burdens imposed on the same item, under equal circumstances. It is the highest degree of harmonisation. An example is the adoption of a common external tariff (CET).

Secondly is compatibility which involves adjusting the tax structure in order to counteract or compensate for the distortionary effects caused by tax burden disparities upon the integration process. However, compatibility does not affect the tax rate or tax benefits, at least not to their full extent. The reason is that, if this were the case, there would be almost no difference between this form of harmonisation and standardisation, thus eliminating its distinctive features that is, the non-exhaustion of its capacity for harmonisation, particularly with respect to an extremely sensitive element such as the tax rate, and that it leaves more room for policymakers to make tax policy decisions.

Ideally, any compatibility scheme should involve an institutionalized follow-up mechanism to ensure its effective enforcement. Unlike equalisation, under which the harmonisation scheme is

[158] Barreix, A. and L. Villela. 2003. Tributación en el MERCOSUR: Evolución, comparación y posibilidades de coordinación. Buenos Aires: Inter-American Development Bank/INTAL, p. 19.

less complex, with compatibility,[159] it is highly advisable to establish a follow-up mechanism to keep track of what each country does in this respect, so as to ensure that the goal of harmonisation is not adversely affected.

Thirdly is coordination which refers to any action transcending typical harmonisation mechanisms, which might be confined to the two categories above. There are various examples of coordination and uniform codes of conduct are a case in point.

Fourthly is cooperation which is the provision of mutual assistance, either for reasons of reciprocity (for instance, one country supplies tax information in the expectation that it will receive similar reciprocal information from its counterpart at some other time) or out of mutual interest (such as when double taxation is detected and two countries undertake to cooperate to reduce its incidence). The creation of cooperation mechanisms make countries aware of and adopt the best solutions, both in terms of tax administration and of policy, for instance, to adopt, after relevant consultations, the same interpretation criteria in a complex case when laws are similar or there is a double taxation agreement (DTA).

Lastly is convergence which is a spontaneous movement towards the same type of solution, as a result of globalisation and competition. Bairreix and Villela contend that convergence forms the standpoint of voluntary political commitments. The present study examines these levels of integration with a view to considering the viability of their juxtaposition into the current EAC initiatives of income tax harmonisation. These five stages of harmonisation are essential to this

[159] This is because there are no strict definitions to determine what has and has not been made compatible which means that some state decisions comply with the harmonisation objectives but others do not.

study as the EAC seeks to depart from a tax competition environment into regionally harmonised income tax framework.

The overall objective of this study is to make a case for harmonisation and consolidation of corporate income tax legislation and policy in the EAC. As such the EU report strongly advocated by Gammie[160] plays a pivotal role in informing the harmonisation debate of tax rates, bases, procedures and policies of the EAC. Generally, the foregoing review of literature informs the present study by drawing parallels with the practice within the EU. The EAC is a unique region owing to diverse politico-socio-economic structures. While the EU has adopted an institutionalized system of decision-making, political will amongst the Heads of Member States in the EAC is more pronounced. This presented a challenge in drawing comparatives from the EU experience.

The foregoing review of literature contributes to the academic framework of the study. The review focuses on income taxation in the EU and partly, NAFTA since specific literature on income taxation within the EAC is lacking. Various authors take different viewpoints regarding the harmonisation of taxes. In support of their suppositions, they put forward various models of harmonisation and argue that the EU and NAFTA need to generally move towards closer fiscal integration. This study uses the reviewed literature to draw comparative parallels for the EAC region. The study thus seeks to identify and fill the gaps in literature as far as the harmonisation of income taxes and specifically the CIT within the EAC is concerned. This is the knowledge gap that the study sought to fill.

[160] Gammie, i*bid*., p. 28.

1.10. The Profile of the Study

The study herein is presented as follows:

Chapter One: Introducing the Challenge of Tax Harmonisation within the EAC

This chapter has dealt with introductory issues which have laid the basis for the study. The chapter contains the historical and contemporary perspectives of the study, statement of the problem, justification for the study, conceptual and theoretical framework of the study, objectives of the study, hypotheses, research questions, research methodology, limitations of the study, literature review and the outline of the chapters. All these jointly constitute the primary foundation on which the rest of the study is built.

Chapter Two: Historical Antecedents to Integration in the EAC Region

This chapter is borne out of the fact that the EAC has had a chequered history especially when evaluated in light of its 1977 collapse and the subsequent long period of interlude in a seeming state of comatose. Therefore, it is crucial to appreciate the historical background with a focus on the impact of the region's geopolitics on income tax policy and law in order to achieve two objectives: one, to appropriately dovetail the proposal for corporate income tax harmonisation into the prevailing historical edifice and economic objectives of the Community; and two, to appreciate the pre-eminent challenges and pitfalls of East African integration as a way of safeguarding against the collapse and/ or the non-realisation of the EAC Common Market. These considerations would subsequently inform the creation of the EAC Monetary Union and the intended Political Federation.

Chapter Three: The Heterogeneous Income Tax Systems in the EAC

At the onset, this chapter seeks to provide an overview of the corporate income tax regimes of the member states from the perspective of the relevant statutes. The chapter is intended to examine the rationale behind the heterogeneity in taxes and provide a platform for interrogation of the need for harmonisation of law and policy on corporate income taxes. Two fundamental questions are borne in mind throughout the discussions in the chapter. These are first, what are the pre-existing fears (social, economic/fiscal and political) of the EAC national governments in embracing a harmonised regime of income taxation? Secondly, what lessons can be drawn for corporate income tax harmonisation in light of the disparities? The chapter also underscores how policy can be used in shaping territorial domestic tax systems to address the distinct needs of each country while ensuring that the tax regimes do not inhibit the ability to attract and maintain the mobile factors of production.

Chapter Four: The Effects of Heterogeneity in (Corporate) Income Taxation in the EAC

This chapter addresses the effects of heterogeneity in the national corporate income tax systems of the EAC Member States as a basis for harmonisation. The concerns examined include, tax distortions of cross-border capital and investment, reduced revenue resulting from tax competition and the ability of multinationals to take advantage of national tax differentials through financial tax planning. It also considers the broader issues associated with heterogeneous tax systems including harmful tax competition, discrimination and double taxation.

Counter-arguments such as tax sovereignty, tax and domestic policy goals are also examined. Further, international tax aspects such as transfer pricing, double taxation reliefs, anti-avoidance measures, amongst others, are examined. These issues underpin the need for a harmonised legislative and policy framework in the EAC. The chapter also justifies the need to examine the political concerns surrounding the potential loss of control over tax policy that would occur if the Member States decided to be bound by harmonised rules at a supranational level. These together with recommendations on how to strike a balance between the economic and political concerns are examined in this chapter.

Chapter Five: A Case for (Corporate) Income Tax Harmonisation and Comparative study

This chapter reviews the problematic areas in income tax legislation that need harmonisation as a matter of priority. It also examines select areas in which the EAC, despite notable challenges, has managed to achieve some sort of harmonisation, integration and/or coordination. These areas include customs, competition, higher education, standardisation, quality assurance, tourism, metrology and testing. This miniature comparative analysis is included to support the contention that if harmonisation has been achieved in these areas by the EAC then it can also work for corporate income taxation in the region.

In addition, the chapter comparatively explores the tax harmonisation experiences of the EU and NAFTA regional organisations. The objective of the comparative study is to find support for the EAC reform initiatives by reflecting more closely on the EU and NAFTA approaches on managing the pressures of increased globalisation and regional integration thus making a case for harmonisation within the EAC framework.

Finally, the chapter proposes a CCCTB framework for the EAC as a step in the harmonisation process. This is a system of standardisation of rules for computing the tax base of a corporate group of companies with subsidiaries and or permanent existence in the EAC. Against the backdrop of the EU proposal, the chapter evaluates the viability of a proposal for the EAC model. Policy options are also considered to guide the establishment of the proposed EAC CCCTB.

Chapter Six: Conclusion and Recommendations

This chapter, as the academic tradition goes, closes the curtain on the stage set in the previous chapters. Specific recommendations are made concerning what direction the EAC Member States should take in terms of policy and legislative measures. These include harmonisation of the legislative provisions on definitions, objectives of taxation, tax bases, rates, procedures and policy formulation. This chapter also summarises the main findings of the study.

CHAPTER TWO

HISTORICAL ANTECEDENTS TO INCOME TAX HARMONISATION IN THE EAC

2.1. Introduction

This chapter intends to show the EAC's chequered history in view of its premature and abrupt collapse in 1977 after only ten (10) years of existence.[161] This failure was accompanied by a long period of inertia on most fronts of integration including in taxation matters.[162] Therefore, this chapter gives a select historical background of EAC integration in order to achieve two objectives: first, to appropriately cascade the proposal for income tax, legal and policy harmonisation into the prevailing historical edifice, failures, successes and the economic objectives of the Community. Secondly, to recognize the historical challenges and weaknesses of East African integration, as a way of cushioning against failure of the subsequent EAC fiscal integration.

2.2. Historical Milestones

The case for corporate income tax harmonisation within the EAC is supported by history. In evaluating the EAC income tax history, the EAC does have a precedent in terms of applying a common Income Tax Act namely the *East Africa Income Tax (Management) Act, 1952*

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[161] The inception of the first EAC was received with expectant hope and positive will. Professor Nye reported about the EAC of 1967 in the following words: *'In 1961, a Nigerian newspaper commented, with reference to the economic integration of East Africa, 'these three States have stolen a march on the older African States. They have achieved one of the main objectives of pan-African nationalism, without tears.' Two years later the leaders of Tanganyika, Uganda, and Kenya announced their intention of going beyond economic integration by forming a federation.'* See Joseph S. Nye, 'East African Economic Integration', 1(4) *Journal of Modern African Studies*, (Dec. 1963), p. 475. Available at: http://www.jstor.org/stable/158881, (accessed on 8 October 2012).

[162] As such, the old EAC will be variously referred to herein as "EAC 1" whilst the new/present EAC will be designated as "EAC 2" for purposes of convenience of reference.

('*EAITMA 1952*'). Furthermore, the IT legislation introduced in the early 1970s following the break-up of EAC 1 essentially replicated the provisions of *EAITMA 1958* which was an amendment of the *1952 Act.* Uganda (in 1997) and Tanzania (in 2004) introduced new modern ITAs whose concepts and structures were modeled along the 1952 legislation.[163]

2.2.1 The history of income taxation in East Africa[164]

Essentially, corporate tax is a tax levied on a corporation's profits. Since corporations are legal entities separate from their shareholders, they are taxed as if they were persons. Corporate tax is therefore the equivalent of income tax for natural persons.[165] Corporate bodies liable for corporate tax include limited companies, trusts and co-operatives.[166]

Corporate tax has not had a separate historical development in the EAC because all along, it has been considered as part of income tax. Income tax laws in the EAC have focused on income derived from business (which includes business done by corporate bodies), employment income, rent income, dividends, interests and pensions among others.[167] These taxes include pay as you earn (PAYE) and corporate tax.[168]

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[163] One of the questions that arise is whether Kenya, Rwanda and Burundi should adopt similar IT legislations to those of Tanzania and Uganda in the spirit of harmonisation.

[164] See Attiya W., '*Taxation without Principles: A Historical Analysis of the Kenyan Taxation System*', Kenya Law Review 272-304 at 272. Available at: <www.kenyalaw.org>. The subject of taxation in Kenya has historically been subject of enquiry and investigation as seen in the Moynes Report, 1932, Rushton Report, 1933, Sandford Report, 1935, Sir Alan Pim Report, 1936, Bowring report, 1937, Plewman report 1937 and Woods Report, 1946 among others.

[165] Kind, H.J., et al, *Corporate tax systems, multinational enterprises, and economic integration*, Journal of International Economics, Elsevier, 2005, vol. 65(2), p.5. Also see the financial dictionary. Available at: http://financial-dictionary.thefreedictionary.com/Corporate+Tax. (Accessed on 15th September 2016).

[166] Kenya Revenue Authority, *Kenya Income tax at a glance*, KRA, 2015. Available at: http://www.kra.go.ke/incometax/pdf/incometaxataglance.pdf. (Accessed on 15th September 2016).

[167] Tarus I., '*The Political Economy of Post-Colonial Taxation in Kenya, 1973 – 1995(Historical Research Letter, 2012*) p. 60.

[168] *Ibid*., at 62.

Income tax was first introduced in Kenya in 1921.[169] This was after the introduction of the Hut tax in 1903[170] and the Poll tax in 1910.[171] The tax was heavily criticized by the Bowring Committee in 1937 due to the low wages earned, the administrative challenges of imposing tax on the elusive taxable persons and the general taxpayer resistance.[172] Consequently, a large proportion of taxpayers failed to pay and the government decided to abolish rather than enforce the taxing law.[173] This was an attempt similar to that in Great Britain where in the year 1799, Prime Minister Pitt had introduced the Pitt's income tax of 10% of a person's total income above £60 per year on the entire territory of Great Britain (excluding Ireland), which was also a failed attempt owing to taxpayer resistance. The principle applied was to tax income rather than the expenditure and the tax was to be paid in six equal installments to finance the war against Napoleon.[174]

The year 1940 marked the introduction of the East Africa Income Tax Ordinance in the other East Africa Nations of Tanganyika, Uganda and Zanzibar after its introduction in Kenya in 1937 with identical rates, allowances and taxes and in 1952, a common legislation was enacted by the EA High Commission formed in 1948 to apply to its territories of Kenya Tanganyika and

[169] The A.W Pim *Report of the commission appointed to enquire into and report on the financial position and system of taxation of Kenya*, 1936, p. 36.
[170] The Hut tax was imposed under the hut Tax Ordinance of 1903 by which the commissioner was empowered to impose a tax on all huts, and to vary it from time to time, provided that the rate imposed was not more than Rs.3 per annum. The tax could be paid in kind or labour in lieu of money. See Pim report, *ibid*., pp. 33-34.
[171] The R. P. Plewman *Report of the taxation enquiry committee, Kenya*, 1947, p. 43. The Poll tax was levied upon every adult male and was intended to encourage the young unmarried men to find employment of some kind and from the proceeds of that employment to contribute to revenue. See Pim Report, ibid., p. 34-44.
[172] Economic and Financial Committee, Chairman C.C. Bowring First Interim Report Oct 21, 1937. See Plewman Report, *ibid.,* pp. 37-43.
[173] Acccording to the Pim report, *ibid*, p.36, in the year 1933, 148 persons were sentenced to imprisonment under the Hut and Poll Tax Ordinance and 8,561 to detention camp, in 1934 the corresponding figures were 1,357 and 8,520 and in 1935 they were 622 and 8,655.
[174] McNeil R. and Bechgaard K. *East African Income Tax*, Butterworths & Co. (Africa) Ltd, 1960, p. 5.

Uganda. [175] It was the duty of the Commission to enact legislation for administrative and general provisions while the legislation on rates and allowances was left to the territorial/ national governments.[176]

In 1952, the East Africa Income tax (Management) Act was enacted to combine three (3) ordinances governing income tax, that is, the Income Tax Ordinance 1940, the War Taxation (Income Tax) Ordinance 1940 and the War Taxation (Income Tax) (Amendment) ordinance 1941.[177] Under the 1952 Act, a resident of the territory was liable to tax on the whole of income arising from sources outside East Africa, to the extent that such income was remitted to and received in East Africa.[178] Consequently, income received in the East Africa in a territory other than the territory of residence was deemed to be received in the territory of residence.[179] This provision was adopted in the 1958 amendment.[180] One of the notable distinction between the 1952 and the 1958 legislation was the lack of distinction between a non-resident and a temporary resident in the 1958 Act as was in the 1952 Act.[181] Another notable departure was on the provisions relating to trade income where under the 1952 law, only profits earned within East Africa were accessible to tax whereas under the 1958 Act, an individual or a body of persons exercising any trade or vocation or profession partly within and partly outside the territories, the whole of the gains or profits were deemed to have accrued or to have been derived from East

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[175] Bategeka L. *et al*, *Gender and Taxation: Analysis of Personal Income Tax (PIT)*, April 2009. Available at *elibrary.acbfpact.org/acbf/collect/acbf/index/assoc/...dir/doc.pdf. (accessed 2nd August 2015).*
[176] The East African Income Tax (Management) Act No 8 of 1952, East African High Commission Legislation, 1952.
[177] Attiya W., *ibid*, p.288.
[178] Section 3(1) of the 1952 Act.
[179] Section 3(2) of the 1952 Act.
[180] Section 3 of Act No. 10 of 1958, The East African Income Tax (Management) Act, 1958.
[181] McNeil, *ibid*., p.24

Africa.[182] Minor adjustments were made on various aspects of the 1958 law including mining, partnerships, limited companies, double taxation relief and retirement benefits.[183] The enactment of this uniform statute meant that the respective tax ordinances of the three (3) inaugural East African countries were repealed in the year 1953.[184] But each respective colonial government reserved the power to fix rates and allowances. Income tax was administered by the East Africa Tax Department falling under the East Africa High Commission.[185]

In 1954 for instance, personal income tax rates were set at 20/= for income earners of less than £60, 40/= for earnings between £60-£80 and 60/= for earnings above £120. The Coates Commission of inquiry into the administration of income tax was established and was chaired by Sir Erick Coates in 1956. The report was published in 1957. It precipitated the 1958 Act which was revised and renumbered to chapter 24 of the Laws of the EAC 1 in 1970.[186]

In conclusion, the EA Income Tax Management and Coordination Act of 1952 was enacted mainly for administrative purposes. The three countries were under one imperial administration and therefore there was need to enhance efficiency in collection and administration of income taxes and not necessarily for harmonisation purposes. The current establishment consists of independent sovereign states and therefore any successful measures undertaken would reflect 'real' income tax harmonisation.

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[182] Section 4(a) of the 1958 Act.

[183] See McNeil, *ibid.,* for an in-depth analysis of the 1952 and the 1958 legislations.

[184] Legal Notice number 31 of 1953 of Kenya, Legal Notice number 30 of 1953 of Uganda (This notice also repealed the Coffee Export Duty Ordinance of 1945, the Cotton Seed Export Ordinance of 1946, and the Cotton Export Duty Ordinance, Cap. 37) and Legal Notice Number 32 of 1953 of Tanzania (This legal notice also repealed the Pyrethrum Industry Ordinance Cap 272).

[185] McNeil, *ibid.*, p. 24.

[186] Attiya W., i*bid.*, p. 289.

2.2.2 Tax coordination in East Africa

The idea of tax coordination dates back to 1917 when Kenya and Uganda established joint internal trade and a common customs union. Thirty years later, in 1947, the East African High Commission (EAHC) was established, and had two main organs: the High Commission and the Central Legislative Assembly.[187] The High Commission comprised the governors of Kenya, Uganda and Tanganyika.

The EAHC came into operation on 1st January 1948 and took over the powers of legislation on various issues such as administration, finance, communication, social services, research and scientific services, economic services, education and defence. One of its major responsibilities was the administration and collection of income tax, customs duties and excise duties. The rates to be paid, however, were technically set by the legislatures of each territory, despite the fact that there was a very high degree of uniformity. *The Income Tax Management Act* of 1952 set out the following income tax features: the tax rates for each territory, the treatment of special forms of income, and the depreciation and allocation of income by territory.[188]

The EAHC remained in existence until 1961. On the eve of independence in Tanganyika, the East African Common Services Organisation (EACSO) was formed to take over the operation of the common services from the EAHC. By the time Kenya and Uganda attained their independence in 1962 and 1963 respectively, external trade, fiscal and monetary policy, infrastructure and university education were operated by EACSO. Due to the failure of attempts

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[187] Brough A. T., and Curtin T.R.C., '*Growth and Stability: An Account of Fiscal and Monetary Policy*', Chapter 1, in Tony Killick (ed.) *Papers on the Kenyan Economy: Performance, Processes and Policies* (Nairobi, 1981), p. 37.
[188] Ingrid D., *The East African Community and Common Market, (*Longman, London, 1970, ISBN 0582645255), p.48.

at political Federation, the three East African countries attained independence as an economic community, with a Common Market marked by the free flow of goods and a common currency.

On 1st December 1967, the EAC replaced EACSO. Its objectives remained to promote economic development, improve the living standards of the people of the region and to manage the fiscal and monetary issues of the three countries. Importantly, the EAC continued to integrate the income tax system and the customs and excise duties of the three states.[189] Another special feature of the EAC included a transfer tax system meant to protect particular industries in Uganda and Tanzania against well established ones in Kenya. At the same time, the East African Development Bank (EADB) was set up, with the aim of promoting industrial development in the underdeveloped countries.[190]

In retrospect, according to John Due,[191] the East African system worked very well in many respects. For example, great emphasis was placed on the development or reform of the tax systems. Secondly, there was established the need for uniformity of tax administration, customs and excise duties and income taxes. This uniformity of taxes was intended to help provide a Common Market for the large population and to help to stimulate trade. Thirdly, the joint customs administration reduced manpower needs and the expenses of tax collection. Fourthly, a single uniform income tax structure allowed more specialization in the administrative personnel, aided taxpayer compliance and facilitated economic development of the region as a whole. A fifth factor was the desire to minimize inconvenience and uncertainty for the taxpayer in the

[189] *Ibid.*
[190] *Ibid.*
[191] John Due, *Taxation and Economic Development in Tropical Africa,* Cambridge, Massachusetts, 1963, pp. 133-140, p. 136. Available at: http://www.journals.cambridge.org/.../cjoGetFulltext/. *(Accessed on 10th June 2010).*

form of duplicating returns and varying rules for calculation of income. Finally, there was a strong desire to avoid discriminatory double taxation by more than one territory.

At the time of attaining its independence, Kenya's taxation system was described as being comparatively sophisticated.[192] Importantly, the three East African countries of Kenya, Uganda and Tanzania continued to coordinate their tax policies, as had been the case during the colonial period. However, the system was not devoid of difficulties. Kenya, with a stronger economy, seemed to her Partner States to be benefiting more from revenue collection. Consequently, after the three countries gained their independence by 1963, great attention was paid to the need for the fiscal autonomy of each country and the desire to ensure themselves some independent revenues and influence in the setting of the tax rates. As a result, in their simultaneous or respective budget speeches of 10th June 1965, the Finance Ministers of Kenya, Uganda and Tanzania announced that their governments had decided to introduce separate currencies and to dismantle the East African Currency Board paving the way for each country to have its own currency.[193] The East Africa Currency Board established in 1920 was mandated to issue currency as well as to regulate monetary policy in East Africa. It introduced the EA shilling in 1921. It is noteworthy that the consolidation of law and the institutional framework on tax and currency administration during the colonial era was inspired by administrative concerns rather than real harmonisation.

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[192] Bates R. H., *Beyond the Miracle of the Market,The Political Economy of Agrarian Development in Kenya*, 2nd edition, Cambridge University Press, 2005, ISBN: 9780521617956, p.58.
[193] *Ibid.*

The current scheme of affairs where territorial sovereignty is safeguarded should be further interrogated especially if fiscal harmonisation is to be attained. This study is therefore important since it examines the appropriate mechanisms that should be applied and the scope of harmonisation as envisaged in the EAC Treaty and its attendant Protocol.

2.2.3. A common income and customs body of the EAC 1967

Income tax and customs revenue were collected jointly by one organisation; the Income Tax and Customs Department for the community which was based in Nairobi.[194] The body was charged with collecting all the customs duty and income tax within East Africa. Complaints started emerging from Uganda and Tanzania about fidgeting and falsification of books of account by Kenya which allegedly retained more revenue and disclosed less fiscal information.

2.2.4. The economic reasons for the collapse of EAC 1

The key economic and fiscal reasons for the collapse of the EAC in 1977 include:[195]

(a) The problem of distribution of gains and losses

As stated above, Tanzania and Uganda raised concern that Kenya was benefiting more from the integration, that is, all the three countries were not benefiting equally. In terms of economies of scale, Tanzania argued that most of the industries, foreign direct investment (FDI) and tourism benefits were accruing to Kenya. Due to this disproportionate benefit, actual or perceived, Tanzania demanded that the underlying basis of cooperation be reviewed. When the Treaty was signed in 1967, transfer taxes were introduced as a means of redressing this concern. Despite the

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194 This was the genesis of the "community area" of Nairobi within the immediate fringes of the CBD which houses important offices, both governmental and non-governmental.

195 See Ingrid D., *ibid.*, p. 30-41.

existence of transfer tax, the issue of distribution of gains and benefits remained contentious within the community.

(b) The Issue of Transfer Taxes

In the case of East Africa, rather than complete trade liberalisation, some kind of protectionism, in the form of the transfer tax, was introduced to raise Tanzania's competitiveness and to some extent Uganda's, but neither of which was able to compete with Kenya where industrial production was relatively more established and commercial affinity for multinational enterprises (MNEs) was more pronounced than in Uganda and Tanzania.[196]

Transfer taxes could be imposed only if a Partner State was in deficit in manufactured goods with the other partners. Kenya, therefore, did not qualify for this 'privilege'.[197] Transfer taxes were imposed only on the manufactured goods that a country was able to produce or 'would produce within three months on a significant scale i.e. 15% of its domestic needs or a value of output of 100,000 pounds. The rate of the transfer tax was at the discretion of the tax-imposing country, but it could not exceed 50% of the external tariff on that commodity (the community maintained a common customs and excise tariff), and expired unless earlier revoked, eight years after the date it was first imposed.[198]

Thus, the transfer tax was conceived as a temporary device and its working was due for review after five (5) years. All unexpired taxes were to be revoked after fifteen (15) years of launch. If a protected industry managed to export 30% of its total sales to the rest of East Africa, then the

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[196] *Ibid.*

[197] Ingrid, p. 38.

[198] Nsekela A.J., 'African Development', in *EAC Special Survey* (1974), at p. 17.

transfer tax would be removed. The argument for this regulation was presumably that an industry able to produce that much was already protected (or competitive). The aim, in a nut-shell, was to encourage the location of industries in the protected market since imports in such a market would be more expensive. In addition, such industries would be sure of a market in at least two countries, if not three. This was intended not to cause import demands from the Member States to be directed to non-East African sources.[199]

The authors of the EAC 1, 1967 Treaty were undoubtedly of the opinion that when the transfer tax was statutorily abolished fifteen years after its imposition or by 1982, there would be free movement of goods within the three countries and that would provide the economic equality desired by Tanzania and Uganda. In such a situation, the most efficient units would expand, coupled with diversification for the less efficient, the pre-requisite being, of course, non-imposition of new trade restrictions through their state trading corporations or other arrangements. The transfer tax was supposed to be the only restriction (tariff barrier) on inter-community trade but some infant industry protection was also allowed for new industries having small output. Although under this arrangement certain Kenyan goods were subject to transfer tax in both Uganda and Tanzania (and, to a lesser extent, Ugandan goods in Tanzania), the transfer tax was much less disruptive of inter-state trade than the pre-Treaty quota and quantitative restrictions.[200]

According to Ingrid, inter-state trade on manufactured goods increased between 1967 and 1970, thus disproving those who had maintained that the transfer taxes would decrease inter-state trade

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[199] *Ibid.*, p.44.
[200] Ngila Mwase, "The *East African Community: A Study of Regional Disintegration*", Economic Research Bureau, University of Dar, 1979, p. 22.

in manufactured goods. In absolute terms, the imbalance in trade, especially Kenya's surplus *vis-a-vis* Tanzania and Uganda, was larger in 1970 than in 1967. At the same time Uganda's surplus with Tanzania changed to a deficit (and this was not necessarily because of the transfer tax but because of other factors).[201] Uganda's transfers fell because she relied on too few products. The main ones being cotton fabrics which were severely restricted by increased production capacity in Kenya. Indeed in the aftermath of the 1971 coup, Uganda directed most of her exports to countries outside East Africa to finance the 'Economic War' including and especially, the procurement of military hardware.[202] Although the transfer tax collections were made by the East African Customs and Excise Department, the costs of collection were met by the tax-imposing country. The amount of these costs, relative to revenue collected, was disturbing especially when compared with other types of taxes.[203]

The transfer tax had on the whole not hindered trade in East Africa. It is a different matter, however, whether it helped to correct industrial imbalance among the Member States. A Community seminar held at the Makerere University, Kampala, in June 1972, was of the general opinion that although the transfer tax had not adversely affected the volume of inter-state trade, it had not achieved its primary goal of promoting new industrial development in those Member States which were less industrially-developed.[204]

Why did the transfer tax fail to achieve its primary objective? It had many pre-conditions and complications. Its aim was to foster and boost production in Tanzania and Uganda, but it was not

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[201] *Ibid.*
[202] Ingrid, p. 28.
[203] *Ibid.*
[204] Ngila, *ibid.*, p. 22.

designed to influence greatly the allocation of new industries in these less-economically privileged partners. Rather, it psychologically fostered the proliferation of numerous small and medium-size industrial units which operated at comparatively high costs and were geared, not to some sort of complementarity within the Common Market, but to national self-sufficiency hence the focus on production of too few products for local rather than regional consumption.[205]

Apparently, the Transfer tax system doubled up as an industrial location policy since transfer taxes were imposed only on manufactured goods from less privileged countries but not on those from much developed partner state. Consequently, FDI inflow into the corporations of the more developed states was minimised due to higher costs of production, both real and perceived. In this context, investment in production in the economically lower countries was perceived to be cheaper thus attracting more FDI. This unusual state of affairs, though justifiable on affirmative action grounds, proved costly and undesirable to the growth of the EAC 1. The lessons learnt from the transfer tax system coupled with the industrial location policy are thus negative in effect. To reverse the trend and safeguard against the effects of the transfer tax system, this thesis proposes a harmonised corporate income tax framework for instance through the use of a CCCTB to leverage the playing field tax-wise for the EAC corporations, whether local or foreign owned. This CCCTB would go a long way towards negating the need for a transfer tax system and mainstream the industrial location policy while at the same time uniformly attracting FDI into the EAC Member States.

Despite its shortcomings, the tax did provide some benefits, at least in monetary terms, to Tanzania and Uganda. Unfortunately, the limited revenue was not specifically used to aid

[205] *Ibid.*

industrialisation. Only in the financial year 1975/76 did Tanzania establish a Special Development Fund, financed by revenue from the transfer tax and manned by the Tanzania Investment Bank.[206] In conclusion therefore, the EAC1 failed to take advantage of the transfer taxes to address economic imbalance within the cooperation. This failure largely contributed to the tragic collapse of the cooperation in 1977.

2.2.5. A brief note on EAC 2

The EAC was re-established under Article 2 of the Treaty for East African Cooperation signed on 30th November 1999.[207] Under Article 3 of the Treaty, the member states of the community are Kenya, Uganda and Tanzania and any other country that the summit shall grant membership. Rwanda and Burundi's applications for membership of the year 2000 were approved and they are now active members of the Community in spite of their French tradition.

The current income and profit taxes of the EAC member states have adopted different approaches. The former partner states under the EAC 1. that is, Uganda, Kenya and Tanzania have had their tax systems substantially influenced by the British tax systems due to the colonial factor. On the other hand, Rwanda and Burundi have been influenced by the French traditions. As discussed in Chapter three, Kenya, Uganda, Tanzania and Rwanda have their income tax regulated by Income Tax Act while Burundi has adopted a general Tax Code (not exclusive to income tax).

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[206] *Ibid.*

[207] The Treaty entered into force on 7th July 2000. Available at: http://www.eac.int/sites/default/files/docs/treaty_eac_amended-2006_1999.pdf. (Accessed on 15th September 2014).

As pointed out in part 1.4 of this study, under the current EAC framework, the differences in income tax laws and policies have resulted in deleterious effects like trade distortion, revenue loss and administrative challenges like double taxation. The authors of the EAC Treaty foresaw this challenge hence the inclusion of Article 83 (2) e)) on tax harmonisation. It is the failure of this Provision together with Article 32 of the Common Market Protocol to clearly define the scope of fiscal harmonisation that has necessitated this study.

2.3 Conclusion

An analysis of the EAC 1 tax laws and practices offer key lessons for instance on the need to strengthen legal and institutional framework for integration. These lessons are useful in any attempts on corporate income tax harmonisation in the current EAC. The EAC 1 adopted heterogeneity of income tax regimes as a means to enhance integration which proved ineffective. Tax policies such as transfer of taxes and the economic policy of distributing gains and losses among the Member States of EAC 1 were meant to bridge economic imbalance. They were further geared towards fostering greater economic integration within the Community.

Transfer of taxes and economic imbalance, being clear hallmarks of tax heterogeneity, failed to spur greater economic integration within the EAC 1. Their failure further exacerbated the deteriorating political relationship between the EAC Member States. Perhaps they may be held to have contributed significantly to the political collapse of the Community in 1977. This can therefore be analyzed as a case of a failed tax heterogeneity regime. Harmonisation of tax regimes among the Community Member States appears a better proposition and likely to deliver further integration, culminating in the economic integration jointly fronted through a common

market and monetary union framework. Ultimately, this economic integration will catalyse the establishment of an EAC political federation as intended in the Treaty.

The next chapter seeks to examine select tax policies and the disparate income tax legislations in the EAC. An analysis of the differences in corporate income tax systems is made in order to ascertain whether it is tenable in the wake of the revamped EAC regional integration (EAC 2). This will subsequently form the basis for analysis of the effects of such heterogeneity which is the subject of discussion in Chapter Four of this study.

CHAPTER THREE

HETEROGENOUS CORPORATE INCOME TAX POLICY AND LAW IN THE EAC

3.1. Introduction

The failure by Treaty and its attendant Protocol on Common Market to explicitly provide for income tax harmonisation has seen the EAC Member States operate five (5) different corporate income tax regimes.[208] At the onset, this chapter provides an overview of the corporate income tax legal regimes and policies of the EAC Member States. As indicated, corporate tax has not had a separate historical development in the EAC because all along, it has been considered as part of income tax. The analysis focuses on the differences within the income tax legislations and procedures applicable in the five EAC Member States. The chapter sought answers to the inquiry of the current national corporate income tax profiles of heterogeneous regimes of the EAC as set out in part 1.7.4 of the study. It is intended to question the underlying policy rationale behind the heterogeneity in income taxation and provide a platform for a review of its effects and the need for harmonisation of law and policy on corporate income taxes by the EAC Member States. In addition, the objectives of the study as set out in part 1.7.2 can be attained upon the examination of the existing heterogeneous and competitive income tax laws and policies obtaining within the EAC.

[208] See Article 83 (2) e)) of the Treaty and Article 32 of the Common Market Protocol. The operation of the five different CIT regimes directly offends the provisions of Article 83 (2) e)) which mandates the EAC countries to harmonise their taxes. Article 32 clarifies the objectives of harmonisation as being the removal of tax distortions with the view of facilitating the free movement of goods, services, capital and investment promotion within the Community.

The practice in the EAC is that the profits of companies are subjected to a separate tax from that applicable to the individuals though the legislative framework is the same. This system of taxation was borrowed from the practice in the UK. The scheme of corporation tax exists to serve two underlying purposes, that is, to simplify the taxes applicable to companies and to create a tax framework under which companies would be encouraged to retain profits for expansion rather than distribute them to their shareholders by way of dividends.[209] Two tier scheme of corporate taxation is as follows: corporation tax on the profits a company earned and income tax on the profits it distributed.[210]

Despite the use of a common legislative framework, the taxation of companies is made on a separate basis from taxation of individuals. This arises from the fact that under company law, the company and its shareholders are treated as separate bodies. Thus, to maintain the principle of charging tax at the point where the income first arises, the company must deduct tax when making distribution to shareholders and account for the tax so deducted to the taxing authority.[211]

In terms of corporate tax incidence, since corporations are legal, not physical entities, they cannot actually bear the burden of taxes. Instead, CIT is passed on to the individuals connected with companies, including corporate owners (shareholders) workers, and customers in the form of lower dividends or capital gains, reduced salaries and fringe benefits and higher prices respectively.[212] As such, the discussion herein will not exclusively focus on corporate income

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[209] Topple B.S, *Corporation Tax*, Mac Donald & Evans, 3rd edn, 1977, p. 1.
[210] *Ibid.*
[211] Carmichael K.S, *Corporation Tax* (HFL Publishers Ltd, London, 2nd edn, (1969) p. 2.
[212] Keightley & Sherlock, *'The CIT system: overview and options for reforms'*, Congressional Research service, Feb 2014, p,16.

taxes but on cross cutting aspects of income taxes that affect the full operationalisation of the EAC Common Market.

3.2. Tax heterogeneity in practice: A comparative analysis of the corporate income tax (IT) Systems and policies of the EAC Member States

The East African Community has far reaching plans to fully operationalise the Common Market, introduce Common Currency and establish a Federation in the coming years. As the integration agenda is advanced, policy should also be considered so as to avoid possible discriminatory effects against any of the Partner States and third parties. All the five Member countries of the EAC have specific issues that they have to address as they seek to fully implement the integration agenda set out in the EAC Treaty. Kenya, for instance, has introduced devolution in its governance structure, an initiative that is intended to devolve resources closer to the people. This objective is currently on course in terms of its implementation. Tanzania, on its part, has the agenda of investing on industries so that she can be on equal level with other EAC members while Rwanda and Burundi are on a reconstruction plan having undergone a turbulent moment during the long period of civil war and most recently, the attempted coup in Burundi. These trajectories herald different policy thrusts thus necessitating divergent corporation tax approaches.[213]

The policy differences highlighted above impact on the progress of regional EAC integration. Revenue from taxation would play a significant role in the financing of these key objectives and appropriate balance should therefore be struck on whether to continue with tax incentive regimes

[213] Therefore, a lot needs to be done in terms addressing policy differences and seeking convergence so as to strike in the same direction in achievement of the Treaty provisions.

perceived to play a role in attraction of FDI while losing revenue or the abolition of tax incentives and improvements in other areas that provide a conducive environment for FDI growth.[214]

3.2.1. The governing/applicable law

In Kenya, Tanzania, Uganda, and Rwanda, corporate income taxes are regulated by the respective *Income Tax Acts* ('ITAs') while Burundi has enacted a general tax code. The Code is similar to tax statutes as it prescribes the nature of taxes applicable including CIT, the tax rates and classes of tax payers. Its implementation is entrusted to the Burundi Tax Authority. The Kenyan ITA[215] is the principal legislation governing income taxation in Kenya. This Act was adopted in 1974 after the abandonment of the joint legislation governing income taxation among the East African countries, Kenya, Uganda and Tanzania in 1973. Under the EAC 1 as noted in Chapter Two, the principal income tax legislation was the *East African Income Tax Management Act* of 1952 as amended in 1958. The Kenyan Act, at its inception and over the subsequent years, borrows most of its respective provisions from the latter enacted *East African Income Tax Management Act* (1958). This further explains the striking similarity of most provisions of the income tax legislations of the three inaugural EAC Member States of Uganda, Kenya and Tanzania.

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214 Harmful tax practices prevalent within the current system might flourish leading to a race to the bottom phenomenon hence reducing the national tax revenue needed to finance the appropriate infrastructure for further development of the EAC. Harmonisation of corporate taxes especially on tax incentives may as well be the solution to the perils of harmful tax competition.

215 Chapter 470 of the Laws of Kenya. The statute identifies the critical components and salient features of the country's income taxation. Under the Act, provisions on; respective taxpayers, scope of taxation, scope of taxable income, tax rates, losses, classification of income taxation, objections and appeals, tax incentives and lastly penalties for tax evasion and other income tax-related offences are clearly outlined. For a general discussion of income tax in Kenya, see Jemima, '*Tax Overview in Kenya', 2012*, LLM dissertation, UoN, Unpublished (on file with author).

The current Tanzanian ITA, 2004[216] was enacted in 2004 with a commencement date of 1st July 2004. It replaced the ITA, 1973.[217] In Uganda, income taxation dates back to the African kingdoms (Buganda Kingdom). Modern income taxation, however, was brought by the British colonialists.[218] The majority of the indigenous people in Uganda at that time were peasants who relied on harnessing natural resources for a living. Only foreign settlers of Asian and European origin initially paid income tax under the Income Tax Ordinance.[219] The tax was subsequently extended to African residents using employment emoluments or Pay as You Earn (PAYE). That was done in 1962/63 under the auspices of the *East African Income Tax Management Act of 1958*. The Act was repealed by the Income Tax Decree of 1984 following the disintegration of the Community in 1977. The Decree was again repealed by the Income Tax Act of 1997 which took effect on 1st July the same year.[220] The Income Tax Act (ITA) covers both the procedural and substantive law for income tax administration in Uganda. The Uganda Revenue Authority (URA), which was established in 1991 by the URA Statute, does the enforcement and implementation of income tax and is counterpart to KRA in Kenya.[221]

As far as Burundi is concerned, during the many years of political instability, still ongoing, there has been no sound tax system. In the year 2005, the Government of Burundi initiated reforms in

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216 Chapter 332, Laws of Tanzania.

217 Deloite, *Income Tax in East Africa*, 2012 Edition, p. 12. Available at: http://www.deloitte.com/assets/DcomKenya/Local%20Assets/Documents/Budget%202012/Deloitte_IncomeTax2012.pdf (accessed on 1st November 2012). See also Sections11-18 ITA.

218 Kasimbazi E., *Taxpayers' Rights and Obligations: Analysis of Implementation and Enforcement Mechanisms in Uganda*, DIIS Working Paper no 2004/12, p. 11. *(Available at: http://www.diis.dk/files/Publications/WP2004/emk_taxpayers_obligations_uganda.pdf*. (Accessed on 1st November 2012).

219 *Ibid*, p.12.

220 *Ibid.*

221 The Uganda Revenue Authority was set up on September 5, 1991 by the Uganda Revenue Statute No. 6 of 1991 as a central body for the assessment and collection of specified tax revenue and to account for all revenue to which those laws apply.

its taxation system with a view to lowering and streamlining the tax regime so as to achieve an effective collection system of domestic taxes. There have been a few reforms in the tax system in Burundi. The Government of Burundi with the support of its development-minded partners has managed to accomplish firstly, the EAC Customs Union Protocol which ensures the country's regional integration (based on Common External Tarriff) hence improving trade within the EAC and secondly, a new revenue authority exchange system which is almost fully operational.[222]

Burundi has an Income tax Act referred to as the 'Law on Income Tax Code' of 2005. Income tax is levied in accordance with Part II of the General Tax Code[223] which was first enacted in 1963 and has undergone numerous amendments since then.

The foregoing illustrates that the EAC member states have maintained heterogeneous income tax profiles with each country applying its own distinct legislation. These findings are supported by empirical data whose findings are analysed in appendix 2 of this study. The data reveals that unlike the EAC customs taxation where common EAC framework has been adopted, the legal regime governing income taxation is disparate as each EAC member state uses its own domestic legislation. As such, the findings support the argument that this heterogeneity contravenes the tenets of regional integration under a Common Market where the freedom of movement of goods, capital, labour and the right of establishment is to be facilitated. Further, with the continued disparities in tax legislation, the objectives of harmonisation as set out in the EAC

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[222] African Development Bank group, *"Domestic Resource Mobilization for Poverty Reduction in East Africa: Lessons for Tax Policy and Administration"* (2011), available at: http://www.afdb.org/fileadmin/uploads/afdb/Documents/Project-and-operations/Domestic%20Resource%20Mobilisation%20Flagship%20Report.pdf, (accessed on 28th Oct 2012).

[223] The word code denotes French influence for instance, refer to the "Code Napoleon."

Treaty and its attendant Protocol on establishment of a Common Market become increasingly difficult to achieve.[224] A closer look at the EAC tax incentive regimes suffices to illustrate the divergence in tax policy and its attendant effects.

3.2.2. Tax Policy issues in the EAC: A focus on tax incentives

The EAC needs a coherent tax policy to support income tax harmonisation. The policy ought to deal with heterogeneity in the disparate CIT systems of the EAC member states. In addition, the harmonised policy will deal with the tensions resulting from each Member States' desire for preservation of sovereign control of fiscal planning and in taxation since it ought to specify the boundaries of national vis a vis regional jurisdiction in taxation. The instrument of policy can also be used to shape domestic tax systems to addresses the distinct needs of each Member State while at the same time preserving harmonisation of CIT systems.

It is the argument of this thesis that such policy must be grounded upon Adam Smith's canons of optimal taxation which constitute the principles of a good tax system what Adam Smith himself called the "optimal tax system." These principles have withstood the test of time and have been entrenched within the legislative framework. They include equality/equity, certainty, convenience and economy. Additional principles of productivity, fiscal adequacy, buoyancy, flexibility, simplicity and diversity have been added by other scholars subject to modern dynamics.[225] Thus, a uniform CIT structure for the EAC should take into account these features

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[224] See Appendix 2.

[225] Adapted from Attiya W., *ibid.*, p.276. For a lucid discussion of the principles of taxation and characteristics of a good tax system, see H.L. Bhatia, *Public Finance*, New Delhi: UBS, 2003, pp. 41-46., p. 42.

in consonance with what Stiglitz[226] has summarised as economic efficiency, administrative simplicity, flexibility, transparency and fairness so as to inform the proposed policy legal framework.

The constitutional principles for the tax policy find expression under the doctrine of constitutionalism which should embrace regional integration efforts. Thus, the state has authority to do only what its national Constitution allows it to do. The principle of constitutionalism can be cascaded onto regional scene when one looks at the Constitution governing a region i.e a Treaty or Protocol. Finding root in constitutionalism, the doctrines of rule of law[227] and separation of powers are closely linked to taxation generally. Classical constitutional lawyers such as Dicey, Aristotle, Locke and Montesquieu defined the power to tax as deriving from Law.[228] In terms of separation of powers, the power to enact taxing legislation is exercised by the legislative arm of the state while tax enforcement or administration is reserved for the executive arm through the relevant agency such as the KRA in case of Kenya. Taxation, generally to use Rousseau's term,

[226] Former Chief Economist of the World Bank. See Stiglitz J., *Globalisation and its discontents* (W. W. Norton & Company 1st edition, 2003) ISBN-13: 978-0393324396.

[227] De Smith and Brazier, *Constitutional and Administrative Law* (Harmondsworth Penguin, 1990) pp. 4, 6. Brennan and Buchanan (pp. 2, 4) agree with this definition and conceptualization of a constitution and opine that *"a constitution is conceived as the set of rules, or social institutions, within which individuals operate and interact with one another … in the absence of collective enforcement of basic property rights and of rules … and of rules by which those property rights might be exchanged, the state of nature would ensure that man's life is 'nasty, brutish and short.' To Thomas Hobbes, the only logical alternative to anarchistic chaos is the assignment of power to government – or some other institution of authority."*

[228] Hayek attempts to apply the rule of law to taxation (discussed in Brennan and Buchanan, *Ibid*., p. 156): "*By this [he] means that all rules involving taxes must be general. They must be universally applicable to all members of the political community, whether or not these persons are inside or outside the subset of persons that make the governmental decisions. This approach essentially reflects the specific application of the traditional legal norm of 'equality before the law' to the taxing activities of government. Historically, the constitutional requirement that taxes be uniform seems to stem directly from this legal norm*." Brennan and Buchanan (pp. 190-191) conclusively argue for a constitutional attitude towards tax reform, including reform in the practice of DTTs. In their own words, "…*tax reform deserves to be discussed constitutionally….In a sense, our argument becomes a plea for a more explicit constitutional attitude toward tax reform*."

is part of the social contract between the state and the citizenry/taxpayers.[229] Thus, governments must present their annual budgets to the representatives of the people which encompass the national tax policy applicable in a given year.

It is worth noting that following the re-establishment of the East Africa Community (EAC) in 1999, Kenya, Tanzania and Uganda created a Customs Union (a duty free trade area with common external tariffs) in 2005 and were joined by Rwanda and Burundi in 2009.[230] The East African Common Market also offers corporate income tax holidays for certain categories of business such as companies engaged in agro-processing and those exporting finished consumer and capital goods. Corporate income tax incentives include tax holidays; tax credit; investments allowances and reinvestment or expansion allowances.

There exist key financial policy disparities among the EAC Member States, having a direct impact on their respective income tax policies. Kenya, the most dominant economy within the regional bloc, is keen to finance its recently introduced devolution governance system. Tanzania has focused on industrial expansion as a way of achieving economic development and growth. Uganda, on the other hand, is keen on the advancement of its oil mining venture. Rwanda and Burundi, on the other hand are still preoccupied with challenges occasioned by civil war, mostly infrastructure development.

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[229] *See generally,* Yoseph M. Edrey. "Constitutional Review and Tax Law: An Analytical Framework", *American University Law Review* 56.5 (2007): 1187-1228, p. 1194.

[230] EAC Report on Harmful Tax Competition. Available at <http://www.actionaid.org/sites/files/actionaid/eac_report.pdf. (Accessed on 2nd July 2014).

It is therefore worth mentioning that disparities in corporate income tax rates and policies among other factors in the EAC have also encouraged illicit trade, complicated operational systems for companies wishing to carry on business throughout the EAC and slowed down the integration process. This has to be monitored by way of harmonising the corporate income tax system in the region. Through these common objectives and policies, the EAC Member States are destined to a common goal of having a harmonised corporate income tax policy.

The EAC policies on tax incentives, for instance, reveal that each Member State has its own distinct policy goals. The uncoordinated approach on tax incentives is a major cause of harmful tax competition in the EAC with results characteristic of a race to the financial bottom.

Tax policy harmonisation is required to facilitate all the integration processes in the EAC since the fundamental basis of economic integration as envisioned by the EAC Treaty is fair play on a level playing field. Under the EAC Common Market, firms in general and Multinational Enterprises (MNEs) set up to bolster the FDI inflows ideally should be located in any of the EAC countries.

A tax incentive is defined as 'a deduction, tax holiday, refund (rebate), waiver, exclusion or exemption from a tax liability, offered as an enticement to engage in a specified activity such as investment in capital goods for a certain period'.[231] Tax incentives to businesses are granted with the aim to attract a greater level of investment (Foreign Direct) into the countries in order to benefit from these investments in form of employment; revenues from taxes, fees, royalties and dividends among others; technology transfers and other potential gains from FDIs in host

[231] See http://www.businessdictionary.com/definition/tax-incentive.html. (Accessed on 7th December, 2014).

economies. Such incentives include corporate income tax holidays, notably in Export Processing Zones (EPZs), and reductions from the standard rate for taxes such as import duties.

Governments in East Africa are providing a wide range of tax incentives to businesses to attract greater levels of foreign direct investment (FDI) into the country.[232] Investors may play one country against another to gain tax incentives and other benefits from the government. Countries also compete on their own accord by providing attractive corporate income taxes through lowering of the rates.

Article 83 (2) (e) of EAC Treaty requires Partner States to undertake to harmonise their tax policies with a view to removing tax distortions in order to bring about a more efficient allocation of resources within the Community.[233] Similarly, Article 32 of the Common Market Protocol requires the Partner States to progressively harmonize their tax policies and laws to remove tax distortions in order to facilitate the free movement of goods, services and capital and to promote investment within the Community. Despite these provisions, the EAC Member States continue to adopt different policies on corporate tax for businesses for purposes of attracting investment hence the need to have a common approach on tax incentives.

Indeed, while responding to the question on the factors hindering income tax harmonisation in the EAC, 20 of the 23 respondents cited fiscal sovereignty over tax matters as the main

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[232] Such incentives include corporate income tax holidays, capital Investment deductions and exemptions from import duties.

[233] Article 80 (f) of the EAC Treaty also provides for the countries to harmonise and rationalize investment incentives including those relating to taxation of industries and labour with a view to promoting the Community as a single Investment area.

hindrance.[234] Those findings forewarn the EAC Member States that any efforts towards harmonisation may not be easily accepted by the individual Member States. It is therefore incumbent upon the EAC membership to explore the best approach to harmonisation without offending principle of sovereign tax autonomy. Important lessons can be drawn from the EAC customs harmonisation where the member states have relinquished their fiscal autonomy and adopted EAC legal and policy framework. The EU/ NAFTA experiences as discussed in Chapter five of this study should inform the EAC initiatives.

3.2.2.1. Kenya

Kenya has over the years provided generous tax incentives to new businesses and those operating within the EPZs. The tax incentives available in Kenya include:

a) *Investment Tax Credit and Allowances*

Here, companies in a specific industry are allowed to make deductions against their tax liabilities, a fraction of expenditures on new additions to physical or capital stock. Under the second schedule to the Income Tax Act[235] the tax credit comprises; Investment Deduction Allowance (IDA) which is claimed at the rate of 100% on the capital investment once manufacturing operations commence. It attracts an additional 50% for investment whose value is Ksh.200 million or more, and is outside the municipalities of Nairobi, Mombasa and Kisumu; Industrial Building Allowances (IBA) is granted on straight-line basis on balance of cost of construction at the rate of 2.5% for manufacturing and 10% for hotels; Mining Deductions Allowance (MDA) is calculated at a rate of 40% in the first year and 10% for the remaining 6

[234] See Appendix 2.
[235] The Income Tax Act Cap 470 of the Laws of Kenya.

years on a straight line basis; Farm Works Deductions (FWD) is computed at the rate of 20% on straight-line basis for 5 years of income.

b) Export promotion incentives

Kenya has various schemes targeting different categories of exporters. The main schemes are the Export Processing Zones (EPZ's) and Manufacture under Bond (MuB). The objective of EPZ is to encourage and generate economic development, foreign direct investments, and economic activities by encouraging foreign investment for the development of zones. Numerous tax incentives are provided in Kenya's EPZs, the most significant of which are: A 10-year corporate income tax holiday, followed by a 25% rate for the next 10 years[236]; A 10-year exemption from all withholding taxes.[237] Other tax incentives apart from CIT include exemption from import duties on machinery, raw materials, and inputs[238] and exemption from stamp duty and VAT on raw materials, machinery and other inputs.[239] In addition, Manufacture under Bond incentive is also extended to manufacturers' import plants, equipment, machinery and raw material on a tax free basis, for use exclusively in the manufacture of goods and services. It is meant to encourage manufacturers, both local and foreign, to manufacture for export within the country.[240]

Consequently, it is estimated that the Government of Kenya looses up to KShs. 100 billion (US$1.1 billion) a year from revenue foregone from all tax exemptions and incentives. This would amount to around 3.1% of GDP. Of these, trade-related tax incentives were at least KShs

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[236] UNCTAD, *An Investment Guide to Kenya, 2005*, p.46, available on the Kenya Investment Authority website.
[237] *Ibid.*
[238] *Ibid.*
[239] *Ibid.*
[240] Institute of Economic Affairs, The Budget Focus, September 2012, Issue No.30.

12 billion (US$133 million) in 2007/08 and as high as US$566.9 million in 2010/11 period.[241] Sadly, Kenya has not taken any concrete steps to review it incentive regime due to the pressure from the other EAC member states that have continued to offer attractive income tax incentives. This miniature analysis points to the effects caused by heterogeneity in regional income taxes, a challenge that could be avoided through systematic harmonisation of policy and legal framework under a consolidated EAC regional regime.

3.2.2.2. Uganda

The government of Uganda, like its Kenyan counterpart offers generous tax incentives to various corporations for purposes of encouraging new investments. These incentives include:

a) *Investment Tax Credit and Allowances*

The criteria used to grant tax incentives is provided for in the Income Tax Act.[242] Some holidays are granted by the President acting through the Ministry of Finance whereby the government commits to pay taxes on behalf of a person.

Uganda offers unlimited corporate income tax holidays for certain categories of businesses such as agro-processing companies. Under the Income Tax Act[243] investment capital allowances offered include: initial allowance on plant and machinery of 50-75%, depending on where the investment is located; Start-up costs allowed for tax purposes over a four-year period i.e. at 25% per annum; Scientific research expenditure allowed for tax purposes, 100% in the year incurred;

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[241] John Njiraini, *'Kenya losing Sh100 billion annually on tax exemptions',* 26. *The Standard*, 23rd August 2011; EAC Secretariat, *EAC Trade Report 2008*, 2010, p.51; GDP estimate based on a nominal GDP figure of KShs 3.18 trillion in 2011/12.

[242] Section 2 (bb), 21 and the 1st Schedule of the Uganda Income Tax Act, Cap 340.

[243] Income Tax Act, Cap 340.

Training expenditure allowed for tax purposes, 100% in the year incurred; Mineral exploration expenditure allowed for tax purposes, 100% in the year incurred; Initial allowance on hotel and industrial buildings of 20% in the year they are put into use; Allowable tax depreciation rates of 20-40% depending on the type of asset; Allowable tax depreciation rate for hotels, industrial buildings, hospitals and approved commercial buildings of 5% per annum and Dividends repatriated which also get relief from double taxation.

b) *Export promotion incentives*

Unlike Kenya and Tanzania, Uganda does not have EPZ's, however, it provides import duty and stamp duty exemptions for companies exporting.[244] Only companies that produce a minimum of 80 per cent products for exportation are given tax holidays.[245]

Consequently, it is estimated that losses from tax incentives and exemptions are at least 2% of GDP. This amount was estimated at UShs. 690 billion (US$272 million) in 2009/10 period.[246] With the harmonisation of legal and policy framework, the EAC may avoid trade distorting practices caused by heterogeneity in their corporate income tax legislations and policies.

3.2.2.3. Tanzania

The following incentives are accorded to corporations in Tanzania:

a) *Investment Tax Credit and Allowances*

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[244] Uganda Investment Authority, *Uganda Tax Guide 2011*, PKF, p.3 Available at: http://www.ugandainvest.go.ug/index.php?option=com_k2&view=item&layout=item&id=22&Itemid=184. (accessed on 20th March 2013).

[245] *Ibid.*

[246] IMF, *Uganda: Second Review under the Policy Support Instrument and Request for Waiver of Assessment Criteria, Country Report No.11*, October 2011, p.24. Also see African Development Bank, 27. *Domestic Resource Mobilisation for Poverty Reduction in East Africa: Uganda Case Study*, November 2010, p.20.

Under the Income Tax Act[247], the withholding tax on earned income is in Tanzania generally a final one if the taxpayer is a resident. The rates of withholding taxes on dividends are 5% for income from listed companies and 15% from others, respectively. Interest payments are charged at a rate of 10% and royalties at 15%.

Initial capital allowances are allowed for mining (exploration and development: 100%), plant, machinery in manufacturing and tourism (50%) and business buildings and hotels (20%).

b) *Export promotion incentives*

In 2006, the Tanzania established special economic zones (SEZs), which include economic processing zones (EPZs), free ports, free trade zones (FTZs), industrial parks, science and technology parks, agricultural free zones, and tourism development zones. As per the Income Tax Act, investors qualify under the SEZ scheme if they demonstrate that their investment is new. In addition, they must also demonstrate that the investment achieves a minimum annual export turnover of US$5 million for foreign investors and US$1 million for domestic investors, provides adequate environmental protection and utilises modern production processes and new machinery.

The tax incentives in Tanzania's EPZs and SEZs include: exemption from corporate income tax for the first 10 years and reduced rates of 25% after that[248] and exemption from withholding tax on rent, dividends and interest` for the first 10 years. Other incentives include import duty exemptions on raw materials and capital goods imported for manufacturing goods in the EPZs;[249]

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[247] Income Tax Act, 2004.
[248] *Ibid.*
[249] East Africa Customs Management Act, 2004.

exemptions from Value Added Tax, charges on utilities and wharfage[250] and exemptions from all taxes and levies imposed by local government authorities for the first 10 years.[251]

Consequently, Tanzania encountered revenue losses from all tax exemptions and incentives estimated at Tshs. 1.8 trillion (US$1.44billion) in 2008 amounting to 6% of GDP, while the minimum revenue loss from tax incentives granted to companies alone has been estimated at Tshs 381 billion (US$266 million) a year (for the years 2008/09-2009/10).[252]

3.2.2.4. Rwanda

Rwanda has in place a system of tax incentives and exemptions for investors. The main beneficiaries are the MNCs, many of which are foreign-owned, although domestically-owned businesses can benefit from some of the incentives and exemptions. The incentives given by the Rwandan government include:

a) *Investment Tax Credit and Allowances*

An investment allowance of forty percent (40%) of the invested amount in new or used assets may be depreciated excluding motor vehicles that carry less than eight (8) persons, except those exclusively used in a tourist business is deductible for a registered investor in the first tax period of purchase and/or of use of such an assets if the amount of business assets invested is equal to thirty million (30,000,000) Rwandan francs[253] and, the business assets are held at the establishment for at least three (3) tax periods after the tax period in which the investment

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[250] Value Added Tax, 1997.
[251] Tanzania Export Processing Zones Authority and the Export Processing Zones Act No. 11 of 2002; 'Corporate Tanzania: Business, Trade and Investment Guide 2010/2011', p.57, 99, < www.corporate-tanzania. com. (Accessed on 8th April 2015).
[252] Uwazi, '*Tanzania's Tax Exemptions: Are they too high and making us too dependent on Foreign Aid?*', Policy Brief, TZ.12/2010E, p.3.
[253] Article 26 of Law No.16/2005 of 18/08/2005 on direct taxes on income.

allowance was taken into consideration. The investment allowance becomes fifty percent (50%) if the registered business is located outside Kigali or falls within the priority sectors determined by the Investment Code of Rwanda. The investment allowance reduces the acquisition or construction cost, as well as the basic depreciation value of pooled business assets.[254]

Training and Research expenses incurred and declared as agreed by a taxpayer and declared and which promote activities during a tax period are considered as deductible from taxable profits.[255] Companies that carry out micro finance activities approved by competent authorities pay corporate income tax at the rate of zero percent (0%) for a period of five (5) years from the time of the approval of the activity.

A registered investor shall be entitled to a profit tax discount if he maintains the employees for a period of at least six (6) months during a tax period and the employees are subject to tax. The rates applicable are: two percent (2%) if the investor employs between one hundred (100) and two hundred (200) Rwandans;[256] five percent (5%) if the investor employs between two hundred and one (201) and four hundred (400) Rwandans;[257] six percent (6%) if the investor employs between four hundred and one (401) and nine hundred (900) Rwandans;[258] seven percent (7%) if the investor employs more than nine hundred (900) Rwandans;[259] The tax discount is granted to the investor only if he or she maintains the employees for a period of at least six (6) months during a tax period and the employees are subject to tax.

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254 *Ibid.*
255 Article 27 of Law No.16/2005 of 18/08/2005 2005 on direct taxes on income.
256 Article 41 of Law No.16/2005 of 18/08/2005 2005 on direct taxes on income.
257 *Ibid.*
258 *Ibid.*
259 *Ibid.*

b) Export Promotion

A registered investment entity that operates in a Free Trade Zone and foreign companies that have their headquarters in Rwanda that fulfill the requirements stipulated in the Rwandan law on Investment Promotion is entitled to pay corporate income tax at the rate of zero per cent (0%); and gets exemption from 15% withholding tax mentioned. They are also entitled to tax free repatriation of profits.[260]

If a taxpayer exports commodities or services that bring to the country between three million (3,000,000) US dollars and five million (5,000,000) US dollars in a tax period, he is entitled to a tax discount of three percent (3%).[261] If he exports commodities or services that bring to the country more than five million (5,000,000) US dollars in a tax period, he or she is entitled to a tax discount of five percent (5%).[262]

Consequently, it has been estimated that revenue losses from tax incentives in Rwanda was Rwf 94 billion (US$156 million) in 2008 and Rwf 141 billion (US$234 million) in 2009. These were the equivalent of 3.6% of GDP in 2008 and 4.7% of GDP in 2009.[263]

3.2.2.5. Burundi

The main business incentives are contained in The Investment Code.[264]

a) Investment Tax Credits and Allowances

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[260] Law No 26/2005 of 17/12/2005, relating to investment and export promotion and facilitation.
[261] *Ibid.*
[262] *Ibid.*
[263] Institute of Policy Analysis and Research, *'East Africa Taxation Project: Rwanda Country Case Study'*, June 2011.
[264] Law No. 1/24 of 10th September 2008 establishing the Investment Code of Burundi.

The acquisition of buildings and land, necessary for the completion of the operation is exempt from transfer duties. Investors are entitled to deduct as tax credit, a proportion of 37% of the amount of depreciable assets invested in the business. These assets must be used in the business for at least five years. The investment tax credit is deducted from the acquisition value of assets invested, and from the basis for depreciation. The investment allowance is 50% for investment in rural areas and specified activities as provided by the Investment Authority.[265]

Investors also benefit from a reduced tax rate on profits based on the employment of Burundian workers who are subject to tax of 2%, if the investor uses a number of Burundian workers between 50 and 200[266] and 5%, if he/she employs over 200 Burundian workers in Burundi.[267]

b) *Export Promotion Incentives*

A registered investment entity that operates in a Free Trade Zone and foreign companies that have their headquarters in Burundi, pay corporate income tax at the rate of zero per cent (0%) for the first 10 years of business. The entities are also entitled to tax-free repatriation of profits and free transfer on purchase or sale of buildings.[268]

3.2.2.6 Effects of lack of coordination of policy framework on tax incentives in the EAC

The 2006 IMF report notes:

> Increased competition over FDI and growing pressure to provide tax holidays and other investment incentives to attract (and retain) investors could result in a "race-to the bottom" that would eventually hurt all three [ie, Kenya, Uganda and Tanzania] EAC members. Left unchecked, the contest could result in revenue loss, especially in Tanzania and Uganda, and threaten the objective of improving revenue collection.[269]

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265 Article 14 of Investment Code, Burundi.

266 Burundi Investment Promotion Authority, p.7. Available at: http://www.investburundi.com/en/incentives. (Accessed on 10th December 2014)

267 *Ibid.*

268 *Ibid.*

269 IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.5.

The World Bank[270], International Monetary Fund[271]and African Development Bank[272], *Uwazi*[273] and the Tax Justice Network[274] among many other multilateral creditors and stakeholders have dismissed the notion that incentives attract FDI. It has been argued that investors would still have made the investment without the tax incentives. A study by the World Bank Investment Climate Advisory Services in 2009 shows that for many developing countries, tax incentives do not effectively counterbalance unattractive investment climate conditions such as poor infrastructure, macroeconomic instability, security and rule of law, weak governance and small markets.

According to the IMF, tax incentives reduce government revenues by 1-2 per cent of GDP[275] and in total, Kenya, Uganda, Tanzania and Rwanda are losing up to US$2.8 billion a year from all tax incentives and exemptions.[276] This is through the foregone revenue that otherwise would have been collected from the activities undertaken, tax payers abuse and tax planning.[277] The impact is huge since according to the IFC/World Bank study, the cost of tax incentives was found to cost Burundi 39% of its total revenue in 2011 and 40% of the total revenue of Rwanda in 2009. A separate study by Hivos - *Twaweza* East Africa, estimates the Tax Incentives to cost 23% of the total revenue in Tanzania in 2009.[278]

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[270] World Bank Group- Private sector and Infrastructure Network: "*Using Tax Incentives to Attract Foreign Direct Investment", in Public Policy for the Private Sector*, Note number 253, February 2003.
[271] IMF, "Kenya*, Uganda and United Republic of Tanzania: Selected Issues",* 1 December 2008, pages 10-11.
[272] African Development Bank, Domestic Resource Mobilisation for Poverty Reduction in East Africa: Tanzania Case Study, November 2010.
[273] Uwazi, "*Tanzania's Tax Exemptions: Are they too high and making us too dependent on foreign aid*?", Policy brief TZ.12/2010E, October 2010.
[274] Tax Justice Network-Africa &Action Aid International, *"Tax Incentives and Revenue Losses in Tanzania*", June 2012.
[275] IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.12.
[276] Tax Justice Network Africa and Action Aid International Tax Competition in East Africa: A race to the bottom? April 2012 p.9.
[277] *Ibid.*
[278] Edward Mwachinga *et al*, *Tax Incentives in the EAC Member States,* Presentation to the EABC Conference, Nov. 11 &12, 2011, Dar Es Salaam, Tanzania, p.12. Available at:

Further, the enforcement and compliance costs increase with the complexity of the tax system and the system of fiscal incentives (in terms of qualifying and reporting requirements, different scheme) and it also makes a tax scheme less transparent and less predictable. This in turn reduces the efficiency of the tax system and increases the risk of taxpayer abuse. Tax incentives also create a differential treatment system that can introduce economic distortions that reduce efficiency and productivity and therefore entrenching discriminatory practices.

In conclusion, as demonstrated above, tax incentives in the EAC are uneven. The drive for governments to issue tax incentives is to attract investors. However, the most recent Investor Motivation Surveys in Tanzania, Rwanda, Uganda, and Burundi show that over 90 percent of investors would have invested even if incentives were not provided.[279]

The Member States of the EAC should therefore have a common position on FDI related tax incentives. This can be achieved by undertaking EAC law reform towards harmonisation of corporate tax policies and legislation on corporate tax incentives regimes. The Draft Code of conduct on tax competition which is yet to be signed by the member states should be reviewed and timelines set for its ratification and implementation. In order to avoid continued revenue erosion caused by uncoordinated incentive environment, the member states are encouraged to consider the following reforms, firstly, the setting up of minimum rates on certain taxes so as to avoid harmful tax competition as a forerunner to full harmonisation, provide for fiscal

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https://www.wbginvestmentclimate.org/advisory-services/regulatory-simplification/business-taxation/upload/Tax-Incentives-in-the-EAC-Member-States-Edward-Mwachinga-Mikra-Krasniqi-Sebastian-James.pdf. (Accessed on 19th December 2014).

[279] James Sebastian., *Tax and Non Tax Incentives and Investment: Evidence and Policy Implications*. WBG (World Bank Group) 2013, Investment Climate Advisory Services, p.12.

transparency through mandatory regular exchange of information and finally, East African governments should increase the capacity in both the EAC Secretariat, and in their own governments, to analyse the effects of tax incentives and negotiate better coordination in the EAC.[280] A permanent working group on tax harmonisation should also be set up to provide technical capacity to implement the proposals.

3.2.3. The EAC legal framework on corporate income taxes: taxable corporations, bases, incidence and principles.

i. Kenya

Within Kenya, taxation on corporate income under the Income Tax Act applies to both resident and non-resident corporations. However, there is marked difference for taxation rates and scopes for these two classes of legal persons. The differences between tax rates for residents and non-residents necessitated a distinction as to the taxpayer for instance whether corporate or individual. Under the Kenyan ITA, a 'resident' has been defined with reference made on both individual and corporate entities. Section 2 of the Act defines a resident as regards an individual to mean a person having a permanent home in Kenya and was present in the country for any period in a particular year of income under consideration.[281] The term also applies to a person not having a permanent residence in Kenya but was present in Kenya for a period(s) amounting in the aggregate to 183 days or more in that year of income; or was present in Kenya in that year of income and in each of the two preceding years of income for periods averaging more than 122 days in each year of income.[282] On the other hand, 'Resident' in reference to a body corporate or

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[280] Tax Justice Network Africa and Action Aid International, *Tax Competition in East Africa: A Race to the Bottom?* April 2012, p. 24.
[281] Income Tax Act Cap. 470, Section 2.
[282] *Ibid.*, Section 1. In company law, a corporation is resident in the country in which its real control and management exists. Furthermore, control as a shareholder without any interference in the management does

body of persons is, defined to constitute a company incorporated under Kenyan law, or a company whose management and control of affairs were exercised in Kenya in a particular year of income under consideration or a company or body declared via a gazette notice by the Minister to be a resident in Kenya for the respective year of income.[283]

The basis of taxation is that the resident and nonresident corporate entities are subject to tax on all income accruing in or derived from Kenya under the source principle.[284] The taxable income is imposed on a company's gross income, less allowable deductions. In general, expenses must be incurred wholly and exclusively in the production of income. It should not be in the form of capital for it to be deductible for tax purposes.[285] In regards to the taxation of dividends, dividends from a Kenyan company are not subject to additional tax other than what is deducted at source, that is, withholding tax. Dividends from a foreign company are not taxable in Kenya. Capital gain tax which had been suspended since 1985 was introduced in the 2014/15 Finance Act effective from 1 January 2015 at the rate of 5% of the net gain being the final tax. The tax is chargeable on both companies and individuals. In the case of companies, qualifying property include, money, goods, choses in action, land and movable and immovable property.[286]

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not constitute effective control. See *De Beers Consolidated Mines Ltd vs. Howe and Bullock vs. Unit Construction Co. Ltd.* Also see Carmichael K.S., *Corporation Tax* (HLF Publishers Ltd, London 2nd Edn., 1969) p. 2.

283 Income Tax Act Cap. 470, Section 2.

284 For a candid analysis of the source-vs-residence principle/bases of income taxation, see Mugo Jemima, '*What is the Impact of the Constitution of Kenya, 2010 on the Formulation, Negotiation, Ratification and Implementation of Double Taxation Treaties*?' (Unpublished LL.M Dissertation, UoN 2012).

285 Deloitte & Touche, International Tax, Kenya highlights, 2015, p. 1 available at: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-kenyahighlights-2015.pdf. ((accessed on 20th March 2013).

286 *Ibid.*

Losses may be deducted in the year in which they arise and the four following years and in case losses are not utilized within four years, an extension may be granted upon application. However, no guidance has been issued to set forth the circumstances under which this approval would be granted.[287] Losses may not be carried back, other than by oil and gas companies and may be set off only against income from the same source. The rate applicable for resident companies is 30%, while foreign companies are taxed at 37.5%. Foreign taxes paid are treated as an allowable expense, except where a tax treaty applies, in which case a tax credit is granted.

There are different categories for withholding tax on interest. Interest received from financial institutions is subject to a 15% tax, while the withholding tax on interest on bearer certificates is 25%. Withholding tax on interest from bearer bonds is 10% while for royalties on natural resource income paid is subject to a 5% withholding tax for resident and 20% if paid to a nonresident.[288]

ii. Tanzania

In Tanzania, incorporated companies, partnerships, individuals both resident and non-resident are taxable. Tanzanian residents are taxed on their worldwide employment income while non-residents are taxed on income from employment with a Tanzanian resident employer or permanent establishment in Tanzania. Income tax for a business is chargeable on business profits and gains. The law makes provisions for deductible and non-deductible expenses. Generally, expenses are allowed only if incurred wholly and exclusively in the production of income from the business or investment. Specific provisions on allowable expenses exist on the following: interest incurred under a debt obligation; trading stock; repair and maintenance

[287] *Ibid.*
[288] *Ibid.*

expenditure; agricultural improvement, research and development and environmental expenditure; gifts to public and charitable institutions; depreciation; losses on realisation of business assets and liabilities; and losses from a business or investment.[289] Non-deductible expenses specifically provided in the Act are, *inter alia*, expenditure of a capital nature; consumption expenditure, i.e. expenditure incurred by a person in the maintenance of himself, his family or establishment, or for any other personal or domestic purpose; income tax or tax of a similar nature paid under the ITA; fines and similar penalties for breach of law; expenditure incurred in deriving exempt amounts or final withholding payments; distributions by an entity and pension payments; annuity premiums and contributions to pension and provident schemes and funds, except for those otherwise allowed.

Non-residents are taxed on their income only to the extent that the income has a source in Tanzania.[290] A non-resident company is taxed in Tanzania to the extent that the income has been sourced in the United Republic of Tanzania. A newly-listed non-resident company (this applies to resident companies too) to the Dar es Salaam Stock Exchange which has at least 35% of its shares issued to the public will be liable to a 25% tax rate for three consecutive years from date of listing.[291] Dividends to a non-resident company controlling 25% of the total shares or more are subject to a withholding tax at the rate of 10 % (this tax is zero-rated for resident companies).

Dividends received from a DSE-listed company (whether resident or otherwise) are liable to withholding tax at a rate of 5% of the gross dividend payable when received by non-resident persons. The following amounts, when paid to a non-resident person are subjected to non-

[289] *Ibid.*, Sections 18, 19, 12(4).
[290] *Ibid.*, Section 6.
[291] *Ibid.*, PKF p. 9.

resident withholding tax rates:[292] For any management or professional fees-15% of the gross amount payable; For any royalty-15% of the gross amount payable; For any rental income (residential house if exceeds Tsh. 500,000/- p.a.)-15% of the gross amount payable for a non-resident company (as compared to 10% for resident company); For dividend interest-10% of the gross amount payable for a non-resident company (same percentage applies for resident companies); For technical services fees (e.g. mining)-15% payable by a non-resident company (compared to 5% of the gross amount payable by a resident company); For natural resource payment-15% of gross amount on a non-resident company (same % for resident companies); For insurance premium-5% by non-resident company (as compared to 0% for resident company); and, for services to the government by persons other than holders of TIN registration, 15% of gross payment by non-resident company (as compared to 2% for a resident company).[293]

Capital gains realised on the disposal of business and investment assets in Tanzania are subject to tax at the rate of 30% for corporations, and the graduated rates for individuals. In the case of gains arising due to the disposal of an interest in land and/or buildings situated within Tanzania, a single installment of tax is due at the point of disposal, which is computed as 10% of the gain in the case of a resident person and 20% of the gain in the case of a non-resident person. A tax credit may be claimed, through the annual tax return, for this upfront installment amount paid.[294]

Branch profits tax of 10% is levied on the repatriated income of a domestic permanent establishment. A Tanzanian branch of a non-resident company referred to as the 'domestic

[292] *Ibid.*, PKF p. 11 and12.
[293] *Ibid.*
[294] KPMG, *Tanzania fiscal guide,* 2013/2014, p.4. available at: https://www.kpmg.com/Africa/en/KPMG-in-Africa/Documents/2014%20Fiscal%20Guides/Fiscal%20Guide%20Tanzania.pdf. (accessed on 20th March 2013).

permanent establishment' under the Income Tax Act, 2004. Repatriated profits include any profits remaining unappropriated in the accounts of the company. The domestic permanent establishment is also liable to 30% corporate income tax.[295]

iii. Uganda

In Uganda, both resident and non-resident persons are subject to tax on income arising from a source within the country. Where the gross turnover of the business of a resident taxpayer is less than 50 million Ugandan shillings, tax is payable under the presumptive tax arrangement using the rates indicated in Appendix 4 of this thesis. Such presumptive tax is a final tax on income, and no deductions are allowed.[296] Credit is allowed only for withholding tax deducted at source on the gross turnover and the provisional tax paid, if any. A small taxpayer may, however, elect not to be taxed under the presumptive tax system by giving a notice in writing to the Commissioner.[297]

For a company, it is a taxable resident for a year of income if firstly, it is incorporated under the laws of Uganda or secondly, if it has its management and control exercised in Uganda at any time during the year of income or thirdly, it carries out most of its operations in Uganda during the year of income.[298]

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[295] *Ibid.*, Sections 4(1)(a), 70(2), 74, 91(2)(a)(iii).
[296] *Ibid.*, Deloite (2012) p. 64.
[297] Income Tax Act, Chapter 340, *Section 95(2), available at: http://www.eac.int/customs/index.php?option=com_docmanandtask=doc_downloadandgid=65andItemid=106*. (Accessed November 1, 2012).
[298] *Ibid.*, Section10.

In Uganda, every corporate entity (excluding exempt entities) that has chargeable income for the year of income is subject to corporate income tax. The tax residents are subject to income tax on their world-wide income, whereas non-residents are subject to tax on income from a source in Uganda. The basic rate of corporate income tax in Uganda is 30 percent. However, mining companies are subject to a corporate income tax calculated according to a specified formula.[299] Similarly, petroleum operations are taxed in accordance with a specific tax regime contained in Part IXA of the ITA, which is based on the Production Sharing Agreements, in terms of which tax is generally levied at 30 percent of the aggregate contract share and any other credits earned by petroleum operations.[300]

Expenditure and losses incurred in the production of income are generally deductible for corporate income tax purposes. Trading losses, including capital losses, may be carried forward indefinitely. Losses on foreign-source income cannot be set off against domestic income and losses may be disallowed where there is more than a 50 percent change in corporate ownership during a 12–month period and within the two years immediately after the ownership change the company engages in new business or investment designed to reduce its tax liability. Transfer pricing regulations were introduced in July 2011, which in principle is modeled on the OECD guidelines. Capital gains are aggregated with business income and taxed at the standard corporate income tax rate of 30 percent.[301] In order to avoid double taxation, Uganda has entered into double tax treaties with Denmark, India, Italy, Mauritius, the Netherlands, Norway, South Africa, United Kingdom and Zambia.

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299 The formula is provided for in part II of the Third Schedule of the Income Tax Act Cap 340.

300 Becker C., *Uganda corporate tax system*, T*ax Planning International, European Tax Service, volume 16, number 7, July 2014, p.1. Available at:* https://www.ensafrica.com/news/Uganda-tax-system-in-a-nutshell?Id=1521&STitle=tax%20ENSight. (Accessed November 1, 2012).

301 *Ibid.*

Withholding tax is applicable on specified payments made to resident and non-resident companies. In respect of payments to resident companies, this tax is generally an advance tax.

The withholding tax rates applicable to payments to non-residents may be reduced or eliminated in terms of a double tax agreement entered into between Uganda and the recipient's country of residence. Dividends paid to resident and non-resident companies are subject to a 15 percent withholding tax, with an exemption available for resident companies controlling at least 25 percent of the voting rights of the company declaring the dividend. Interest paid to residents and non-residents is subject to a 15 percent withholding tax.

In the case of resident recipients, this is not a final tax. Interest payments on government securities are subject to a final 20 percent withholding tax. There is no withholding tax on royalty payments to resident companies, but royalties paid to non-residents are subject to final 15 percent withholding tax. Except in the case of exempt companies, management or professional fees paid to a resident company are subject to a 6 percent withholding tax on the gross amount. Payments by the government, a government institution, any government-controlled company and other person designated by the Minister exceeding UG Sh.1 million are also subject to 6 percent withholding tax. In addition, a 6 percent tax is levied on the value of imported goods, which may be set off against the final tax liability of the importer. In addition, 15 percent withholding tax applies to payments to non-residents including natural resource payments, management charges and Ugandan-sourced service contracts. Further, a 15 percent withholding tax is levied on the

repatriated income of branches. Repatriated income is calculated according to a specified formula, irrespective of whether such income has actually been repatriated.[302]

iv. Rwanda

In Rwanda, ‘residence’ is defined under Article 3 of the ITA where an individual is considered as resident in Rwanda if he or she fulfills the following conditions: has a permanent residence in Rwanda, has a habitual abode in Rwanda or is a Rwandan representing the country abroad.

Under the Act, an individual who stays in Rwanda for more than 183 days in any 12-month period, either continuously or intermittently is resident in Rwanda for the tax period in which the 12 month precedes. It further states that a person other than an individual is considered as a resident in Rwanda during a tax period if: it is a company or an association established according to Rwandese laws, has its place of effective management in Rwanda at any time during that tax period or is a Rwanda government company. The Act gives the Minister power to issue instructions specifying “a person’s permanent residence” or where the “effective place of management” is located.

Article 5 of the Act defines what a ‘permanent establishment’ is by stating that a permanent establishment means a fixed place of business (activity) through which the business of a person is wholly or partially carried on. The article further goes on to give the examples of permanent establishments to include an administrative branch, factory, workshop, mine, quarry or any other place for the exploitation of natural resources and a building site or a place where construction or assembly works are carried out. It further states that a person is considered not to have a

[302] *Ibid.*

permanent establishment if that person; firstly, uses the facilities solely for the purpose of storage or display of goods or merchandise; secondly maintains a stock of goods or merchandise belonging to that person solely for the purpose of storage or display; thirdly maintains a stock of goods or merchandise belonging to that person solely for the purpose of processing by another person; fourthly has a place of operation aimed purposely at purchasing goods or merchandise or of collecting information related to his or her business and lastly has a place of operation solely for the purpose of carrying on preparations of his or her activities and performing any other activities that make them more effective.

The Article has a proviso to the effect that where an agent except an independent person concerned acts on behalf of a person and who has capacity to make contracts in the name of that person, that person is considered as if he or she owns a permanent establishment in respect of the activities his or her agent undertakes for the person. It further provides that a person is not considered a permanent establishment if he, she or it only carries out activities through a broker, general commission agent or any other private agent in accordance with the procedures of the ordinary course of the activities of such an agent. A company that controls or is controlled by another company does not of itself constitute either company to be a permanent establishment of the other.[303]

A company is resident if it is established according to Rwandan law or if its headquarters are in Rwanda. Residents are taxed on worldwide income while nonresidents are taxed on Rwandan source income. Foreign-source income derived by residents is subject to corporation tax in the

[303] Article 5 of the Act.

same way as Rwandan-source income ie at 30%.[304] The Corporation tax is imposed on a company's total income after deduction of normal business expenses. The determination of taxable income is on the basis of accounting income adjusted for non-taxable income and for non-deductible expenses. Expenses are deductible if they are incurred wholly and exclusively in the production of income.[305]

Company tax rate in Rwanda is 30% of taxable income with some discounts for registered investors based on the number of employees and the amount of income derived from the export of goods and services. A company is considered a resident if it is established according to Rwandan law or if its headquarters are in Rwanda. The Residents are taxed on worldwide income while non-residents are taxed on Rwandan source income. Foreign-source income derived by residents is subject to corporation tax in the same way as Rwandan-source income. The Taxable income is calculated on the basis of company's total income after deduction of normal business expenses. With regards to taxation of dividends, dividends received by a Rwandan-resident company from another are exempt from corporation tax while other dividends are subject to a withholding tax of 15%. Capital gains are taxable as ordinary income at the standard rate of corporation tax of 30%. Losses may be carried forward for 5 tax periods and the carry-back of losses is not permitted. A company that transfers its assets to another company is exonerated from tax in respect of capital gains and losses realised on the participation.[306]

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[304] Price Waterhouse Coopers (PWC) Report, *Doing Business in Rwanda: Know Your Taxes, East Africa Tax Guide* 2011/2012, p. 19. Available at: https://www.pwc.com/rw/en/assets/pdf/taxguide2015-rwanda.pdf. (Accessed November 1, 2012).

[305] *Ibid.*

[306] Rwanda Revenue Authority, taxes for growth and development, p. 2. Available at: http://www.rra.gov.rw/spip.php?article566. (Accessed November 1, 2012).

A withholding tax is imposed upon dividends, interests and royalties. Dividends paid to another Rwandan company are exempt from withholding tax while dividends paid to a nonresident or an individual are subject to a 15% withholding tax unless the rate is reduced under a tax treaty. Interest paid to a nonresident is subject to a 15% withholding tax unless the rate is reduced under a tax treaty and similarly, royalties paid to a nonresident are subject to a 15% withholding tax unless the rate is reduced under a tax treaty.[307]

v. Burundi

In Burundi, corporate income tax of 30% is payable by residents while 35% is payable by non-residents. A tax credit of 37% of the amount invested in new or used assets is available to investors provided the amount invested is at least BIF100 million and the business assets are held for at least five tax periods. The investment allowance is 50% for investment in rural areas and specified activities as provided by the Investment Authority. A tax discount and exemption is available to a registered investment entity that operates in a Free Trade Zone (FTZ), and foreign companies that have their headquarters in Burundi that fulfills the requirements stipulated in the Burundian law on Investment Promotion. A corporation that fulfils such requirements is entitled exemption from corporate income tax for its 10 years of business; 15% corporate income tax from year 11 and upwards; 10% corporate income tax if the investor employs more than 100 Burundians; exemption from 15% WHT on dividends; tax-free repatriation of profits and a free transfer on purchase or sale of buildings.[308]

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[307] *Ibid.*

[308] PWC, tax summary for Burundi, p. 1. Available at: https://www.pwc.co.za/en/assets/pdf/tax-summaries/burundi_2014.pdf. (Accessed November 1, 2012).

There are no specific transfer pricing rules yet the Burundian Income Tax Law provides guidance on transfer pricing. Transactions should take place at arm's length. Interest expenses paid to related entities are non-deductible for tax purposes if the debt-to-equity ratio exceeds 30%.[309]

3.2.4. Scope of taxable income.

Corporate income tax is applicable in the EAC as provided in the respective income tax legislations of the member states. The income tax specifically targets profits or gains made by both individuals and companies in different classes of activities.[310] The taxation covers, *inter alia*, business income, rental income and investment income (including dividends interest and royalties) and, quite often, income can be "deemed".[311] The following various classes of income/profits constitute the core of the income tax pool area in the EAC Member States:

1) *Business income*

Kenya

The Kenyan ITA defines the kind of business that is taxable under the relevant provisions of the Act. A business carried out wholly in Kenya or carried out partly within Kenya and partly outside Kenya by a person considered a resident is classified under the businesses taxable under the Act. Any profits or gains accruing from such venture is deemed by the Act to have accrued in or been derived from Kenya and therefore taxable under the ITA.[312] In the event a business is a partnership, the Act under section 4(b) provides the criteria of establishing the taxable income.

The gains or profits of a particular partner in such business is held to be the sum of remuneration

[309] *Ibid.*
[310] *Ibid.,* Section 3(2)(a).
[311] *Ibid.,* Section 3(2).
[312] *Ibid.,* Section 4(a).

payable to him by the partnership together with interest on capital so payable, less interest on capital payable by him to the partnership and his share of the total income of the partnership, calculated after deducting the total of any remuneration and interest on capital payable to any partner by the partnership and after adding any interest on capital payable by any partner to the partnership.

Some Kenyan businesses engage in foreign trade where the mode of transaction is governed by the use of foreign currency. The Act is clear that any foreign exchange gains or losses accruing from a Kenyan business will be treated as trading receipts or deductible expenses. The income taxation calculation will then be calculable with reference to the date when the particular foreign asset or liability is established. In the event of a foreign exchange loss, such a loss is stated to be deferred for taxation purposes if realized in respect of a loan from a person who, alone or with up to four other persons, controls the indebted company and where the aggregate of all loans made to that company exceeds three times the sum of paid up capital and revenue reserves.[313]

The ITA outlines specific expenses allowed to be deductible in the ascertainment of total annual income from a particular business. In this regard, businesses for both residents and non-residents are given consideration. Section 15(1) provides that expenses are generally allowed only if incurred wholly and exclusively in the production of income. Such expenses are listed to include, *inter alia*; bad debts written off and doubtful debts specifically provided for subject to compliance with the guidelines issued by KRA; capital allowances[314]; legal expenses and stamp

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[313] *Ibid.,* Section 4A as analysed by Deloitte Touché, "*Income tax in East Africa*, pg 9, (June 2012). Available at: http://www.deloitte.com/assets/DcomKenya/Local%20Assets/Documents/Budget%202012/Deloitte_IncomeTax2012.pdf. (Accessed on 29th October 2012).
[314] *Ibid.,* Section 9.

duties in connection with the acquisition of a lease not exceeding 99 years; expenses incurred prior to commencement of business where these would have been deductible if incurred after the date of the commencement; capital expenditure incurred in the prevention of soil erosion by a farmer; costs of structural alterations necessary to maintain rents; loss in value of tools and utensils and agricultural land development.

Other expenses include on scientific research for business purposes or paid to approved research or educational institutions; interest paid on borrowings made to generate investment income (dividends and interest except qualifying dividends interest) but not exceeding the amount of investment income earned; mortgage interest not exceeding Kshs. 150,000 on borrowings in respect of owner-occupied houses; legal and other costs incurred in issuing shares or debentures on a securities exchange; club subscriptions paid by an employer on behalf of an employee, with effect from 1st January 2006; cash donations to charitable organisations subject to the *Income Tax (Charitable Donations) Regulations 2007*; and lastly, expenditure on the construction of a public school, hospital, road or any similar kind of social infrastructure, upon approval of the Minister.[315]

However, other expenses are disallowed from being classified as deductible costs in respect to tax calculation and subsequent deduction. Section 16 of the ITA lists the following as disallowable expenses: capital costs and losses; personal expenses-with effect from 1st January 1991 these include personal entertainment expenses, hotel and restaurant expenses except for specified exclusions, vacation expenses except for air fares on home leave for expatriates,

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[315] Section 15(2), as analysed by Deloite and Touche, "*Income Tax in East Africa,*" p. 8, (June 2012) http://www.deloitte.com/assets/DcomKenya/Local%20Assets/Documents/Budget%202012/Deloitte_IncomeTax2012.pdf. (Accessed October 29, 2012).

employee's dependants or relatives' educational fees if not taxed on the employee; income tax or tax of a similar nature paid on income; pension payments, annuity premiums and contributions to pension and provident schemes and funds, except for those allowed under clause 5.2; expenses of non-resident persons relating to certain types of income (i.e. management fees and royalties); and interest payments by a non-resident controlled company to the extent that loans made to that company exceed the greater of three times the sum of paid-up capital and revenue reserves or the sum of all loans acquired prior to 16th June 1988 and still outstanding. Under the Act, with effect from 13th June 2008, the expression 'revenue reserves' was defined to include accumulated losses.[316]

The Kenyan ITA distinguishes taxation of business income as between residents and non-residents. Both residents and non-residents are subject to income taxation under the Act whenever they carry out business. Section 18 of the Act provides the paradigms and conditions of income taxation as regards business carried out by non-residents. Section 18(1) is clear that where a non-resident person carries out of business that may include manufacturing, mining, growing and harvesting in Kenya, irrespective of whether he makes sales of the same within or outside Kenya, the respective gains and profits from the same venture would be subject to taxation. Such gains would be deemed to be accrued income from Kenya.

Similarly, where a bank or financial institution maintains assets, deposits or property acquired from its operations in Kenya, gains and profits from any of such deposits and property shall be subject to taxation as provided for by the ITA.[317] A new scenario emerges where a resident and

[316] *Ibid.*, Section 16.
[317] *Ibid.,* Section 18(2).

non-resident jointly operate a single business. Under section 18(3), profits from such business would be eligible for taxation on the premise as to the profits that would have accrued in an event the relevant transactions had been between independent persons dealing at arm's length.

The Act imposes restrictions as to deductions allowed on expenditure incurred outside Kenya by a non-resident. The tax commissioner is bestowed with the power to give considerations on the expenditures to be deducted in tax assessment. However, the Act expressly prohibits any expenditure deduction that concerns executive and general administrative expenses as well as directors' fees.[318] Further, under section 18(5), the Act prohibits any deductions during tax assessment for any payments to a non-resident by a permanent business establishment that concerns the following: interest, royalties and management/professional fees. Foreign exchange losses and gains are also given a wide berth during tax assessment where the gains or losses are a result of net assets or liabilities transactions between the permanent establishment and foreign office of the non-resident person.[319]

Tanzania

In Tanzania, employers are required to calculate and deduct tax from payments made to employees in respect of employment income. The PAYE rules set out the manner in which this is to be done, and tax tables are issued on which the appropriate deductions should be based. PAYE must be deducted on the value of all benefits in kind (including loans at favourable rates of interest) paid to an employee, in addition to that calculated on the value of cash emoluments.[320]

[318] *Ibid.*, Section 18(4).
[319] *Ibid.,* Section 18(5).
[320] *Ibid.,* Section 81 Cap 332 on the 'withholding obligation' of an employer.

A low interest loan benefit (also known as 'fringe benefit') is chargeable to withholding tax if the loans are advanced to staff at interest rates less than the statutory rate.

The applicable statutory interest rate on these loans from the year 2012 has been set at 12% per annum, compounding monthly. However, this benefit is not taxable if the loan is for a period less than 12 months and the aggregate amount of the loan and any similar loans do not exceed three months basic salary.[321] Tax on the total income of a resident and non-resident company except a company listed on the DSE is charged at the corporate rate of 30%. Tax on the income of newly-listed companies on the DSE will be charged at the corporate tax rate of 25% for the first three years of listing.[322] Tax on the income of companies listed on the exchange with at least 30% of its share capital issued to the public will be charged at a reduced corporate income tax rate of 25%. The income of a sole trader is taxed on the basis of presumptive income determined tax rates.[323] An individual's business falls under the regime of presumptive tax if income is exclusively from a source in Tanzania and does not exceed Tshs. 20,000,000 in a year.

Uganda

In Uganda, business income includes any income from carrying on a business, whether revenue or capital. Gains on disposal of business assets, or the cancellation of business debts; gross proceeds from the disposal of trading stock; the value of gifts given in the course of business relationships; interest derived from trade receivables or in the business of lending money; and income from property where the business is wholly or mainly the holding or letting of property are good examples.

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[321] *Ibid.*, PKF.
[322] *Ibid.*, First Schedule.
[323] *Ibid.*, Appendix 1 of the Schedule to the ITA.

The sources of taxable income of a company include profits and gains from any business carried on for whatever period of time. Other sources include dividends from shares in other companies, and interest from the use of the company's property. The income tax rate applicable to companies other than mining companies is 30%. The income tax rate applicable to mining companies ranges between 25% and 45%.[324] Income tax assessments for a partnership can be made either in respect of individual partners or in the partnership's name. The profits of a partnership, including a firm carrying on a trade or profession are taxable. A small business taxpayer is defined as a resident person whose gross turnover for a year of income derived upon carrying a trade or business is less than Ushs. 50 million.

The income tax payable by the taxpayer for a year of income is as follows: (i) taxation of trusts **-** the income tax rate applicable to trusts is 30% of the chargeable trust income for the year of income. A trust is exempt from income tax: (a) where income of the trust is paid directly to the beneficiary without passing through the hands of the trustee; and (b) where a trustee relies on the ground that a share or part of income to be assessed accrues or arises for the benefit of the beneficiary. (ii) Provisional tax -all persons operating businesses are required to pay provisional tax based on past trends and future projections.[325] In the case of companies, the tax should be paid in two equal installments, at 6 months and 12 months from the start of the accounting period. For the final payment of corporation tax, Form IR2C (called the final return) must be completed. In general, the taxable profits of a Ugandan branch of a foreign company are computed in the same way as those of a resident company. However, no deduction is allowed for

[324] *Ibid.*, Deloite, (2012) p. 85.
[325] *Ibid*, Section 111.

interest, royalties, management charges, or professional fees paid by a Ugandan branch to its foreign head office. Such payments by a Ugandan subsidiary to its foreign parent company are deductible in principle, although the provision relating to transactions between related persons may be invoked to restrict tax avoidance through artificial inter-company pricing practices.

Expenditure incurred by a branch outside Uganda is deductible only if adequate consideration is given. This rule applies particularly to executive and general administrative expenses, which are disallowed except to the extent that the Commissioner considers the expenditure just and reasonable. Restrictions apply also where a branch pays for services rendered by non-resident directors of a foreign company. Sales abroad, by a branch, of items that it manufactures, produces or grows in Uganda are deemed to generate income arising in Uganda. Such income is, therefore, taxable in Uganda. Although a branch does not suffer any withholding tax on remittances of profits to its head office, in contrast to a subsidiary (whose dividends to its foreign parent are subject to withholding tax), a branch pays CIT at a higher rate than a locally incorporated subsidiary.

In practice, most foreign investors prefer to set up a company in Uganda rather than a branch. All non-resident companies carrying on business in Uganda through a branch have to pay 15% tax on repatriated income for the year of income.[326] In effect, the branch repatriation tax is akin to withholding tax on dividends. It is noteworthy that withholding tax does not apply in the case of payments made to a branch of a non-resident person, which is taxed under corporation tax and by way of branch profits.

[326] *Ibid*, Deloite (2012), p. 43. See also section 82(1) ITA.

Rwanda

In Rwanda, a resident taxpayer is liable to income tax as per the tax period from all domestic source and foreign sources in accordance with Articles 3 and 4 of the ITA and on the other hand, a non-resident taxpayer is only liable to income tax which has a source in Rwanda.[327] Taxable income is composed of the following: employment income, business profits and investment income.[328] Taxable income is rounded to the nearest thousand Rwandan Francs and taxed at 0% for income between 0-360,000. Income between 360001-1,200,000 is taxed at the rate of 20% while that which is above 1,200,001 is taxed at 30%. However, a registered investment entity that operates in a free trade zone and foreign companies that have their headquarters in Rwanda that fulfill the requirements stipulated in the Rwandan law of Investment Promotion are entitled to: (a) pay corporate income tax at the rate of 0%; (b) exemption from withholding tax; and (c) tax-free repatriation of profits.

Burundi

In Burundi, the highest marginal rate on income tax levied stands at 35%. This rate is levied on all net profits received by domestic and foreign entities from Burundian sources.[329] The following institutions are exempt from corporate tax: (a) firms covered under the Investment Code; (b) agriculture and (c) livestock business. Loss-making companies are required to pay corporate tax equivalent to 1% of their turnovers. Capital income tax of 1% is also payable on dividends and equity ownership in companies. As stated at the beginning of this chapter, the income tax regime in Burundi is governed by the General Tax code. The term 'taxpayer' depends on the type of income one gets. There is no wide distinction between personal income tax and

[327] Article 9 of the Act.
[328] Article 10 of the Act.
[329] Part II of the Burundi General Tax code.

corporate income tax. There are three types of income tax bases: rental income, investment income and business income whose threshold amount is 480,000 FBU. The taxable amount is ascertained using the following procedure: (a) the real profit exactly deduced from the book-keeping system and in compliance with the generally accepted accounting rules; (b) a simplified method with a receipt and expenditure or (c) lump sum system with smaller enterprises consisting of the elements of profit appraisal carried out by the taxing authority. The regular tax-rate is 35%. Entities which deal with non-traditional goods like coffee are subject to a reduced tax of 50%.

The minimum rate of taxation is 1% of the annual turnover even in instances where an entity has suffered losses in that tax period. The standard rate is 35% on business income excluding wages. For rental income there is provided a progressive table.[330] The following enterprises enjoy a reduced rate: (a) enterprises exporting non-traditional merchandise such as coffee are taxed at 17.5% and the minimum rate of taxation is 1% of turnover figures in case of losses, (b) certain enterprises registered as exempted according to the Investment Code of 2008 are indeed exempted for the first ten years of existence. As of the 11th year, the applicable tax rate will be 15% without time limitation (c) enterprises employing more than 100 Burundians enjoy a reduced rate of 10% and (d) leasing and hire-purchase enterprises are fully exempted for 3 years and taxed at 20% for the next four years.[331]

The rates of withholding taxes on a company's distributed income are 15% on dividends for Burundi, Rwanda, Tanzania and Uganda while 12.5% applies to Kenya; 15% on interest income

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[330] This shows that Burundi adopts progressive taxation for rental income.
[331] Petersen et al, *Tax Study on Tax Harmonisation in the EAC, GTZ/EAC Report*, 2009 p.78.

for the four countries mentioned while 10% for Kenya; 15% on royalties for Burundi, Rwanda, Tanzania while 5% for Kenya and 0% for Uganda; 15% on service charge for Burundi and Rwanda and 5% for Kenya whereas 0% applies to Tanzania and Uganda respectively and 15% on rental income for Burundi, 12% for Kenya (applicable to annual rental income below Kshs. 10 million)[332];10% for Tanzania applicable to land and buildings only while 0% applies to Rwanda and Uganda.[333]

As for profit shifting, transfer pricing, thin capitalization rules and dividend stripping, no guidelines/regulations apply to Burundi. In Kenya, the Income Tax Rules on Transfer Pricing apply with effect from July 1st 2006. In Rwanda, Tanzania, and Uganda, the Armslength principle is to be applied in determination of the resale price. The thin capitalisation rules of Rwanda of Rwanda, Tanzania and Uganda allow for a limited deduction of interest on debt capital. On the other hand, regarding dividend stripping, no special regulation applies to Burundi, Kenya and Rwanda while general anti-avoidance rules applies to Tanzania and Uganda.[334]

2) ***Investment income***

Kenya

Investment income under the Kenyan ITA refers to both dividend payment as well as interest incomes accruing from being a shareholder in a particular company. Payment of dividends and interest attracts income tax as provided for by the Act. Dividends are payments made by a

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[332] See paragraph 129 of the Budget Statement For the Fiscal Year 2015/2016 (1st July – 30th June) read by Mr. Henry K. Rotich Cabinet Secretary for The National Treasury June 11, 2015; available at: www.treasury.go.ke/.../31-budget-speeches.html. (Accessed November 1, 2012).

[333] See GTZ report, *Ibid.*

[334] See GTZ report, *Ibid.*

company to its shareholders and the Act identifies different dividend payments falling under taxable income.

Generally, any dividends paid by resident companies in Kenya are considered to be the income of the year of income in which it was payable. Dividends qualifying as chargeable income include any payment distribution by a company to its shareholders, including distribution made upon voluntary winding-up, except for reimbursement of sums paid in as share capital. Distribution of profits that includes profit from asset disposition constitutes payment of dividends chargeable under the ITA. The issuance of debentures and redeemable preference shares falls under the category of dividend payment. This would only be possible where the company receives no payment from the said shareholders. The dividend arising from such a transaction has its value equaled to either nominal or redeemable value of the debentures and preference shares respectively.

However, the Act provides under section 7(1) that dividends received by a resident company from another resident company of which it controls 12.5% or more of the voting power, (such dividends) are not subject to taxation. Section 7(3) of the Kenyan ITA further provides that any dividends received by some particular financial institution or corporate are taxable under the Act. The question of non-resident of companies also plays a role in determining the scope of taxation for investment income. Any dividends received from any sources not within Kenya are considered not chargeable under the ITA.

Tanzania

In Tanzania, dividends to a company controlling 25% of shares or more are subject to a withholding tax rate of 0% for a resident company, and 10% for a non-resident company. Dividends received from a DSE listed company are liable to withholding tax at a rate of 5% of the gross dividend payable when received by both resident and non-resident persons. Dividend received from other companies is subject to tax at a withholding tax rate of 10%. Withholding tax on dividends applies to dividends with a source in Tanzania, paid by a resident person. This is a final tax where the dividend is distributed by a resident corporation or received by a resident individual from a non-resident corporation.

Rwanda

In Rwanda, income derived from investment under the Act includes any payment in cash or in kind by an individual in the form of interest, dividend, royalty or rent which has not been taxed as business income in accordance with the provisions of section 3 of Chapter II.[335] The different rates are provided as follows: Interest income is subject to a flat tax rate of 15%; [336]Dividend income is also subject to a flat tax rate of 15%;[337] and, royalty income is subject to a flat tax rate of 15%.[338]

Burundi

In Burundi, 'investment income' is income derived from corporate entities in the country such as dividends, interests and similar distributed profits. The amount to be taxed comprises the capital gain in share property as well as hidden reserves on condition that these gains have been realised.

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[335] Section 4 of the Act.
[336] Article 33 of the Act.
[337] Article 34 of the Act.
[338] Article 35 of the Act.

All liquidation proceeds are subject to taxation as well as hidden profits. The tax rate is 15%. If the investment income is distributed to another business entity then regardless of its legal status, 50% is treated by operation of law as acquired within the professional activity and taxed as business income. This is not applicable in case the profit is re-invested.

3) Rental Income

Uganda

As far as rental income tax in Uganda is concerned, the rental income of an individual is segregated from other income and is taxed at a rate of 20% of the gross rental income in excess of Ushs.1, 560,000 per year. Rental tax is a separate income tax charged on the rental income of individuals. 'Rent' is defined as any payment, including a premium or like amount, made as consideration for the use or occupation of, or the right to use or occupy, land or buildings. In effect, payment made on a lease of immovable property would be considered to be rent.[339] An individual's rental income should be segregated from other income and charged to tax as though it were a sole source of income for the taxpayer. For taxation purposes in the first instance, a rate of 20% of the gross rental income is allowed as a deduction. No other expenditure and loss is allowed against the gross rental income; as to the remaining 80% of the gross rental income, the first Ushs 1,560,000 p.a. is not taxable. Then the balance is taxed at the rate of 20%. In the case of resident companies, the rent is aggregated with other income and taxed at a corporation tax rate of 30%. Without prejudice to the provisions of a Double Taxation Agreement entered into between Uganda and another country, non-residents are taxed on rental income derived from Ugandan sources by way of a withholding tax of 15%.

[339] *Ibid.*, Deloite, (2012) Chapter 9 at p. 76.

Burundi

In Burundi, 'rental income' means all net revenue derived from rent of buildings and land in the country irrespective of the owner's residence in Burundi or elsewhere. The amount of tax payable is based on a schedule with progressive tax brackets ranging from 20-60%. The highest rate is applicable to income that exceeds Burundian Francs 3.8 million. Nevertheless, the total amount of tax paid must not exceed 35% of the total income. The law provides for a 40% deduction from the gross revenue as compensation for possible expenses.[340]

Kenya

For purposes of Kenyan income tax, rental income, premium or similar consideration is regarded as taxable income pursuant to section 3(2) (a) (iii) of the Income Tax Act. Such other consideration aforesaid include rent realized from sub-leases. All persons should pay income tax on rental income except if exempted. For instance, charitable organizations can be exempted to pay income tax on rental income pursuant to paragraph 10 of the First Schedule to the Income Tax Act. Section (2) (a) (iii) of the Income Tax Act state that income tax shall be chargeable for each year of income upon all income of a person, whether resident or non-resident, which accrue in or is derived from Kenya. Under section 6 of the Income Tax Act, gains or profits from trade or business which are taxable under the Act includes a royalty, rent, premium or similar consideration received for the use or occupation of the property.

[340] African Development Bank Group, *"Domestic Resource Mobilization for Poverty Reduction in East Africa: Lessons for Tax Policy and Administration"* (2011), http://www.afdb.org/fileadmin/uploads/afdb/Documents/Project-and-Operations/Domestic%20Resource%20Mobilisation%20Flagship%20Report.pdf, (accessed Oct. 28 2012).

Resident taxes payable are supposed to declare the gross rent income but pay tax on net income. Pursuant to section 16 of the Income Tax Act, such net income is arrived at after deducting all expenses which are 'wholly and exclusively incurred in the production of the income'. Deductible expenses in respect of rental income are covered under section 15 (1) of the Act and include repairs and maintenance, caretaker costs, legal expenses for preparation of leases, land rents and rates, insurance, agency fees, ground men etc. In certain cases, some capital expenditures are also deductible and these include costs incurred for the alternation of the premises in order to maintain the existing rent (section 15(2) (f) of the Act). Under section 15(3) (a) of the Act interest on money borrowed and used to put up rental premises is also a deductible expense. It should be noted that non-resident tax payer are not allowed to deduct any expenses heighted above from rental income. There are different rates of income tax which are dependent on whether the tax payer is a corporate or individual or is resident or non-resident for income tax purposes.

For individuals, the entire income includes net rental income is taxed at the current graduated rate, as follow:-

i) For the first KShs.121, 968………………..…10%

ii) For the next KShs. 114, 912 ………………..15%

iii) For the next KShs. 114,912………………….20%

iv) For the next KShs., 114,912………………..25%

v) For the next KShs. 466, 704………………..30%

For a resident corporate tax payer the entire taxable income including net rental income is taxable at the flat rate of 30%. For a non-resident taxpayer, there is only a 30% withholding tax on gross rent, which is the final tax. As stated above such tax payers are not allowed to deduct any expenses on gross rent income. For partnership, only a single rent declaration is submitted but individual partners will be taxed on their respective share of rental income. For the estate of a deceased landlord, the net rental income is taxable at resident corporate rate of 30%. Such tax should be paid by, and assessed on, the estate administrator or legal personal representative of the deceased.

3.2.5. Deductible expenses and allowances

Kenya

In Kenya, the losses incurred by an individual or corporate entity affect the computation of tax upon the yearly income. Under section 15(4), the Act provides that any loss in an individual's yearly income is held to be an allowable deduction and is carried forward for a period of four years. This means the amount of loss would be deductable for a further four years and can only be extended on approval by the Minister.

The Act further outlines a class of sources of income that qualifies for the deductible provision on losses. Under section 15(7(e)), the following are listed as categories of income where losses incurred are deductible for the year of income and a further four year period: rents from immovable property; employment and self-employment professional income; a wife's employment, self-employment and professional income; agricultural, pastoral, horticultural, forestry and similar activities; other business income and lastly surplus funds from registered

pension or provident funds. The ITA under the 8th Schedule and section 15 (3(f)), however, provide that any capital losses cannot be deductable or set off against trading income.

Tanzania

In Tanzania, capital allowances are granted for depreciable assets classified as follows:[341] Class I: for computers and data handling equipment; automobiles, buses and mini-buses with a seating capacity of less than 30 passengers; Lorries with a load capacity of less than seven tons; and earth moving equipment, the allowance is 37.5% as per the diminishing value method; Class II: for trucks, buses (with a seating capacity of 30 or more passengers), railroad cars, trailers, locomotives, vessels, barges, tags and other water transportation equipment, aircraft and other self propelling vehicles, plant and machinery including windmills, electric generators, specialized public utility plant and equipment, and other irrigation installations and equipment, the rate is 25% as per the diminishing value method;

Taxation under Class III is for office furniture, fixtures and equipment, and any asset not included in another class, the capital allowance rate is 12.5% as per the diminishing value method. While Class IV for natural resources exploration and production rights and assets in respect of natural resources prospecting, exploration and development expenditure, the capital allowance rate is 20% by the straight-line method. Under Class V for buildings, structures, dams, water reservoirs, fences and similar works of a permanent nature used in agriculture, livestock farming or fishing farming, the capital allowance is 20% by straight-line method. For those in Class VI including buildings, structures and similar works of a permanent nature other than those

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[341] See Classification and Pooling of Depreciable Assets in Act No.15 of 2004 (ITA) ,Section 35, Also Ss.17, 37(2)(a) ITA.

mentioned in Class V, the capital allowance rate is 5% by the straight-line method and those in Class VII for intangible assets other than those in Class IV, the rate is divided by the useful life of the asset in the pool and rounded down to the nearest half year on straight-line basis; and finally Class VIII for plant and machinery (including windmills, electric generators and distribution equipments) used in agriculture are 100% depreciable. In addition, there is an initial capital allowance of 50% of the cost of a depreciable asset in the year in which it has been purchased for each plant and machinery used in agriculture, livestock or fish farming, manufacturing process and for hotel fixtures used for providing services to tourists. A further 100% capital allowances are available to persons carrying on mining operations in respect of development and prospecting capital expenditures.

Uganda

In Uganda, domestic or private expenses such as the cost of maintaining the person's family or residence; expenses or losses of a capital nature or those recoverable under an insurance contract or indemnity; the cost of gifts to an individual, not included in the individual's gross income; income transferred to a reserve fund or capitalised; income tax payable in Uganda or in a foreign country; a fine or penalty paid to the government for the breach of any law and contribution to a retirement fund by an employee for his/her benefit or for the benefit of any other person are disallowable expenses.[342] However, with effect from 1st July 2004 henceforth, contributions made by the employer to retirement funds for the benefit of an employee constitute an allowable deduction on the employer. Other non-deductible expenses include the premium paid on the life of the person making the premium or any other person, donations in excess of 5% of chargeable

[342] *Ibid.*, Section 16: gives a list of disallowable expenses.

income and to a non-exempt organisation, alimony or allowance paid under a court order/or agreement of separation and pension payments to any person.

Noteworthy, however, is the fact that where there has been a change of 50% or more in the underlying ownership of a company, compared to its ownership in the previous year, losses cannot be deducted from the income of the new company, unless if within a period of two years after the change or until the assessed loss has been exhausted, the company continues to carry on the same business as before; and it does not engage in any new business or investment after the change designed to reduce the tax payable on the income of the new business or investment.[343]

The sixth schedule to the Act gives the classification of depreciable assets and the rates for capital allowances. Allowances are available in the form of the following: start-up costs allowance; initial allowance; industrial building allowance; mining allowance; wear and tear allowance; intangible assets and horticultural or farming allowance. The allowance is 50% of the base cost of plant and machinery where the property is located within Kampala, Entebbe, Namanve, Jinja and Njeru and 75% elsewhere in Uganda.[344] An initial allowance of 20% is also allowed on the base cost of an industrial building, other than an approved commercial building, or the extension to an existing industrial building at the time it is placed in services. There is an annual industrial building allowance of 5% on the cost of a building. An industrial building is defined in the Act as any building used wholly or partly in manufacturing operations, research

[343] *Ibid.*, Section 75.
[344] *Ibid.*, Section 28(1).

and development, mining operations, a hotel or an approved hospital or commercial building.[345] An approved commercial building includes shops and offices but excludes buildings lent out for residential purposes. The allowance is given on the building as long as it is used during the year in the production of income.

Rwanda

In Rwanda, concerning the determination of business profit, depreciation of business assets is deducted from taxable profits by the owner of those assets. Land, fine arts, antiquities, jewellery and any other assets that are not subject to wear and tear or obsolescence are not depreciated under the Act.

The rates differ significantly, for instance: buildings, equipment and plant are taxed at 5% and purchased goodwill, the cost of construction of intangible assets at 10%. The assets in the following two categories are depreciated in a pooling system on the basis of the indicated rates: (a) computers and accessories, information and communication systems, software products and data equipment: 50%; (b) all other business assets at 25%,[346] investment allowance of 40% of the invested amount in new or used assets are provided to be depreciated except for motor vehicles that carry less than eight persons but not for those exclusively used in a tourist business. Training and research expenses are also deductible under the Rwandan Act. Bad debts are only deductible under the Act if the following conditions are fulfilled: (a) if an amount corresponding to the debt was previously included in the income of the taxpayer; (b) if the debt is written off in the books of accounts of the taxpayer; and (c) if the taxpayer has taken all possible steps in pursuing

[345] *Ibid.*, Section 28(3).
[346] Article 24 of the Act.

payment and has shown concrete proofs that the debtor is insolvent.[347] Loss carried forward may be deducted from the business profit in the next five subsequent tax periods with earlier losses being deducted before later losses. Losses suffered abroad are not to be offset.[348]

Burundi

In Burundi, revenue expenditures are generally deductible. For depreciation on capital expenditures, there are no special regulations provided for by the law. The following expenditures are non-deductible: (a) income tax (b) profit distribution (c) fines and penalties (d) all expenses not necessary to run the business and (e) certain expenses of the supervisory board e.g. cost of meetings. Like in Tanzania, but unlike in Kenya, capital gains are taxable at the same rate as other profits. Other exemptions include income that is designed to be re-invested in vocational information and education and certain profit gained by agricultural enterprises including cattle breeding. Losses can be carried forward for four years and those suffered abroad cannot be offset.

3.2.6. Range of tax incentives

Kenya

The Kenyan ITA provides for tax incentives that cover Export Processing Zones (EPZs). As stated earlier, EPZs are granted a ten year tax holiday period but subject to the conditions set by the Act. The ten years of tax holiday are afforded to the firms within EPZs on conditions that they do not engage in any commercial activities.

[347] Article 28 of the Act.
[348] Article 29 of the Act.

The ITA under the Third Schedule defines personal reliefs to be the respective amount deductable by an eligible person from his respective computed tax payable. Recently, the tax relief for the period starting 2005 to 2012 was provided to be Kshs 13,944 p.a. An individual can only enjoy personal relief from a single employer especially in the event that he is multi-employed.[349] Personal relief under the Act is also afforded in the event of death of an individual or where an individual either arrives into the country or leaves the country permanently.[350] Lastly, the Act under the Third Schedule, section 31(1)(a)(vi), provides that personal reliefs extend to premiums paid for either life or health insurance which are deductible from the respective payable tax. The rate of deduction is pegged at 15% of the respective premiums or but the maximum deductible amount is fixed at Kshs 60,000 p.a. A penalty is charged in the event that such a health or insurance policy is surrendered prematurely or before it matures as the relief earlier granted is promptly repayable to the Kenya Revenue Authority.

Tanzania

On the other hand, Tanzanian law allows a 50% initial allowance for plant and machinery that is used in manufacturing processes and fixed in a factory, fish farming or for providing services to tourists and fixed in a hotel.[351] Mining allowances are still available under the new Income Tax Act, 2004. These provide for an allowance of 100%, plus, in certain cases an uplift of 15% on qualifying expenditure.[352]

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349 Kenya PAYE Rules of 2011.
350 *Ibid.,* Section 29 (2), (3) and (4).
351 *Ibid.,* Subsection 2 of the Third Schedule to Cap. 332.
352 Granted under the Income Tax Act, 1973 (repealed by Cap. 332).

Investors in the EPZs are entitled to a number of incentives including the following: access to the export credit guarantee scheme; exemption from payments of corporate tax for an initial period of ten years; exemption from payment of withholding tax on rent, dividends and interest for the first ten years; remission of customs duty, value added tax and any other tax payable on raw materials and goods of a capital nature; exemption from payment of all taxes and levies imposed by local government authorities for goods and services produced or purchased in the EPZ for a period of ten years; exemption from pre-shipment or destination inspection requirements; on site customs inspection of goods; provision of business visas at the point of entry to key technical, management, and training staff for a maximum period of two months; thereafter the requirement to obtain a residence permit applies; entitlement to automatic immigration quota of five persons; treatment of goods destined for the EPZ as transit cargo; exemption from VAT on utility and wharfage charges; and unconditional foreign exchange transferability of not more than 20% of the EPZ goods can be sold outside the Tanzanian territory though necessary permits must be obtained in that regard.

Special economic zones (SEZs) offer similar incentives to EPZs for persons wishing to export from the customs territory. However, a special category is created for persons wishing to sell within the customs territory. There is also an exemption available from withholding tax on interest on foreign sourced loans.

A resident person may claim a foreign tax credit for a year of income in respect of any foreign income tax paid by the person to the extent to which it is paid with respect to the person's taxable foreign income for the year of income. This, however, does not apply with regard to a

partnership.[353] Foreign income tax paid by a Tanzanian resident person may be credited against the income tax payable in Tanzania calculated on the basis of worldwide income if there is no existing Double Taxation Agreement between Tanzania and that foreign country. The foreign tax relief does not exceed the average rate of the general Tanzanian income tax. In addition, Tanzania has DTAs with a number of countries including Kenya, Uganda, Italy, Denmark, Finland, India, Sweden, Norway and Zambia. Kenya also has DTTs with the same countries.

Uganda

In Uganda, a resident taxpayer is entitled to a foreign tax credit for any foreign tax paid by the taxpayer in respect of income included in his gross income.[354] However, the amount of foreign tax credit should not exceed the tax payable in Uganda on the foreign income and is calculated by applying the average Ugandan tax rate to the taxpayer's net foreign income. The foreign tax credit is available even with respect to employment income from a foreign source of a resident individual.

Rwanda

If during a tax period a resident in Rwanda generates income derived from taxable activities performed abroad, an income tax payable by that resident in respect of that income is reduced by the amount of foreign tax payable on such income in accordance with Articles 3 and 4 of the ITA. The amount of foreign tax payable is substantiated by appropriate evidence such as a tax declaration, a withholding tax certificate or any other similar acceptable document.[355]

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[353] *Ibid.*, Section 77(1), (2), (3).
[354] *Ibid.*, Section 77(1).
[355] Article 6 of the Act.

Burundi

There are no 'tax free zones', as a geographical term, but there are *'zone franche'* according to the investment code. These are tax reliefs on certain conditions. The tax period is a tax year as in the other EAC countries.

3.2.7. Tax Procedures and Enforcement

Kenya

The Kenyan ITA creates a host of tax offences as well as their respective penalties. The submission of tax returns is mostly based on the facts and figures found in the books of accounts. Under section 54A (2), failure to adequately keep books of accounts to an offence that attracts a penalty of Kshs 20,000 payable to KRA. Section 72(1)(a) provides that failure to furnish a return of income attracts a penalty or charge of 5% of the normal tax after deducting the amounts already paid and withholding tax credits.

The failure to furnish a return of compensating tax also attracts a fine of 5% of the compensating tax which should have been shown for each month or on such return.[356] Where an individual, in filing his returns, omits any amount that should have been included or claims a personal relief he is not entitled to or makes incorrect statement in relation to his tax liabilities, he is guilty of an offence. Such a person is therefore charged with an additional tax not exceeding twice the tax concealed.[357] Similarly, where a person knowingly omits income, improperly claims relief or makes incorrect statements that affect his liability to tax inclusive of compensating tax is held to

[356] *Ibid.,* Section 72 (1) (c).
[357] *Ibid.,* Section 72(2).

be guilty. The penalty is provided to be double the tax concealed in addition to a fine not exceeding Kshs 200,000 or a two year imprisonment term.[358]

In the event that additional tax is charged for the offences defined by sections 72 and 72A ostensibly due to the described reasons but are primarily a result of gross negligence or disregard of the law by an authorized tax agent, the latter is held to be liable to a penalty equaling half of the additional payable tax and a further fine of more than Kshs 1,000 but not more than Kshs 50,000 with respect to each return, statement or document.[359] Section 72(c) provides for a penalty on an offence concerning installment tax payment. In case of an underestimated installment tax, a penalty of 20% is payable on the difference between the amount of installment tax payable and the installment tax actually paid multiplied by 110%. Section 72 D and 94 as well as the new Withholding Tax and PAYE Rules of Kenya provide for penalty and interest on unpaid tax. Prior to 11th June 2010, 20% of the tax remaining unpaid after the due date plus late payment interest of 2% per month (on tax unpaid plus penalty) were payable. This applies to installment tax only where it remains unpaid as at the date of self assessment.

With effect from 13th June 2008, the 2% interest shall not exceed 100% of the principal tax. From 11th June 2010 the 20% penalty has not been applicable on late payment of withholding tax and PAYE tax. In addition, the 2% interest per month has not been applicable on the 20% penalty where imposed. The penalty for late payment of withholding tax is 10% while that for PAYE tax is 25%.[360] The Commissioner has the discretionary power and right of levying penalty up to Kshs 1,500,000. Further, under section 74(B), the minimum additional tax or penalties

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[358] *Ibid.,* Section 72A and 108(1).
[359] *Ibid.,* Section 72B and 108(2).
[360] *Ibid.,* Section 72D.

levied is pegged at Kshs 10,000 for companies while individuals attract a sum of Kshs 1,000. Lastly, under section 107, any other offence with no specified penalty under the Act attracts a maximum fine of Kshs 100,000 or imprisonment term not exceeding six months.

Tanzania

In Tanzania, the Act permits incorporated businesses to alter the date on which accounts are made provided an application is made to the Commissioner of Income Tax and subject to his written approval. The default year of income is a calendar year, being the year ending 31st December.[361] A completed final return constitutes a self-assessment for payment of the relevant tax and this tax is payable on the last working day of the sixth month following the end of the year of income.[362] The self-assessment return is also due on the last working day of the sixth month following the end of the year of income. Returns are required of a person's total income for a year of income not later than six months after the end of the year of income by every person. In the case of a corporation, returns must be certified by a Certified Public Accountant (CPA) in public practice.[363]

Failure to keep adequate books of accounts or file a provisional return or file a final return is an offence punishable by law. Every taxpayer is under a duty to keep adequate books of account and to grant access thereto to the officers of the revenue authority. Failure by a withholding agent to file a return, tax evasion, making false or misleading statements, or abetting/aiding the

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[361] *Ibid.*, Section 27.
[362] *Ibid.*, Section 94.
[363] *Ibid.*, Sections 91, 92 and 93.

foregoing act/omission are among other punishable tax offences in Tanzania.[364] The final return of income is made by the taxpayer and thereafter the Commissioner makes an adjusted assessment. If no return has been filed, a jeopardy assessment may be lodged based on the Commissioner's best judgment. Within 30 days of the date of service of an assessment, an objection to disputed income may be made in a formal letter of objection.[365] Such an objection will be invalid unless accompanied or preceded by a return of income together with all supporting documents. The date of service is the date of an assessment. A taxpayer still disputing the original or amended assessment may make further appeal to the Appeals Board or Tribunal made up of laymen appointed by the Minister of Finance. Either party may appeal to the Court of Appeal against the decision of the Tribunal, but only on a question of law.[366]

Uganda

In Uganda, URA registration prior to the commencement of business operations is mandatory. Unincorporated bodies and individuals are expected to file a Preliminary Enquiry Form with the nearest URA office. For companies, the following are required, in addition:

i) Memorandum and Articles of Association;

ii) Completed Internal Revenue Company Application Form, IR (CO);

iii) Copies of vending agreement (if an already established business has been purchased); and,

iv) Names and addresses of Directors and Shareholders ;

[364] *Ibid.*, Sections 98, 99, 100, 101, 102 and103, enumerate the Various Tax Penalties and Sections 104, 105, 106, 107, 108 and 109, enumerate Tax offences.
[365] Section 12(2) Tax Revenue Appeals Act, No. 15 of 2000.
[366] *Ibid.*, Section 25 Act No. 15.

Once the above process has been completed, and upon receipt of a file number, the investor can apply for a Tax Identification Number (TIN) by completing TIN application forms. Both businesses and individuals including foreign investors, for purposes of identification of taxpayers, fill TIN request forms. For most taxpayers, a year of income runs from 1st July to 30th June annually, but a taxpayer on application is permitted to use a substituted year of income, i.e. a period of twelve months, ending on a day other than 30th June.[367]

The Commissioner of Income Tax issues assessments based on the return of income submitted by a taxpayer within five years of the date of the return. Where an assessment has been made, the Commissioner serves a notice of the assessment stating the amount of chargeable income, the tax payable, the tax already paid, if any, and the time, place and manner of objecting to the assessment. All registered companies are expected to submit a self-assessment return for the years of income ending after 15th December 2000,[368] while individuals in business will be required to file self-assessment returns with effect from periods ending on or after 30th March 2010. The taxpayer's return is to be treated as a notice of assessment served by the Commissioner on the due date for the submission of the return or on the actual day the return was furnished, whichever is later. If a taxpayer fails to submit a return when required to, or the Commissioner is not satisfied with the return submitted, an estimate of the taxpayer's chargeable income and the tax payable may be made. The Commissioner may, within three years after the service of the notice of assessment, issue an additional assessment amending a previous one.[369] However, if the reason for making the additional assessment is fraud, neglect by or on

[367] *Ibid.*, Section 39.
[368] *Ibid.*, Section 96.
[369] *Ibid.*, Section 97(1).

behalf of the taxpayer or the discovery of new information relating to the tax payable, the Commissioner may make the assessment for that year at any time.

For taxpayers under self assessment, the tax is due for payment on the date of furnishing the return of income and in any other case, assessed tax is payable within 45 days after the date of service of the notice of assessment.[370] The Commissioner may allow a taxpayer to pay the tax due by installments following an application in writing. Should the taxpayer default, however, the balance of the tax is payable immediately. Even where the tax is payable by installment, there is liability for interest on the unpaid balance of the tax due.

Every taxpayer is required to maintain accounts and records as evidence for the information contained in the return and to enable the tax payable to be determined. The records and accounts must be retained for a period of five years. The Commissioner or an authorised officer has full and free access to any premises, place, book, record or computer without prior notice. No return of income is necessary for an individual whose gross income consists exclusively of employment income derived exclusively from a single employer from which tax has been withheld and paid.

An employee whose employment income for a tax year includes a gain on disposal of a right or option to acquire shares under an employee share acquisition scheme is required to file a return of income.[371] All registered business organisations are under an obligation to send a provisional return of income to the URA for any year of income as follows: Individuals: within 3 months of the end of the year of income for which such individual makes up his or her accounts and in any

[370] *Ibid.*, Section 103.
[371] *Ibid.*, Sections 123.

other case of an individual, not later than 31st March of such year of income; Corporate bodies: within 6 months after the end of the year of income for which the body prepares the accounts and in any case not later than 30th June in such year of income. The returns are based on income of the year immediately preceding the year of income in respect of which the provisional return is made or on the last assessment which has by then become final and conclusive, whichever is greater.

A taxpayer who has income or expects to have income, which is not subject to withholding tax is liable to pay provisional tax based on the estimated income for the year. A provisional taxpayer, other an individual, pays two equal installments of provisional tax on or before the last day of the 6th and 12th month of the year of income.[372] An individual is liable to pay four equal installments of provisional tax on or before the last day of the 3rd, 6th, 9th and 12th months in the year of income. The taxpayer is allowed to amend the provisional return earlier submitted before the end of the year. Final returns are to be completed and filed at the end of the accounting period and show the taxable income earned during the year. The final accounts must accompany these returns. The due date for filing is six months after the end of the accounting period. A taxpayer is allowed to apply to the Commissioner to extend the period in which to file a final return before the due date for filing.

If the Commissioner is satisfied that the taxpayer is unable to file returns due to absence from Uganda, sickness or other reasonable cause, he may grant an extension of up to 90 days. The granting of an extension to submit the return does not change the due date for payment of tax. That is to say that there is no extension for payment of tax. A resident individual receiving

[372] *Ibid.*, Section 111.

rental income must submit a return of gross rental income for each year of income, not later than six months after the end of that year. Where a person carries on a business, and makes payments from sources within Uganda, he must submit a return of such payments within 60 days of the end of the year of payment. This does not apply with respect to employment income, interest, royalties and management fees. A partnership is required to submit a return of income for each year, at latest, 6 months after the end of the year.[373]

In terms of penalties, a fine not exceeding Ushs. 300,000 is imposed on conviction on a person who fails to submit a return or any other document within 15 days of being requested to do so.[374] A fine not exceeding Ushs 400,000 is imposed for failing to furnish the specified return or document within the time specified a directing court. A penal tax of twice the amount of tax payable for the year is imposed for failure to maintain records of income which changes to fine of not less than Ushs. 300,000 or imprisonment for a term not exceeding one year is imposed on conviction if the failure is deliberate. In the alternative, a fine of not more than Ushs. 500,000 is imposed on conviction. A penal tax of 20% of the difference between the tax on the taxpayer's original or revised provisional estimate and the tax in respect of 90% of his actual income for the year is imposed for making false or misleading statements with regard to income except where a taxpayer is in the business of agricultural, plantation or horticultural farming. In the latter case, a penal tax equal to double the difference between the tax properly payable and the tax is imposed. For a statement or omission made knowingly or recklessly, a fine on conviction of not less than Ushs. 500,000 shillings and/or imprisonment for a term of not more than one year is the penal response. A simple interest of 2% per month on the unpaid amount

[373] *Ibid.*, Section 94.
[374] Penalties are generally dealt with under sections 138-154 of the ITA.

from the due date to the date of payment is levied. A taxpayer in Uganda who is dissatisfied with a tax assessment can lodge an objection with the Commissioner of Income Tax who is required to review the assessment.

If the taxpayer is not satisfied with the review, the investor can appeal to the Tax Appeals Tribunal. The Tribunal is a specialist tax court that deals with disputes between the URA and taxpayers. Further appeals lie to the High court from the Tribunal only on points of law. If a taxpayer is dissatisfied with an assessment, he may lodge a written objection within 45 days of the service of notice of assessment stating the grounds of objection.[375] The Commissioner may, upon a written application by a taxpayer, extend the time for lodging an objection where the Commissioner is satisfied that the delay is due to absence from Uganda, sickness or other reasonable cause.

Where the Commissioner refuses to grant an extension, a taxpayer may apply to the Tribunal for a review of the decision.[376] After consideration of the objection, the Commissioner may either allow the objection in whole or in part and amend the assessment accordingly, or disallow the objection.[377] As soon as practicable after making an objection, the Commissioner shall serve the taxpayer with notice of the decision. Where the objection decision is not made within 90 days after the taxpayer lodged his objection with the Commissioner, the taxpayer may, by notice in writing to the Commissioner, elect to treat the Commissioner as having made a decision to allow the objection. Such an election is treated as a notice of an objection decision on the date the taxpayer's election was lodged with the Commissioner. A taxpayer who is dissatisfied with

[375] *Ibid.*, Section 99(1) and (2).
[376] *Ibid.*, Section 99(3) and (4).
[377] *Ibid.*, Section 99(5).

an objection decision may, within 45 days of being served with the notice, make an application to the Tax Appeals Tribunal for review of the objection appeal and should submit a copy of the application of appeal to the commissioner.

The taxpayer could also appeal directly to the High Court. Where a taxpayer has lodged a notice of objection to an assessment, the taxpayer must pay to the Commissioner either 30% of the tax in dispute or the amount of tax assessed but not in dispute, whichever is greater, pending final resolution of the objection.[378] A taxpayer may appeal to the Registrar of the High Court if he is dissatisfied with a decision of the Tribunal within 5 working days of being notified of the decision if it is on a point of law only.[379] For any objection the onus is on the taxpayer to prove the extent to which the assessment is excessive or erroneous.

Burundi

In Burundi, there is 'self assessment' and returns should be filed not later than three months after the end of a year of income. Payment of tax is done through banks. Prepayments are also present and are allowed. Returns for group members are filed separately with each member filing his or her personal returns. Additional assessments are possible within four years. There are also penalties and interest for late payments. In case sanctions are imposed, one can appeal to a special commission consisting of representatives of taxpayers and of the tax administration. The decision of the commission is not binding. A further appeal can be made to the Minister of

[378] *Ibid.*, Section 103(2).
[379] *Ibid.*, Section 102.

Finance within three months of the decision made by the commission. The decision by the Minister can still be contested by instituting a law suit in the administrative courts.[380]

3.3. Conclusion

The Member States derive significant tax revenue by way of income taxes which are either corporate or personal. The basic elements of these income tax bases whether business, rental, or investment incomes including tax rules vary greatly in many circumstances within the EAC. These differences cause distortion of trade, revenue foregone and losses, tax avoidance, undue tax competition, double taxation and administrative challenges, for instance in the computation of the corporate tax base.

The chapter has evaluated the wholistic spectrum of income tax in the EAC to exemplify general heterogeneity. It has emerged that each Member State has exploited her fiscal sovereignty to the maximum full potential ranging from legislation to practice as far corporate income taxation is concerned. As such, the harmonisation of the divergent corporate income taxes of the EAC region, as proposed by this thesis, is no mean task. Hence, the next chapter focuses on the effects of corporate income tax heterogeneity as manifest in the EAC practice.

[380] Mabushi A.J.N., *Investment Guide for Burundi*, p. 10. Available at: http://www.africalegalnetwork.com/wpcontent/uploads/2012/03/Investment-Guide-Burundi.pdf, (accessed October 28, 2012).

CHAPTER FOUR

THE EFFECTS OF HETEROGENEITY ON CORPORATE INCOME TAXATION IN THE EAC

4.1. Introduction

This chapter examines the effects of heterogeneity in national corporate income tax systems of the EAC Member States and assess whether legal reforms for harmonisation of tax law and policy are needed in order to address the negative effects of heterogeneity. As set out in chapter one, the insufficiencies in the Treaty as well as the Common Market Protocol have led to the continued application of harmful corporate income tax regimes in the EAC. The demerits of differentiation or heterogeneity in the national tax systems of countries that are, simultaneously, members of a regional bloc or "Single Market" include: tax distortions of cross-border capital and investment, reduced revenue resulting from tax competition and the ability of multinationals to take advantage of national tax differentiations by their financial planning.[381]

This chapter also considers the broader issues associated with heterogeneous corporate income tax systems including the following: harmful tax competition, discrimination and double taxation. In addition, the context of international tax aspects such as double taxation agreements (DTAs) and reliefs, anti-avoidance measures, thin capitalisation[382] rules amongst others is also

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[381] There is bound to be a high cost attributable to transfer pricing since there may be lack of comparables resulting in difficulties in benchmarking under the 'arms-length principle'. For instance, the use of intangibles, that is the knowhow, where companies are normally not willing to allow independent parties access to these intangibles which constitute business secrets.

[382] For instance, Section 16(2) of the ITA, Kenya contains provisions on thin capitalisation of foreign controlled companies. Thin capitalisation arises where a company incorporated in Kenya is controlled by a non-resident person alone or together with four or fewer other persons and the highest amount of all loans advanced to that company at anytime during the year are more than three times the sum of the revenue reserves and the issued and paid up capital of that company. Where a company is thinly capitalised, the Kenya

visualized. It is submitted that these negative effects necessitate a harmonised legislative and policy framework on, not just corporate income, but all taxation within the EAC.[383]

This chapter lastly explores the political concerns[384] surrounding the potential loss of fiscal sovereignty or piercing the sovereignty veil and control over the tax policy that would occur if the EAC Member States decided to be bound by rules at the supra-national level. A balance should therefore be struck between the legal, economic and political concerns surrounding the harmonisation of corporate income tax policy and law.

4.2. Tax Heterogeneity and its Effects Conceptualized

4.2.1 Analysis of the term 'Tax heterogeneity'

Within the context of this study, heterogeneity means the marked variance or differences in the corporate income tax profiles of the Member States of the EAC economic region. For example,

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Revenue Authority will disallow for tax part of the interest charged in proportion to the amount of debt that exceeds the prescribed ratio of debt to capital. In addition, the deductions of exchange differences are also restricted.

[383] On general tax harmonisation to overcome heterogeneity and its effects, Watkin V.G., *Taxes and Tax Harmonisation in Central America*, Cambridge Mass.: The Law School of Harvard University 1967, p. 519 has advised that *"… for all taxes the first major step towards harmonisation is standardisation of the terminology used in tax laws, the definitions of goods subject to tax, the unit equivalents upon which the taxes are calculated, etc. The standardisation of these factors is undoubtedly desirable, but the order of importance would differ from tax to tax. Even though it is a necessary condition of customs duties imposed by all members of a customs union on imports from outside - in order to avoid deflections of trade - standardisation is not a necessary condition for the general excise taxes imposed by the country of destination, which allows the member countries to employ their own independent rates without distorting intra-union trade much."*

[384] Prof. AA Eshiwani has aptly captured the interactional nexus between tax reform, of which tax harmonisation is part, and politics. He writes that *"[t]ax reform, whether for simplicity or some other reason, is a political act. Those that legislate are not the technocrats that apply the law. Their duty is to bring to the notice of politicians what needs to be done and then wait to apply what has been legislated. There is some kind of danger in this – namely that politicians are likely to misrepresent issues to the concerned public."* See Eshiwani A. A, 'A Quest for Simplicity in Individual Taxation – What are the Policy Implications?' 1 (2003) *UNLJ* 131-145, at 145. Of the complex interplay between economic and political union within the gamut of regional integration, see Omoke G.N, '*The Legal Aspects of Regional Integration as a Tool for Development: A Critical Perspective of the Challenges, Realities and Prospects of Success of the East African Community*"1 (2003) *UNLJ* 237-249, at 237.

with regard to income tax as shown in the previous chapter,[385] heterogeneity can be manifest at different levels for instance on the definition of taxable persons/bases determined as provided in the separate income tax legislations of the member states; definition and scope of taxable income which is based on business profits or gains. Other member states for instance Rwanda and Uganda do not levy capital gains tax. It was not until the year 2015 when Kenya reintroduced capital gains tax after suspending it from 1985; computation of taxable income for legal persons (individuals and corporations) which is based in disparate accounting rules applicable in different member states; diversity of tax incidences and burdens; deductibility or allowability of expenses; treatment of depreciation; exempt income; applicable tax rates; range of tax incentives which vary significantly; mode of registration of taxpayers; mode of tax assessment; treatment of non-residents; and in dispute-settlement procedures.

Tax may be levied on corporate income by reference either to the source of the income or the residence of its recipient on a permanent establishment basis. This means that the revenue authority can levy tax by reference to where the income came from, or where it went, or both.

The determinant factors include the speed of international capital movement and the opportunities for definitive identification of either where the income came from or where it was spent. The outcome may seek to achieve capital import neutrality for instance where capital is taxed at the same rate regardless of where it originates, or capital export neutrality for instance where capital is taxed at the same rate regardless of where it is used.[386] If the residence principle

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[385] See Chapter 3 as summarized in Appendix 4 to this thesis.

[386] Discussing *'obstruction to the free movement of capital' as an effect of tax heterogeneity, Chetcuti (*infra*) observes that* "one of the principles underlying the concept of the internal market is the principle of 'capital export neutrality'. Discriminatory treatment of international investment activities, as compared with purely domestic investment

is used, capital will tend to migrate to where it is most efficiently deployed. If the source of income is what matters, capital will move to wherever it is taxed most lightly. Thus, a residence basis does not require uniformity of the tax base and rates to secure efficiency in the use of capital, but the source principle does require such harmonisation. In addition and as far as the East African region is concerned, the EAC Member States tax their capital income by means of corporation tax. Applying the residence principle rigorously to corporate income would mean that they charge tax by reference to where the ultimate shareholder domiciles. However, these countries do not do this. Instead, they look at the location of the corporation which is the place of its effective management and control. The considerable problems which both the source and residence bases of capital income taxation pose are further discussed by Kay under part 4.2.6 below.

4.2.2. Tax heterogeneity in the EAC income tax statutes

As far as the local regional scene is concerned, **t**here is disparity in the definition of income tax in the five (5) EAC Member States. A sampled preview of the income-definition sections of the income tax statutes of the five countries suffices to illustrate this heterogeneity. This is clear from Section 3 of the Kenyan Income Tax Act.[387] Kenya uses the schedular as opposed to global approach to income taxation. The schedular approach provides lists of taxable incomes.[388] Thus,

activities, acts to frustrate the ideal of capital export neutrality by hindering the free movement of capital. Thus, the creation of preferences for investment in some Member States rather than others prevents capital export neutrality, whilst the diversity of tax burdens affecting businesses wishing to invest in the same member state means that 'neutrality of capital imports' is not achieved."

387 Chapter 470 of the Laws of Kenya.

388 This is a tax system used in which income levels are divided into different classifications for determining tax rates. Each income classification represents a different source of income such as business profits, capital gains, employment income, entitlements, that is taxed according to the specific provision of the Tax Act to which it applies.

taxation of income can only be based upon a strict positivist interpretation of the charging section since the *ejusdem generis* rule of statutory interpretation does not apply to tax statutes. Notwithstanding the merits of the schedular or listing approach, controversial tax bases within the ambit of section 3 of the Income Tax Act include 'deemed income', pension and Home Owners Savings plan withdrawals.[389] The same goes for the corresponding section of the Tanzania Income Tax Act.[390]

In Rwanda**,** profit and income tax rules and rates are set out in the 2005 Law (Law 16/2005) and regulations relating to the implementation of the Law by the Minister and the Commissioner General. Any resident who earns an income from domestic and foreign sources as well as non-residents who have income from a source in Rwanda are liable to pay income tax. The lower tax threshold is 360,000 RWF and the marginal tax rates are 20% and 30 % (for a taxable income of above 1.2 million RWF). Small non-farm business owners with an annual turnover of between 1.4 and 20 million RWF a year pay a presumptive tax of 4%. Farmers are exempt from taxes until they have an annual turnover of 12 million RWF a year. A withholding tax of 15% is levied on dividends, interest payments, royalties, service fees and performance payments. Contributions made by employers to the state social security fund[391] and qualifying pension fund are exempt. Non-residents who receive income from an employer not based in Rwanda are exempt from

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[389] For the technical details of (income) taxation in Kenya, see Jemima, '*Tax Overview in Kenya',* 2012 (on file with writer). For a conceptual analysis of the statutory construction of tax statutes, see WB Harvey, *Introduction to the Legal System in East Africa* (Nrb, KLB 1975/2004), p. 835.
[390] Chapter 332 of the Laws of Tanzania (Revised Edition 2006).
[391] Comparative to Kenya's National Social Security Fund (NSSF).

income tax. A withholding tax of 5% of the CIF value of imported goods for commercial use is paid to customs before the goods are released from the bonded warehouse.[392]

This indicates that there is indeed marked heterogeneity in the levying of corporate income taxes by the EAC Member States. Thus, in the overall, the pluriformity of corporate income taxes in the EAC baffles the advocate for tax harmonisation and consolidation of law and policy. As has been seen, the effects of heterogeneity are generally deleterious to the economies of the Member States of regional organisations that set out to form a single market such as the EAC. With respect to the EU,[393] McGee and Weatherill have critically noted that the differences in tax laws between different Member States may operate as a barrier to the operation of a free market.[394]

4.2.3. The inequity of income tax heterogeneity

Tax heterogeneity or pluriformity offends the equity canon of taxation.[395] Equity in international taxation has two aspects: inter-individual equity and inter-nation equity. Inter-individual equity considerations determine the proper rate of taxation on cross-border transactions.[396] Inter-nation

392 Institute of Policy Analysis and Research (IPAR), *East African Taxation Project: Rwanda Country Case Study* June 2011, p. 19. The report is available at: http://www.taxjustice.netcmsupload/pdfRwanda_Case_Study_Report.pdf. (Accessed on 12th January 2012).

393 A detailed examination of the EU and NAFTA variants of tax harmonisation form the comparative studies in Chapter 5 of this thesis.

394 McGee A., and Weatherill S., '*The Evolution of the Single Market: Harmonisation or Liberalisation'*, pp. 591-2; available at http://www.jstor.org/stable/1096490. (Accessed on 18th June 2010).

395 For a basic understanding of how equity affects taxation, see NTT Simiyu, *Taxation in Kenya* (Nrb., FIP 2008), p. 23.

396 The analysis of inter-individual equity usually proceeds in terms of horizontal and vertical equity, although some commentators have argued that the former is merely a subset of the latter. See Louis Kaplow, '*Horizontal Equity: Measures in Search of a Principle'*, 42 *National Tax Journal.* 1989, p. I43-44; Paul R. McDaniel and James R. Repetti, '*Horizontal and Vertical Equity:* The Musgrave/Kaplow Exchange', I *Fla. Tax. Rev.* 1993, pp. 607-62I; Richard A. Musgrave, '*Horizontal Equity, Once More*', 43 *National Tax Journal, 1990, p. 11.*

equity considerations determine the proper division of the tax base among countries.[397] Avi-Yonah gives the following example to illustrate the traditional inter-individual equity analysis of international taxation. In his illustration; suppose individual A earns 100 shillings in income from domestic sources while individual B earns 100 shillings in income from domestic sources and 100 shillings in income from foreign sources. Vertical equity requires taxing B more than A because B has more income, but if foreign source income is excluded, B and A will be taxed the same. Thus, under-taxation of foreign source income is inconsistent with inter-individual equity. The problem with this argument, when couched in such general terms is that it disregards the parties' abilities to respond to taxation by shifting the source of their income or profits. Suppose, for example, that A's income is interest income that he can easily shift to a foreign income source, whereas B's domestic source income is labour income that he cannot so easily move. In that case, taxing B the same as A is not problematic from an equity perspective because A can easily ensure that he pays less tax than B by shifting the source of his income (or else other people will adjust their investments so that in equilibrium the after-tax returns to A and B will be equal).[398]

4.2.4. A general overview of the impact of heterogeneity in taxation

One of the major reasons behind regional integration arrangements is to create large investment areas and enlarge markets.[399] This demands that cooperation be promoted in areas that prioritise

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[397] See, e.g., Kaufman N. H.,, *'Fairness and the Taxation of International Income'*, 29 *Law and Policy in International Business, 1998, p.* I45; Musgrave P. B.,, '*International Tax Base Division and the Multi-national Corporation*', 27 *Public Finance Journal, 1972, p.* 394; Richard A. Musgrave and Peggy B. Musgrave, '*Inter-nation Equity, in Modern Fiscal Issues'* 63, (Richard M. Bird and John G. Head eds., I972).

[398] Avi-Yonah R. S., '*Globalisation, Tax Competition, and the Fiscal Crisis of the Welfare State'*, pp. 1617-18; available at http://www.jstor.org/stable/1342445. (Accessed 18th June 2010).

[399] Ogot M., interview, conducted by the candidate on 24th July 2013 at the Ministry of East African Community, Nairobi. He emphasised the importance of regional integration as expansion of markets and

the enlargement of trade and investment opportunities within a regional arrangement. Countries in the EAC have some differences in their tax systems including the basics such as the definition of their tax base.[400] These differentials in income taxes in the EAC results in the following: revenue loss through tax planning, trade distortion through harmful tax competition, administrative challenges due to double taxation[401] and tax evasion due to lack of transparency or information exchange among the Member States.[402]

The main argument in this thesis is that the heterogeneity in corporate income taxes in the EAC has caused and continues to harm the economies of the member states. Revenue loss is one such effect. This arises in two forms, first is the actions of governments of the EAC that compete with one another to offer the lowest tax rate and the most preferential regimes in order to attract and

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creation of investment opportunities to tap into the over 150 million population comprising the EAC. See Appendix 2.

[400] Interview with Muthee G, conducted by the writer on 28th June 2013 at PWC, Nairobi. He confirmed that the EAC Member States have subtle variances in income taxes for instance in interest deductions and thin capitalisation, transfer pricing regulations, treatment of foreign taxes paid, differences in capital gains taxes and compensating/ dividend taxes, access to different Treaty networks, differences in income tax rates, differences in allowable and disallowable deductions and investment allowances etc. The upshot of these disparities, he concludes would be double taxation and increased business costs, competition disparities between similar industries in different countries, disparities in case of conducting business owing to different tax compliance and tax administrative procedures and deepening economic disparities due to the challenge of differences in taxes. See Appendix 2.

[401] To avert this problem, Ogot M., (interview) *ibid.,* opines that the revenue authorities of the various Member States should enhance information exchange, cooperation, coordination and ultimately convergence of their administrative measures. He stated that the EAC founding Member States signed an agreement on double taxation in 1997. However, Uganda did not ratify and since it was a tripartite agreement, it never took effect. He expressed dissatisfaction with the level of commitment of developed countries in implementation of DTTs ratified with Kenya as they have not reciprocated in equal measure. Indeed, double taxation places financial burden on firms with a cross-border presence and therefore hinders the realization of Common Market ideals of free movement of capital. He concludes that if not well managed, this is bound to cause future problems as EAC is set to expand to include other countries such as South Sudan, Ethiopia, DRC and Somalia. See Appendix 2.

[402] *Ibid.*

retain FDI and secondly, the actions of companies using methods of tax planning to exploit opportunities to minimize their tax payments.[403]

The existence of disparate corporate income tax systems in the EAC gives the corporations an opportunity to shop around for favourable tax regimes, and governments respond to that mobility by reducing their tax rates in the hope to preserve levels of investment. As set out in chapter one and three of this thesis, the current state of affairs at the EAC encourages harmful tax competition where the member states are at liberty to reduce their corporate income taxes without the involvement of the other member states. Therefore, as one country lowers its corporate tax rate, its neighbours and competitor countries could feel that they need to follow suit leading to a 'race to the bottom' phenomenon.[404] The existence of natural resources and untapped market has placed the EAC Member States at a vantage position to foreign investors hence the need to rethink the use of lucrative tax incentives at the expense of foregone revenue.[405] Consequently, these differences in tax laws and policies sometimes confer unfair tax competition and unequal treatment of taxpayers, goods and services in the region, which if not addressed, in the long run, distort the effective functioning of the common regional market in terms of misallocation of resources and as stated above, the 'race to the bottom' phenomenon. The harmonisation of tax policies and laws on domestic taxes is, therefore, an important aspect

[403] For an in-depth analysis of the harmonisation efforts in the EU, see Bond S., *et al, Corporate Tax Harmonisation in Europe: A Guide to the Debate,* the Institute for Fiscal Studies, May 2000 ISBN 1-873357-96-6.p. 47.
[404] Interview with Ongore V., conducted by the candidate on 16th July 2013 at KRA, (Times Towers) Nairobi. He opined that the other possible effects of differences in income taxes are lopsided investment flows (FDI) in favour of lower tax regimes, prevalence of informal cross-border trade, exacerbation of transfer pricing activities across the region, lopsided movement/ transfer of factors of production in the region etc. See Appendix 2.
[405] *Ibid.*

of macroeconomic convergence that is also one of the benchmarks to be attained for an effective functioning of the common regional market.[406]

In addition to cutting their overall tax rates, governments of the EAC have signed separate double taxation agreements with other non-EAC countries with an intention to attract investment. This type of tax competition over special regimes in the form of DTAs rather than the overall tax rate affects both the location of real economic activity and the amount of income shifting to avoid the payment of tax.

Another form of distortion occurs through tax planning. The heterogeneity in corporate income taxes as set out in chapter three gives corporations a window of opportunity to legally exploit these differences to reduce the tax payments that they would otherwise make, contributing to the revenue erosion to the economies of the member states.[407]

Another effect of the heterogeneous income tax systems in the EAC is the opportunity to minimise tax through manipulation of transfer prices. Transfer prices are the prices charged between related companies for goods or services provided. For example, if Company Y is based in a country with a relatively high corporate income tax rate, and its subsidiary, Company Z, is based in a low-tax country, their total tax bill can be reduced by lowering the prices charged for goods and services supplied by Company Y to Company Z, which shifts the group's profits to the lower-tax jurisdiction.[408]

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[406]GTZ, EAC Report, 2010, *ibid*, p.67.
[407] *Ibid.*
[408] *Ibid.*

The challenge however is that the EAC member states have not harmonised their transfer pricing rules. Indeed countries like Burundi have not formulated such rules. The rules would require the prices charged between connected companies to mimic those that would have been charged between two unconnected companies under the 'arm's length' principle. The challenge however is that there may, be no comparable market price for the item. It is hoped that greater EAC integration would allow the member states to have a comprehensive databank of commodity prices in order to deal with the problems associate the application of Arms length approach.

The corporations may also take advantage of heterogeneity in corporate tax rates to reduce tax payable through structuring of the company financing. For example if a parent company Y is based in a low-tax country, while its subsidiary, company Z, is based in a high-tax country, the financing of company Z can be arranged to make the most of this difference. If Company Z can receive a loan from company Y, the interest payments made on the loan are deductible from profits in the high-tax country, while the interest payments received by company Y are taxable at a lower tax rate, resulting in a lower total tax payment. Indeed this can lead to 'thin capitalisation', where companies are financed largely through debt rather than equity capital. The challenge again however is that the EAC has not formulated regulations to deal with this problem. It is only Kenya and Uganda that have rules on thin capitalization, the rest of the EAC member states do not have such rules.[409]

Differences in the types of deductions given against tax as set out in chapter three of this thesis can also be exploited to reduce tax payments. For example, the fact that interest payments on loans are deductible from the corporate tax base creates incentives for companies to label some

409 *Ibid.*

of their equity finance as debt, in order that payments for the finance qualify for interest deductibility. This poses a challenge since it becomes difficult to distinguish between debt and equity. Similar types of challenge is experienced with the use of other deductible items, such as royalty payments for the use of patents, management fees paid to associated companies and leasing agreements.

As noted in Chapter 3 of this thesis as well as in Appendix 4, depreciation rates given for investment spending, as well as the treatment of losses, can also vary significantly between countries. Different approaches to allocating the ownership of assets in different countries may enable an international company to claim depreciation allowances in two jurisdictions on the same underlying asset. As such, due to the disparities, a company will wherever possible want to route flows of income in order to take advantage of the highest available deductions. Indeed, studies have revealed that companies behave in ways that are consistent with tax-minimising activity. For example, Hines and Hubbard have found that foreign subsidiaries of US multinational firms are more likely to use debt finance when based in high-tax countries than when based in low-tax countries. These finding have been corroborated by Grubert, who identified that tax-motivated transfer pricing occurs as a tool of tax planning by MNCs. He concludes from the research that there is an inverse relationship between the tax rate and the tax profit, that is, the higher the tax rate, the lower the pre-tax profits reported.[410]

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[410] Grubert, Harry and Mutti, John, *Do Taxes Influence Where U.S. Corporations Invest*? National Tax Journal, Vol. 53, No. 4, December 2000, p.5. Available at SSRN: http://ssrn.com/abstract=251088. (Accessed November 1, 2012). Also see *Hines* and *Eric M. Rice*, (1994), *Fiscal Paradise: Foreign Tax Havens and American Business.* The Quarterly Journal of Economics, 109, (1), 149-182, p. 159.

The current system of corporate taxation in the EAC based on tax competition can affect several aspects of company behavior for instance how much to invest and where to locate that investment, which companies will carry out the investment and how those companies are likely to be organised. In an ideal situation, investment should be located in the area where production can be carried out at the minimum cost. However, disparities in income tax in a single market may influence locative decisions and consequently, companies are likely to locate in the country with the highest after-tax return on their investment. If differences in the amount of tax payable change a company's decision about where to locate, this could result in production being carried out in a country with higher costs but lower taxes. For example, a car company deciding where to expand could choose to locate in a low-tax country where production costs are high, because the lower tax payment more than offsets the higher cost of producing each car. Although the low tax country gains from the increased investment, resources are wasted on each car produced directly as a result of the difference in tax. On the other hand, if the tax treatment varies between investors based in different countries, a less efficient company might end up producing a product, because its investors are taxed less heavily than those of the company that could produce most cheaply. Again, because of the tax differential, a company with a higher cost of production could be the one making the investment.

Finally, the existence of five separate tax systems, revenue authorities, accounting standards and legal structures makes it difficult for multinational companies to operate on the true ideals of an EAC common market. Companies do not operate as efficiently as they would otherwise be able to which constitutes a real economic cost in addition to the compliance costs involved. It is

hoped as suggested in chapter seven of this study that with the adoption of common systems and procedures, this economic cost of compliance would be eliminated.

In support of the adoption of a harmonised EAC corporate income tax framework, studies[411] have found that levels of foreign direct investment (FDI) are sensitive to the tax rates in the country where the FDI is located. Devereux and Griffith in their study found that the decisions of US multinationals over where to locate within Europe are affected by the average effective tax rate faced, while another study into the location of investment within the US found that differences in the local (state-level) corporate income tax rates did affect where investments were located.[412]

The administrative and compliance cost associated with the maintenance of disparate corporate income tax systems pose another challenge to the integration process. For instance, the taxation of corporate income becomes administratively quite complicated when a corporation is located in more than one taxing jurisdiction.[413] National governments, in taxing a multinational firm, have established separate economic accounting for the activity of a firm in each country or even attempted transfer pricing or double taxation mechanisms. This approach creates the difficulty

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411 Slemrod J., Tax Effects on Foreign Direct Investment in the United States: Evidence from a Cross-Country Comparison, (1990) Chicago: University of Chicago Press, p. 79

412 Hines, J., Fiscal Paradise: Foreign Tax Havens and American Business, II Quarterly Journal of Economics (1994) p.149.

413 Kay has illuminatively noted that the *"harmonisation of aspects of the rate structure would mean little if there was no harmonisation of the tax base. Different countries compute taxable profits in different ways. Economists differ in their interpretation of the significance of these choices and differences. These issues pose a more fundamental question. What is it that corporation tax taxes?"* See JA Kay, 'Tax Policy: A Survey', p. 27; available at <http://www.jstor.org/stable/2233594> (accessed 18 June 2010 at 10:05 hrs). Chetcuti (*infra.*) has supported the harmonisation of corporate income taxes in the following persuasive argument: *"… at least partial harmonisation of corporate income tax [CIT]would greatly reduce the financial and practical price presently paid by companies attempting to adhere to various evolutionary and dynamic fiscal systems."*

that non-marketed intermediate goods transferred across-borders must be priced, however arbitrarily. [414]

The fact that the investors have to comply with five separate legal, accounting and administrative regimes in the determination of corporate tax payable indeed requires expertise or relevant knowledge in legal, economics and accounting matters. This undoubtedly increases the costs of compliance and administration, relative to the aspiration of the authors of the EAC common market protocol calling for establishment of an EAC single market. The costs involved in complying with five different corporate tax systems include: firstly, the issues surrounding the allocation of revenue and expenses between jurisdictions; secondly the treatment of taxes on cross-border income flows between companies, such as withholding taxes on dividends and interest and corresponding tax credits; thirdly the treatment of elements of the tax base, such as interest costs, depreciation and tax ownership of assets, and capital gains; and the interaction of systems that give some credit to individual shareholders for corporate taxes paid and those that do not.[415] As stated above some of these discrepancies that lead to increased costs of compliance might also give incentive to the corporations to engage in tax planning leading to revenue loss to the economies of the EAC member states.

The EAC should seek to find ways to prevent deductions for financing costs being given in more than one jurisdiction, for example, and to prevent a situation where two separate jurisdictions

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[414] R Gordon and JD Wilson, '*An Examination of Multijurisdictional Corporate Income Taxation under Formula Apportionment*', available at <http://www.jstor.org/stable/1914303> accessed 12 January 2013 at 06.00 hrs. The authors observe that *"In contrast, U.S. state governments, in taxing a multistate firm, have adopted one of various formulas to apportion the total profits of the firm among the various states where it does business. With formula apportionment, internal prices need not be established. This advantage is sufficiently attractive that in recent years there has been some interest in replacing separate accounting with formula apportionment when taxing multi-national firms."*

[415] *Ibid.*

treat different companies as owning the same asset. They should also formulate rules for taxing controlled foreign companies (CFCs), to reflect the amount of tax that would have been paid in the taxing country, had the company not sheltered much of its income in a low-tax country.

4.2.5. Harmful tax competition caused by heterogeneity

With regard to tax competition, its two forms include implicit competition and active competition. Implicit competition occurs when states constrain tax levels for fear of losing resources and economic activity to other states. Active competition exists when states actively compete for resources by purposefully lowering or eliminating taxes in a 'race to the bottom'. However, Rounds has forcefully argued that the absence of any type of agreement or policy to reduce tax differentials may not automatically produce tax competition. It is also interesting to note that both forms of competition (implicit and active) may lead to harmonised tax levels which beg the question, "why is policy intervention needed to promote harmonised taxes?"[416] This question is part of the core of the hypotheses of this study which aims to simultaneously make a case for both policy and legal harmonisation and consolidation.

Chetcuti, on his part, stresses the competition-distortion effect of tax heterogeneity in the following words:

> Differences in the overall tax burden of similar investors in the various [regional] Member States result in different after-tax rates of return and different pay-back periods. This clearly gives rise to a distortion of the conditions of competition and, thus, the frustration of the principles underpinning

[416] TA Rounds, '*Tax Harmonisation and Tax Competition: Contrasting Views and Policy Issues in Three Federal Countries*', pp. 92-93; available at http://www.jstor.org/stable/3330503n, (accessed on 18 June 2012). Kitty Ussher's book entitled '*The Spectre of Tax Harmonisation*', Centre for European Reform. ISBN-10: 1901229165, indirectly discusses four effects of tax heterogeneity in the comparative case of the EU. The author opines that *"the issues of taxation and competition policy are closely linked in the EU. There is a critical distinction between 'fair' differences in tax treatment, which arise from the political priorities and macroeconomic policy decisions of national governments; and 'unfair' differences, which distort competition in a prejudicial way, similar to the operation of state aid."*

> the internal market. The creation of benefits emanating from nationality or residence preserves inter-state frontiers and keeps national markets segregated.[417]

Tax competition can occur when firms are able to locate where tax rates are lowest, thereby encouraging other countries to lower their tax rates in order to retain and attract dynamic firms and able workers.[418] Tax competition makes it harder for countries to maintain higher tax rates, leading to ever-declining rates and revenues. Harmful tax practices in East Africa, include the widespread tax holidays, other zero or low effective tax rates, and a lack of publicly- available data on the extent of incentives. As a result, disparities in tax rates in the EAC have encouraged illicit trade, complicated operational systems for companies wishing to carry on business throughout the EAC and slowed down the integration process.[419]

A study of harmful taxes in the EAC[420] reveals that they do exist. This can be seen from a number of features such as zero or low effective tax rates, lack of transparency and ineffective (or total lack of) exchange of information, artificial definition of a tax base,[421] state aid and subsidies, failure to adhere to international transfer pricing guidelines, existence of secrecy

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[417] Chetcuti, J. P., '*The Process of Corporate Tax Harmonisation in the EC*', available at <http://www.cc-advocates.com/publications/.../eu-tax-harmonisation>, *(*accessed 10 June 2012).

[418] Interview with Awuonda, G. O., conducted by the Candidate on 5th August 2013 at County Hall, Nairobi. The interviewee is a legislative drafter and he participated in the drafting of the EAC Customs and Management Act, 2004.

[419] *Ibid.*

[420] Tax Justice Network Report and Action Aid Report, Tax competition in East Africa: *A race to the bottom*, 2012. p.13. Available at: www.actionaid.org/sites/files/actionaid/eac_report.pdf, (accessed on 20th June 2013).

[421] There are considerable differences in the definitions of the tax bases, the tax rates as well as schedules in the EAC which lay ground for potential harmful tax competition in the region. For instance, apart from Burundi which has a corporation tax rate of 35%, other member countries have 30% for Corporation tax. Kenya and Tanzania have reduced rates of 25% for companies which have been part of an Export Processing Zone (EPZ). In Rwanda, EPZs are not operative as yet but there are important tax exemptions granted whereas in Burundi, the Investment Code makes provision for the "Zone Franche". Although in Uganda, such incentives were abolished in 1997, the Income Tax Act has re-introduced various exemptions e.g. a ten-year tax holiday to exporters of more than 80% of their processed goods, exemption of income derived from managing education institutions and exemptions on new investments in agro-processing. This, to some extent compensates for the competitive advantage in Kenya and Tanzania.

provisions, etc. The study recognizes as pertinent the OECD recommendations concerning domestic legislation, such as on transfer pricing rules, tax rulings, foreign information reporting rules, access to banking information; concerning tax treaties such as efficient exchange of information, entitlement to Treaty benefits, clarification of domestic anti-abuse provisions, specific exclusion provisions found in treaties, coordinated enforcement regimes (joint audits) and assistance in recovery claims; and those concerning intensifying international cooperation, such as guidelines and a forum on harmful tax practices and promoting principles of good tax administration.

One significant initiative for promoting tax coordination in the EAC is the *Draft Code of Conduct against Harmful Tax Competition*, the product of a consultancy commissioned by the EAC Secretariat and GIZ. The draft code is still being discussed and is yet to be adopted by the EAC. The code is intended to set guidelines to eliminate harmful tax practices in order to ensure fair competition in the region. Positively, it is meant to freeze the current provision of tax incentives so that additional harmful incentives are not introduced. It also calls for greater transparency and exchange of information on tax exemptions among the EAC Member States, the adoption of uniform transfer pricing rules, and common Value Added Tax, income tax and excise duty regimes in the EAC countries.

In 2006, the IMF in its report argued that a coordinated approach to providing investment incentives should become a priority in the EAC and further that in order to facilitate closer regional economic integration and to avoid the damaging uncoordinated contest to attract foreign investors, the EAC members should seek a closer coordination of investment and tax policies

and the creation of an EAC-wide legal framework for foreign investment.[422] Indeed, the problem of harmful tax competition was cited by all the respondents interviewed in this study as a major effect of heterogeneity in income tax regimes of the EAC. The code on the EAC harmful tax competition and comprehensive income tax harmonisation was presented as solution to this challenge.[423]

However, there are several reasons why EAC Member States are insufficiently addressing harmful tax competition. These include the unwillingness of Member States to relinquish their fiscal sovereignty, lack of human resource capacity to analyse the impact of revenue foregone occasioned by tax incentives, lack of information and knowledge on the impact of tax incentives amongst the general populace of the Member States and lack of knowledge among government officials and businesses, for example, of the various commitments and mechanisms in the EAC intended to promote fiscal coordination.[424]

4.2.6. Double taxation and the conflict of jurisdiction effects

As the EAC member state MNCs increase their activities in another member state, the problem of taxation of operations taking place in the two countries is increased. Each country, with its own tax base and rules for imposing tax liability may claim the right to tax the same earnings

[422] IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1st December 2006, p.5.
[423] See Appendix 2.
[424] See Appendix 2 herein. Despite these studies, there is a contrary view that the so called race to the bottom theory only exists in imagination. During the interview, Ngugi. J.Z of the Kenyan Treasury faulted the TJN-A report that Kenya has lost revenue to a tune of 100b (information attributed to John Njiraini, former Deputy Commissioner and now Commissioner General KRA). He observed that revenue foregone should not be confused for revenue loss. He further explained that an empirical study had not been done to ascertain the benefits accrued to the economy due to incentive regimes available through EPZs and SEZs. He defended the programme that it was intended to complement the government efforts in opening up the rural areas that lack requisite infrastructure to unlock the optimal potential of those areas.

giving rise to double taxation. As set out in Article 5 of the EAC Treaty, the objective is to ensure fair allocation of revenue among the member states.

The data findings from the questionnaire responses reveal that indeed double taxation is one of the major problems caused by heterogeneity in income taxation regimes. The findings also showed that the failure by Uganda to ratify the Tripartite Double Taxation agreement of 1997 had impacted heavily on the future of EAC Double tax Agreement. Other reasons cited for failure to expedite the ratification of the Double Tax Agreement were fiscal sovereignty concerns and divergent policy interests of the Member States.[425] It is the argument of this thesis that such perils of heterogeneity can be overcome by comprehensive EAC income tax harmonisation.

The benefits of having a harmonised system of taxation based on the EAC model agreement is that regulations will be formulated on how to tax such companies' income only once either in the country of origin or in the company it is operating in. This will provide greater incentives for cross-border investments that, in the long run, will increase employment as well as domestic revenue. The harmonised framework will also ensure that corporation taxes will be charged only in one country, with the operating subsidiaries in other EAC countries being required to pay domestic taxes like excise and value added tax only.

Kenya, Uganda, Tanzania and Rwanda have each signed separate DTAs with a number of countries for instance Uganda is a signatory to 10 DTTs, with countries like Zambia, Mauritius, India, Netherlands and the UK. Five others are pending ratification or final negotiation. On the other hand, Tanzania has treaties with nine countries. Burundi does not have any tax treaty with

[425] See Appendix 2.

any country. It is envisaged in this study that with a harmonised double taxation systems based on an EAC model, it will make it easier to enter into new tax treaties with foreign countries in future.

On corporate income tax matters, payments of interest and royalties between associated companies of different Member States are subject to withholding taxes that effectively create situations of double taxation since the parent and the subsidiary company are taxed differently. Similarly, double taxation in transfer pricing occurs when the tax administration of one Member State unilaterally adjusts the price put by a company on a cross-border intra-group transaction, without this adjustment being offset by a corresponding adjustment in the other Member State or States concerned.

Indeed, the report by accounting firm Ernst &Young revealed a significant number of instances of double taxation arising from transfer pricing adjustments.[426] The study also identifies the area of double taxation agreements as a potential source of obstacles and distortions for cross-border economic activities within the EAC due to the differences in the terms of their negotiation, application, interpretation and enforcement. Within the EU, the double taxation agreements are based on the OECD Model particularly on the principle of equal treatment. Moreover, the lack of co-ordination in the treaty practice of Member States in relation to third countries, for example regarding limitation of treaty benefits, is liable to give rise to distortions and fragmentation of the Internal Market. The findings in this study have been corroborated by a survey undertaken in

[426] Ernst-Young Survey: *Transfer pricing 1999 Global Survey: Practices, Perceptions, and Trends for 2000 and beyond*. The survey showed indicated that 42% of all adjustments led to double taxation. See the Ruding Report on the EU Company taxation pg 301.

Sweden where the results showed that in 166 companies, 56 % of the cases had resulted in double taxation to at least some degree.[427]

Three main approaches have been identified within the EU on the approach that should be taken in order to deal with the challenge of double taxation. It is suggested in this study that the EAC should consider these proposals as it seeks to enhance its fiscal integration efforts. These are: the conclusion of a multilateral tax treaty between all EU Member States; the development of an EU Model Treaty, based on the OECD Model but taking account of the requirements of the EC Treaty, which could be used by Member States in their future tax treaty negotiations with each other and with third countries; and thirdly within the OECD framework, work on specific EU concepts (such as the definition of "residence" and "non-discrimination") culminating in a recommendation to Member States or an agreement by Member States to reflect these concepts in their relations with each other and with third countries.[428] It is proposed in the current study that with the adoption of these approaches, corporate income tax harmonisation is indeed one step toward the removal of the problem associated with double taxation. Additional benefits of harmonisation would include efficiency and effectiveness of tax administrations.

At the other end of the spectrum of this analysis, Kay[429] illustrates both the competition-distortion and conflict of jurisdiction effects of tax heterogeneity. How then is the 'competition-distortion' and 'conflict of jurisdiction' problem overcome? Double tax treaties (DTTs) give *ad hoc* relief in certain circumstances to multiple claims to tax on the same income.

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[427] *Ibid.*, Ruding Report on Company taxation, p. 286.
[428] *Ibid.*
[429] See J.A. Kay, 'Tax Policy: A Survey', p. 28; available at http://www.jstor.org/stable/2233594. (Accessed on 20th June 2012).

The 'arm's length' principle[430] is invoked to impute prices for transactions which, although internal to the company, nevertheless cross international borders.[431] But where, as is increasingly the case, the transaction is in specific factors under conditions of bilateral monopoly, this arm's length principle can provide no guide, since there are no markets in the factors concerned. In an integrated economy, such as the United States, an agreed apportionment formula and the adoption of a tax base which is more or less common to all states is the only way in which multiple local corporation tax jurisdictions can be made to operate. Attempts to extend this principle internationally have encountered vigorous resistance and as a result, arguments over unitary taxation have been a major diplomatic issue between Europe and the United States since the 1980s.[432]

However, in general, jurisdictional issues are much less important for local taxation within a single state than they are internationally. The fundamental difference between the relations between sovereign states in the international economy, and between local authorities in the integrating region, is that in the second case there is a single overriding national government which can determine conflicting jurisdictional claims.[433]

Section 18(3) of the Kenyan ITA requires business carried on between a non-resident and a related Kenyan resident to be conducted at arm's length and the provision gives the tax Commissioner the power to adjust the profits of the Kenyan resident from that business to the

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[430] *Ibid.*
[431] During the interview, Ongore, *ibid.*, stated that double taxation generally results in higher costs of doing business across the borders where tax reliefs are not available and that the taxpayers will generally incur a greater cost for doing business. He also stated that the absence of EAC Double Tax Treaty presents a continued challenge to future administrative integration. Uganda failed to ratify the 1997 agreement.
[432] *Ibid.*, p. 56.
[433] *Ibid.*

profits that would be expected to have accrued to it had the business been conducted between independent persons dealing at arm's length. *The Income Tax (Transfer Pricing) Rules, 2006*,[434] published under section 18(8) of the ITA with an effective date of 1st July 2006, provide guidance on the determination of arm's-length prices.

Under section 18(3) of the Act and the TP rules, persons or enterprises are related if either of them participates directly or indirectly in the management, control or capital of the other or if a third person participates directly or indirectly in the management, control or capital of both. Control is not specifically defined in this section, but is elsewhere defined in the Act to mean the holding of shares with voting power of 25% or more.[435] In practice, this definition has been adopted for transfer pricing purposes. The definition of 'related parties' has been expanded to include relationships with natural persons, and the section has been amended to ensure that it is not interpreted only in an anti-avoidance context.

Prior to the amendment, there may have been an untested legal interpretation that the KRA could make TP adjustments only if it could prove a tax avoidance motive. The TP Rules state that they apply to transactions between branches and their head office or other related branches. Doubts as to the legitimacy of this provision have arisen in light of the restrictive application of section 18(3) to "resident persons", which excludes branches. Notwithstanding this, the widely held view is that it is prudent for branches to apply the TP rules in their dealings with the head office

[434] Legal Notice No. 67 of 2006.
[435] Section 26 of the Income Tax Act.

4.2.7. CIT Heterogeneity as a fiscal barrier

Governments have responded to the problem of the absence of an over-reaching supra-national tax authority by erecting fiscal barriers around their frontiers. From an international trade law perspective, such fiscal barriers hinder competitive trade. Indeed, the co-existence of 5 company tax systems in one internal market introduces compliance cost which tends to increase the administrative cost for tax administrations which in itself constitutes a barrier to trade. It also opens considerable room for tax evasion and tax avoidance. For as long as commodity taxes have been imposed, excise officers have battled with smugglers to ensure that the tax due is properly collected.

In the 21st century, the smuggling of capital has become has become more rampant than the smuggling of goods. As the world economy becomes more integrated, the ability of governments to maintain such barriers is eroded since exchange controls on capital movements have largely collapsed in the face of the growth of an international capital market. At the same time, those fiscal barriers which remain become more irksome and more costly, and institutions such as the EU and EAC which are concerned to promote economic integration between Member States have sought to remove or reduce them.[436] Harmonisation of tax laws and policies is therefore seen as a step towards attainment of full economic integration and realization of the benefits of a single EAC market.

[436] The analysis of the data from the questionnaire responses in Appendix 2 of this study reveals that the loopholes created by income tax heterogeneity in the EAC has caused numerous challenges on the functioning of the Common Market. These challenges include, double taxation, harmful tax competition, misallocation of resources, revenue loss, tax avoidance, tax discrimination and administrative costs of compliance.

4.2.8. Trade distortion and Misallocation of resources

The existence of heterogeneous CIT systems encourages harmful tax competition which causes negative influence on investment decision making.[437] For example, a member state may grant an investment tax credit for business building and hotels and thus hope to attract this type of investment from the MNCs. The resultant effect of such actions is that transactions and investment between countries are potentially entered into for non-economic reasons but on tax considerations.

A consequence of fiscal disharmony is that optimum allocation of resources within the regional body cannot be achieved. This is because as stated, corporate location or capital investment strategies are not based on purely economic efficiency such as relative labour and production costs but are ultimately influenced by tax considerations. Indeed, the economic inefficiency that results from such distortions reduces capital productivity, impairs the ability of nations to be internationally competitive and therefore lowering the level of total output and standards of living of the citizens of a member state.[438] The principle of fiscal neutrality which ingrains that of locational neutrality and which harmonisation seeks to uphold, prevents buyers and sellers, in otherwise efficient markets, to take different courses of action for tax reasons alone. It also ensures that differences in the tax systems do not interfere with efficiency in production and consumer choice in the regional market.[439]

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[437] See Appendix 2.

[438] Arthur Cockfield, "*Tax Integration under NAFTA: Resolving the Conflict between Economic and Sovereignty Interests*" (1998) 34 *Stan. J. Int'l L*, p. 4.

[439] Chetcuti, *ibid.*, p.112.

4.2.9. Tax evasion and avoidance

While the fear that governments will lose revenues through tax competition may not be clear, there is little doubt that tax authorities do lose revenue as a result of illegal tax evasion. MNCs exploit differences in corporate taxes among the member states in order to safeguard their own economic welfare. They may attempt to reduce or avoid the payment of taxes through tax planning measures such as setting up of subsidiaries in the low tax jurisdictions in order to divert income to such subsidiaries. They may also use financial strategies to reduce taxes through seeking financing for corporate activities in countries that impose high taxes and allow interest deductibility.[440]

Where there are marked differences between the tax regimes on mobile goods and services in neighbouring countries, there is a clear 'incentive' to trade across-borders in ways that reduce tax payments through tax planning. Indeed the findings from the questionnaire responses as analysed in Appendix 2 of this study reveal that tax planning, tax evasion and tax avoidance continue to thrive in the EAC through the medium of income tax heterogeneity.[441] Thus, harmonising income taxes across-borders would go a long way towards eliminating this disincentive to trade since there is a powerful incentive for people to engage in cross-border arbitrage when the taxes systems in a single market are disparate.

Comparatively-speaking, the EU's single market programme increased the incentive by allowing individuals to import legally large quantities of goods across the internal EU borders, without completing any paperwork or paying duty. Although such goods must, in theory, be for personal

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[440] Arthur Cockfield, "*Tax Integration under NAFTA: Resolving the Conflict between Economic and Sovereignty Interests*" (1998) 34 *Stan. J. Int'l L*, p.3.
[441] See Appendix 2.

use only, this restriction has proved nigh-impossible to enforce. It is both simple and lucrative to buy off-the-shelf in low-tax regimes and sell illegally off the back of a lorry, without paying tax, that is, in high-tax regimes.[442]

4.2.10. Revenue loss and effects on the economic welfare of the EAC

In a bid to attract FDI inflows in the EAC region, the Member States have resorted to providing a wide range of tax incentives to businesses. Such incentives include corporate income tax holidays, notably in export processing zones (EPZs), and reductions from the standard rate for taxes such as import duties. Recent studies, however, show that these incentives result in large revenue losses for governments, promote harmful tax competition in the region, and do not necessarily constitute a major factor in attracting FDI inflows.[443] The Tax Justice Network-Africa (TJN-A) report indicates that in total, Kenya, Uganda, Tanzania and Rwanda are losing up to US$2.8 billion a year from all tax incentives and exemptions.[444] The report shows that Kenya alone is losing over Kshs. 100 billion (US$ 1.1 billion) a year from all tax incentives and exemptions.[445] This was estimated to amount to 3.1% of GDP. Government figures show that losses from trade-related tax incentives, including those provided in the EPZs, were at least Kshs. 12 billion (US$ 133 million) in 2007/08. Other figures, from the EAC Secretariat, show

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[442] Ussher K., *ibid.*, p. 28. Comparatively speaking on the 'lost revenue' effect of tax heterogeneity, Chetcuti, ibid., p. 66, has written thus of the EU experience: *"Increased opportunities for tax planning, avoidance and evasion arise where differences exist in the national tax systems of the various Member States. These activities tend to lead to considerable losses of revenue so that revenue authorities have to make good the lost revenue by digging their hands deeper in the pockets of other taxpayers. Arguably, the harmonisation of corporate income tax (CIT) could diminish the incidence of such activities as the application of non-arm's length transfer prices within European groups of companies. This might contribute to the recent tendency to lower the tax burden with the aim of enhancing the position of European businesses in the world market and promote commercial activity and economic growth."*

[443] Tax Justice Network Africa and Action Aid International Report 2012, *Tax competition in East Africa: a race to the bottom,* p. 4.

[444] *Ibid.*

[445] The report by TJN-A attributes the statistics to the remarks by Mr. John Njiraini, former Deputy Commissioner KRA and now Commissioner General. The information was echoed by the then Economic Secretary of the Kenyan Treasury, Mr. Geoffrey Mwau.

that Kenya lost US$ 566.9 million in 2008 from import duty exemptions in the same period.[446] These findings are corroborated by the empirical findings from questionnaire responses herein where interviewees cited revenue loss and harmful tax competition as the direct effects the heterogeneity in income taxation regimes of the EAC. [447]

In Kenya, the more prominent incentives concern the EPZs which give companies a 10-year corporate income tax holiday and exemptions from import duties on machinery, raw materials and inputs, and from stamp duty. In Tanzania's EPZs and Special Economic Zones (SEZs), companies are exempted for the first 10 years from paying CIT and all taxes and levies imposed by local government authorities. They are also granted import duty exemptions on raw materials and capital goods imported for manufacturing goods. Mining companies are given special treatment, and pay zero import duty on fuel. In addition, they are exempt from Capital Gains Tax (CGT) and pay a reduced rate of stamp duty.

On the other hand, Uganda provides incentives such as import duty and stamp duty exemptions for companies that are export oriented. The country also offers corporate income tax holidays for certain categories of businesses, such as companies engaged in agro-processing and those exporting finished consumer and capital goods. Other reports, however, indicate that investment incentives and, particularly, tax incentives are not an important factor in attracting foreign investment. More important factors are good quality infrastructure, low administrative costs of setting up and running businesses, political stability and a predictable macroeconomic policy.[448] A 2010 study found that the main reasons for firms investing in Kenya are access to the local and

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[446] *Ibid.*

[447] See Appendix 2.

[448] IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1st December 2006, p.5.

regional market, political and economic stability, and favourable bilateral trade agreements. Fiscal concessions offered by EPZs were mentioned by only 1% of the businesses sampled by the study. Despite its generous tax incentives, Kenya has in recent years attracted very low levels of FDI, largely due to political violence and instability witnessed in 2007/8 period. The IMF report notes that the introduction of EPZs in Tanzania in 2002 has similarly, not resulted in a noticeable pick up in foreign investment.[449]

Uganda has continued to attract higher levels of FDI than Kenya or Tanzania, which provide much more generous investment incentives. Uganda's attraction of more FDI than its neighbours is unlikely to be due to its use of tax incentives.[450] Unless East African governments deepen and speed up their commitment to reduce tax incentives, the region may experience increasing tax competition and a "race to the bottom." Tax competition makes it harder for countries to maintain higher tax rates, leading to ever-declining rates and revenues. Disparities in tax rates in the EAC have also encouraged illicit trade, complicated operational systems for companies wishing to carry on business throughout the EAC, and slowed down the integration process.[451]

One significant initiative for promoting tax coordination in the EAC is the *Draft Code of Conduct against Harmful Tax Competition*, the product of a consultancy commissioned by the EAC Secretariat and GIZ, the German government development agency. The draft code is still being discussed and is yet to be adopted by the EAC. Positively, it is meant to "freeze" the current provision of tax incentives so that additional harmful incentives are not introduced. Less positively, the draft code proposes only weak enforcement mechanisms and emphasises tax

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[449] *Ibid.*

[450] IMF, *Seventh Review under the Policy Support Instrument*, 18 May 2010, p. 20.

[451] TJN-A Report, *Ibid.* p. 26.

harmonisation more than regional cooperation. Also, it does not oblige EAC states to undertake tax expenditure analyses to better assess the efficacy of tax incentives in realising the region's development objectives. The general weakness of these steps suggests that the EAC Member States may be reluctant to surrender their tax sovereignty, despite the mutual gains that could be realised.[452]The income tax harmonisation envisaged in this study entails legislative, policy and institutional reforms at the national and supranational stage. It is suggested that a common EAC income tax authority be established as the ultimate body on enforcement of legislative and policy reforms on harmonisation.

4.2.11. Fiscal sovereignty and domestic policy concerns

As the member states grapple with an appropriate harmonisation route to take, political environment that surrounds integration should be considered. This is so especially because politics will largely determine the commitments to the integration process. While the drive towards tax harmonisation is the desire to eliminate tax distortion within the EAC single market, there is likely to be tensions due to the potential loss of sovereign control over domestic tax policy. The need to preserve fiscal sovereignty may be the reason for non implementation of harmonisation initiatives. In fact the empirical study findings from questionnaire responses show that the issue of autonomy on fiscal sovereignty and competing fiscal policy matters present a major hindrance on the EAC harmonisation initiatives.[453] However, the Treaty provisions already portray an image of an EAC deal that supports harmonisation and the loss of autonomy. This can be inferred from customs harmonisation that has seen the implementation of Common External Tariffs. It is also supported by the Treaty, the EA Customs Union Protocol and the EAC

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[452] *Ibid.*
[453] See Appendix 2.

Customs and Management Act, 2004. The challenge however remains that the currents system of taxation of income in the EAC remains unchanged despite the Treaty and Common Market Protocol provisions requiring a coordinated approach. This is inconsistent with the drive towards removal of trade distorting taxes. The reason for rigidity lies with the unique place the tax measures occupy in fiscal policy since tax is seen as an important policy tool to serve the distinct needs of the citizens of each member state. Within the context of this study, fiscal integration in general and corporate income tax harmonisation in particular involves the member states agreeing to adopt similar tax systems to avoid the trade distorting ones. This would require the member states to repeal their domestic tax legislation and be bound by the rules set at the EAC level. The EAC member states should in the long run consider their collective welfare arising from a harmonised framework in order to address the hostility to proposals for reform which would impose significant constraints on domestic tax policy. The above analysis shows the negative effects of a heterogeneous tax system and the need for harmonisation. Tax education will therefore play a pivotal role in sensitizing the citizens of the EAC on the effects of income tax heterogeneity and the justifications for harmonisation. The income tax harmonisation envisaged in this study entails legislative, policy and institutional reforms at the national and supranational stage. It is suggested that a common EAC income tax authority be established as the ultimate body on enforcement of the EAC legislative and policy reforms on harmonisation and a substantive legislative structure be attempted or passed.

4.3. Conclusion

Most of the above discussion has been pursued using the fiscal-economic, rather than legal, approach. Therefore, perhaps, the discussion might be better understood by an economist rather

than a lawyer. But, since the parameters of tax heterogeneity and its anti-thesis, tax harmonisation, are a concern to the tax lawyer, especially since the Treaty provisions and its attendant Protocols should be implemented through legal instruments, attempts have been made to give the chapter legal flavour.

This chapter has generally tackled the effects of heterogeneity in income taxation with some focus on corporate income tax. The adverse effects of tax heterogeneity or differentiation particularly within the EAC region have been weighed against its counter-arguments such as loss of national fiscal sovereignty. These findings have been corroborated by the empirical data presented in Appendix 2 herein. Overall, it has emerged that a case can be made for income tax harmonisation due to the inherent adverse effects of corporate income tax heterogeneity. This proposal is the subject matter of the subsequent Chapters Five and Six.

CHAPTER FIVE

A CASE FOR EAC (CORPORATE) INCOME TAX HARMONISATION AND COMPARATIVE STUDY

5.1. Introduction

The aim of this chapter is to make a case for harmonisation of CIT against the backdrop of the effects of heterogeneity discussed in the Chapter Four herein. The issues to be considered for harmonisation within the CIT systems of the EAC Member States include harmonisation of policies, laws and the institutional framework. The chapter will also take into account the historical development of integration and/or cooperation within both the EU and EAC while evaluating the latter's second attempt at harmonisation of (corporate) income tax. To justify the need for harmonisation, the chapter utilizes comparative studies of the EU and NAFTA, especially the former. The NAFTA experience is useful in providing insight on how policy coordination can help in resolving the sovereign concerns of the EAC member states. The chapter culminates with a proposal for the EAC CCCTB following the EU's near-successful attempt. The argument of this study is that the CCCTB will ensure closer fiscal integration between the EAC Member States and reduce the adverse effects of CIT heterogeneity.

This chapter acknowledges that with regard to the EU, a number of recent developments in Europe have focused attention on the need for countries to seek further tax integration in order to reduce the problems caused by heterogeneity in the collision-prone interaction of their divergent tax systems.[454] One of such forms of integration within the context of this thesis is 'tax harmonisation' which is achieved when the affected countries negotiate an agreement to adopt

[454] Some of the negative effects of tax heterogeneity including high administrative and compliance costs were seen in Chapter Four of this thesis.

common tax measures such as the same statutory base, tax procedures or tax rate for company corporate income taxes (CITs).

In addition, the chapter comparatively overviews the potential economic benefits derived from tax harmonisation initiatives, including a reduction in tax distortions and lowered tax competition. The main costs, from the perspective of countries considering harmonisation, is the loss of sovereign control over domestic tax policy that occurs when a country agrees to be bound by a set of tax rules at the supranational level. Tension thus exists between seeking economic benefits under tax harmonisation and the resulting loss of sovereign control over tax policy. This chapter examines how the EU and NAFTA regional organisations have managed to resolve this tension. In trying to overcome the tensions inherent in tax harmonisation initiatives, these twin experiences offer invaluable lessons to the EAC in her quest to eliminate heterogeneity in taxation, especially in corporate income taxation.

5.2. Background issues towards CIT harmonisation

5.2.1. Overview

The recommended tax reforms is intended to focus on the following key aspects *inter alia*: review and harmonisation of all tax incentive schemes in the CIT system, especially EPZs and SEZs; harmonisation of initial capital allowances; harmonise the treatment of losses (carry forward) including foreign losses; harmonisation of the withholding taxes on dividends, interest payments, royalties and service fees; enactment of EAC laws and the repeal of national laws and harmonisation of rules on transfer pricing (TP) and thin capitalisation in addition to general anti-avoidance clauses regarding profit shifting; enforcement of the EAC Model Convention for

DTAs with third party countries; and, creation of an EAC institutional framework to oversee the implementation and enforcement of the intended reforms.[455]

Due to the fact that the focus of income tax analysis in the context of this study is laid on corporate taxation mainly due to investment and revenue depth reasons, the CIT is a tax directed to production and trade activities, which substantially contributes to the GNP of a country or region. Additionally, at least medium-sized and larger companies are usually involved in international competition so that a neutral CIT is the best pre-requisite to prevent competitive distortions or to avoid harmful tax competition.[456]

Each of the EAC Member State has implemented the integrated income and profit tax system, which principally corresponds to the modern forms of income taxation proposed in the international sphere.[457] The laws apply to single proprietors, business partnerships and corporate bodies. The complexity of tax laws and the many different specific schedules and exemptions are a clear indication that these laws are presumably not neutral regarding the legal status, investment, financing, profit distribution and inflation.[458] Therefore, national tax reforms have to be discussed to liberate the income tax and especially CIT from steering mechanisms, which very likely have created or will create massive competitive distortion within the recently

[455] Petersen *et al*, '*Tax Systems and Tax Harmonisation in the East African Community (EAC)*, 2009. Available at: http://www.eacgermany.org/index.php/documents-and-studies/cat_view/39-tax-harmonisation-in-the-eac/43-study-on-tax-systems-in-the-eac. . (Accessed November 1, 2012).
For overall tax harmonisation within the EAC, see Vayani S O., '*Essence of Tax Harmonisation within the East African Community',* The East African Lawyer Issue No. 15 (March 2009), pp. 16-17.

[456] Petersen *et al*, ibid., p.78.

[457] *Ibid.* The structures and single elements are, however, far away from being modern and efficient. For a simple and efficient income and profit tax model see Petersen (2004) and Petersen/Rose (2004), which in the meantime has been implemented in a district of Bosnia-Herzegovina in connection with a GTZ advisory mission. A similar approach has been developed for Liechtenstein where the draft law is currently in parliamentary discussion.

[458] For more details on an efficient *PIT* and *CIT* system see Petersen, *ibid.,* pp.76-91.

established Common Market. The national CIT systems should guarantee equity and equality regarding cross-border transactions, but this process signifies the ideal when full fiscal harmonisation has been implemented. As long as such fundamental reforms are not carried out, the most serious elements of harmful tax competition will beset the EAC.

Granted, the collisions within the income tax systems of EAC Member States are caused by the intentions of the single member countries to broaden their national tax bases. The dominating method for national states is to define their national income and profit tax base in applying the 'residence principle' regarding the personal tax liability and the 'worldwide income principle' for the factual tax liability (income generated in other countries). If the source countries also tax the same base, double taxation takes place. In this instance, three collision-avoidance methods can be implemented: in case of unilateral measures, the nation-state can implement the tax credit method so that in case the income is taxed in the source State, the tax is meant to offset the national tax liability. If the national tax rate applied is higher than the foreign tax rate, an additional tax burden results.

In the opposite scenario, a tax refund would be necessary. With this method, the source State gets the revenue partly or even totally. A refund would reduce the tax revenue in the residence state, which makes the implementation of such a method politically less attractive. The other two collision-avoiding methods (tax exemption in the source State; source principle for personal taxes and the territoriality principle for the factual tax liability; are also possible but they go against the intention, especially, of synthetically-orientated income tax systems to tax the total income of national taxpayers. The intention to tax the total income (inland and worldwide) is

closely connected with the directly progressive tax schedules (with increasing marginal rates) due to equity argumentations. Because progression (via increasing marginal tax rates) is losing relevance especially regarding company taxation, in the meantime many national tax laws have moved from a synthetic to a dual or even more scheduled system. For the EAC, currently none of the three approaches is chosen but instead double taxation-avoiding details are negotiated.[459] The most notable challenge obtains when no treaty framework has been negotiated. This is further complicated by the haphazard agreements on DTTs without involving the other member states in a regional bloc.

The EAC Member States have applied the residence principle and the worldwide income principle with the exception of Kenya where the source principle is combined with the territoriality principle. The mix and the missing systematic provisions within the national tax laws against double taxation create many practical problems because in no member country is the assignment of the income elements to domestic and foreign income sufficiently done. Consequently, the assignment to the own or foreign fiscal sovereignty is more or less arbitrary.[460]

As seen in the previous chapter and as summarized in Appendix 4, the tax rates regarding company taxation are almost harmonised on a 30% tax rate with the exception of Burundi, which applies a 35% tax rate. Again with the exception of Burundi, the company tax rates correspond to the highest marginal rates in PIT so that at least a certain equal treatment of companies with a different legal status seems to be guaranteed. The determination of profitable income is partly based on the International Financial Reporting Standards (IFRS) or on comprehensive

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[459] GTZ Report, *Ibid.* The costs and benefits (in form of national revenue losses or gains) of the different methods can be estimated in simulation approaches if the necessary information is raised.
[460] *Ibid.*

international accounting standards. In the large businesses, the profit definitions follow the International Accounting Standards (IAS).

These standards are supplemented by national regulations especially in case of depreciation rules. Usually the tax authorities accept the profit as testified by a Certified Public Accountant (CPA). Business expenses (i.e. operating expenditures) like financing costs, maintenance expenses and advertising costs should generally be fully deductible. In almost each CIT cost component can be found expenses, which are not deductible (e.g. gifts to business associates, bribes and fines). Large differences in tax rates or deductibility range of business expenses might also cause competitive disadvantages but such are not significantly observable within the EAC.[461]

Much more problems are involved with the tax incentives provided by the single member laws. Tax incentives and state aid are often connected with discrimination of foreign suppliers and have to be critically analysed regarding the harmonisation necessities. Here, the EPZ tax holidays, high special depreciations, and additional initial capital allowances have to be taken into consideration. Kenya and Tanzania have implemented the EPZ idea. In Rwanda, EPZs are not yet operating, but important tax exemptions are granted, and in Burundi the "Zone franche" exist. Uganda abolished such incentives in 1997 but the IMF[462] noticed that efforts are made to reintroduce such incentives to compensate for the competitive advantages of the neighbouring countries. However, when all the EAC Member States have introduced such questionable measures, the incentives and their competitive advantages will disappear so that the only

[461] *Ibid.*
[462] See the IMF Country Report 06/353, 1, December 2006.

negative impact of such construction is the existence of privileges for some companies and substantial revenue losses.[463]

According to official statements of Kenya's Ministry of Finance, the relevance of EPZs is declining (that is, appetite for EPZs is going down). The legal regulation that 80% of the products have to be exported and 20% should be supplied in the domestic markets has become more and more difficult to achieve, especially since China and Korea have entered the textile markets in the former importing countries. The time horizon is another problem: In EPZ the tax-free status is guaranteed for 10 years; afterwards a reduced tax rate has to be paid. Many companies expect the government to extend the tax holidays and they threaten to move out of the country – the usual attempted extortion as a consequence of misguided incentives. Other tricks include winding up upon the expiry of incentive period and re-appearing under a different entity with a view to obtain renewed full package of incentives. The Ministry now considers introducing Special Economic Zones (SEZs) following the example of Singapore and Tanzania.[464] EPZs and other special incentives extensively distort fair competition in a Common Market. They are contradictory to economic integration and cause unfair tax and state aid competition – with the only result that all the concerned parties become losers in a foot race for the ever- increasing incentives and decreasing tax revenue.[465]

Therefore, it is necessary to review and harmonise the incentive schemes and, in a medium-term perspective, abolish all EPZs, SEZs and similar arrangements in the transitional phase of the

[463] Therefore, it is much better to implement efficient PIT and CIT systems as suggested by Petersen (2009) without specific incentives for a few employees as well as the companies but with simplicity, transparency, fair rules and adequate tax rates for all.
[464] Critics have termed this move as coming out of the frying pan and jumping into the fire.
[465] *Ibid.*, EAC/GTZ Report 2009.

establishment of a Common Market. The same is true regarding special depreciations and initial capital allowances. The high depreciation rates for mining in Tanzania (100%), Uganda (75%), and Kenya (40%) are questionable. Beyond that, in Kenya special depreciations exist for machinery and hotels (100%) whereas in Tanzania and Uganda the rates are between 20% and 50%. However, almost all depreciation allowances exceeding 50% in the first year have elements of tax incentives, which should be abolished instead of harmonising them on a comparatively high level. The latter would lead to a further eroded company tax base with all the negative impacts for the future tax revenue. The other depreciation rates are in accordance with the standards and a certain deviation from country to country does not play a decisive role but allows the Member States to have a certain margin for the internal tax policy without distorting the Common Market interests.[466]

Another important aspect is the treatment of capital gains, which play an important role in case of dissolving hidden reserves. Often, a large tax yield may result. At least, partially, the capital gains are taxed within the CIT and burdened with the standard tax rate. The different treatment within the Member States[467] again may cause competitive disadvantages so that generally a harmonisation need has to be taken into consideration, which should be directed at the tax rate as well as to the estimation of the capital gain. The problem arises because profits are determined by subtracting the acquisition or manufacturing costs from the realized sales prices. These variables influence the amount of the profit in a crucial way. Hence, this variable has to be adjusted to inflation to avoid a pure paper profit.

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[466] *Ibid.*

[467] Kenya suspended the imposition of CGT in 1985 but her sister EAC Member States continue to levy the tax at the same rate as other business profits.

The treatment of losses is also important, especially in a dynamic analysis. Because of the principle of annual taxation, losses would only be taken into consideration in their year of occurrence, which is perceived as unfair in a long-term, or even, life-time perspective. Therefore, most of the CIT systems have established carry forward rules so that losses usually are transferred into future tax periods either for a specified number of years or indefinitely.[468] Restrictions of volumes or time limits might cause serious excess burdens for the companies under consideration.[469]

The withholding taxes within the EAC create enormous problems. Such taxes are withheld at the source for payment: The income bases of these taxes include dividends, remunerations for particular benefits being taxable such as interest payments, royalties, service fees and management services. In accordance with the source or territoriality principle, the taxation in the source State is generally justified for non-residents, even if the burden is a flat-rate. Usually the tax liability of the foreign taxpayer is satisfied with that procedure in the source State. The income is then part of the income tax base in his residence state. The treatment of income in the residence state is of utmost relevance as it has already been discussed above. As far as no compensating measures are implemented in the national tax laws, double taxation might be a very frequent challenge. Such problems will lose relevance if the draft DTA for the EAC is implemented.[470]

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[468] See Appendix 4 of the study.

[469] Therefore the carry forward methods should also be included in the harmonisation activities as well as the acceptance of foreign losses (depending on the method to avoid double taxation). In the EU, there is a vivid discussion on this problem since the ECJ has decided a case in favour of concerned companies with reference to the free movement of capital within the EU.

[470] Nonetheless, the field of withholding taxation has to be considered seriously within the harmonisation activities. In the meeting held on 5th November 2009 the EAC Ministers of Finance adopted fixed rates for

Multinational or international groups (i.e. consolidated companies) act in the markets of several countries. The structures of parent companies with their subsidiaries (permanent establishments) are often less determined by market factors than by entrepreneurial decisions in which tax planning plays an important role. Specific price formation or profit shifting between the countries where the head office and the subsidiaries are located is a matter that has gained relevance in the harmonisation debate. The outcome is a shift of the taxable base into the countries with the lower tax rates resulting in tax systems competition. The high-tax states have developed counter measures such as the arm's length principle, which is applied in case of "unacceptable" transfer prices. The prices must not deviate from those which are agreed between non-affiliated companies. These principles were fixed by the OECD and published for the first time in 1979.[471] Closely connected with the principles are interest payments between parent companies and their subsidiaries, which made their way into the tax evasion literature as part of the problem of "thin capitalisation".[472]

In Kenya, TP has become a major issue especially after the Budget Speech of 2009 when it was extensively discussed even in the print media. The Kenyan "Transfer Pricing Rules" have existed since 1st July 2006, but obviously many questions have remained open as the following direct quotation demonstrates:

> KRA… starts its audit activities by challenging the soft underbelly of transfer pricing services… The makeup and allocation of the costs may result in a complex exercise where multiple jurisdictions are involved to ensure that no party to the transaction is inappropriately charged for the services received… KRA is actively looking for easy pickings" (PWC), and Deloitte[473]states: 'one of the most glaring and disturbing omissions from the current regulation is the manner in which the KRA or Minister would go about adjusting the taxable income of a taxpayer whose pricing they determine does not meet the arm's length rules. It would be useful if KRA

withholding tax at 5% on dividends, and 10% on interest, royalties, management and professional fees under the DTA. Thus, the draft DTA proposes reduced withholding tax on these items.

[471] See OECD (2001).

[472] See OECD (1998).

[473] *The Financial Journal,* 16 June 2009.

> would have very narrow and clear guidelines and defer the methodologies to the most recent OECD Guidelines. The ambiguities and gaps in the current rule might lead to the extraneous and mischievous interpretation and application of the law by KRA and taxpayers, which would in turn lead to the wastage of time and resources'.[474]

Thus, a Common Market for the EAC should develop solutions for such problems: currently the Member States of the EAC have quite divergent approaches. At least partly the legal rules correspond to the OECD principles; while other rules consist of vague general clauses which allow for the tax authorities to make decisions in single cases. In Uganda, there is a draft version of a directive for the treatment of TP while in the remaining countries of the region, such problems are under discussion but still remain largely unsolved. Because of possible arbitrary decisions on single cases, there exists a serious threat that within the EAC, similar cases are treated quite differently.[475]

The unilateral avoidance of double taxation is a direct consequence of tax harmonisation. In practical tax cases, the national regulations have to be applied prior to the international regulations set out in a DTA. Only if double taxation cannot be avoided nationally, will the DTA rules apply. Through a combination of national and DTA rules, double taxation problems can be solved sufficiently. Therefore, the ratification by all member states and implementation of the draft EAC DTA is recommended on priority basis. To ensure the congruence in the implementation of the DTA frameworks, the harmonisation of the EAC DTA with the DTAs between individual EAC Member States and third party countries should be another common

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[474] Quoted from the GTZ Report, *op cit.* Deloitte has added that *"The Kenyan transfer pricing rules became operational on 1 July 2006. These rules require certain taxpayers to develop and document their transfer pricing policies. There appears to be some confusion as to what 'transfer pricing documentation' includes."*

[475] As such, 'profit shifting' has to be a core element within the harmonisation activities to avoid harmful tax competition.

goal.[476] The problem of DTAs has hitherto not been seen as urgent, which explains why the already long existing draft DTA for the EAC has not yet been finally approved. Additionally, the number of DTAs with third party countries is comparatively low, which might be taken as a proof or proxy that all the EAC Member States are not sufficiently mainstreamed into the international markets. But beyond that, the insight seems to be lacking within the EAC Member States that double taxation has enormous negative impacts on intra-community trade and the economic integration process. The threat of possible tax revenue losses is evaluated higher than future growth enhancing community advantages, which will also lead to revenue increases in the Member States, respectively. The previously often mentioned accession of Rwanda and Burundi to the community as the reason for the delay is utilized more as a welcome excuse for the delays than a rational justification.[477] This explains the non-enactment of the DTA despite Rwanda and Burundi's inclusion into the membership of the EAC.

5.2.2. Harmonisation Steps: Proposals for the EAC corporate income taxes

There is no consensus on the technical definition of 'tax harmonisation'. Indeed, the dictionary is of little help, since the general dictionary definition does not address a technical issue such as this. In terms of ordinary lexicology, the term 'harmonisation' refers to "bringing into harmony [that is, "establishing a proper proportion and correspondence between some things and others"], or bringing into consonance two or more parts of a whole, two or more things that must concur to the same end." Historically, the word derives from *armos* in ancient Greek, which means "a

[476] For example, currently, Kenya has ratified 9 DTAs with the following governments: United Kingdom, Germany, Norway, Sweden, Denmark, India, Canada, Zambia and, more recently, France.
[477] Regarding tax incentives and EPZs, the political will to follow new concepts is necessary for a successful harmonisation process.

fitting or joining." The question therefore would be whether the term is synonymous with uniformity.[478]

The analysis could consider whether there is any explicit legal concept. In the EAC context, Article 83(2) (e) of the Treaty requires the Member States to harmonise their tax policies with a view to removing tax distortions in order to bring about a more efficient allocation of resources within the Community. Similarly, Article 32 of the Protocol provides that the Member States should progressively harmonise their tax policies and laws to remove tax distortions in order to facilitate the free movement of goods, services and capital and to promote investment within the Community. Turning to the technical meaning, the *International Tax Glossary of the International Bureau of Fiscal Documentation* (IBFD)[479] defines "tax harmonisation" as the elimination of differences or inconsistencies between the tax systems of different jurisdictions, or making such differences or inconsistencies compatible with each other. Chapter Three of the study[480] has shown distinct and heterogeneous income taxes within the Member States of the EAC.

Peggy Musgrave, a renowned public finance author defines tax harmonisation as "the process of adjusting national fiscal systems to conform with a set of common economic aims."[481] It should be pointed out that the term has attracted varied meanings. For instance, while some authors

[478] Vito Tanzi, A. Barreix and L. Villela, *Taxation and Latin American Integration*, Harvard University Press and Inter-American Development Bank, 2008, p. 68.
[479] IBFD, *International Tax Glossary*, Fifth edition, Ed. Barry Larkin. IBFD 2005.
[480] Also see Appendix 4 of the study.
[481] Musgrave, p. 1989. *Fiscal Coordination and Competition in an International Setting*. University of California, Santa Cruz. Dept. of Economics. P 4.

associate the concept with the adoption of a common tax rate,[482] Kopits, on his part, refers to 'concerted' and 'spontaneous' tax harmonisation[483] the first being a convergence-oriented formal agreement not necessarily meaning 'equalisation' and the second a convergence in response to competitive pressures.

The term 'harmonisation' has been defined in different ways, but the underlying notion is that there are several possible degrees of harmonisation and that these are related to the economic background which is determined by the level of integration pursued. The EAC Member States have chosen the path of a Customs Union, Common Market, Monetary Union and, ultimately, a Political Federation. Judging from this sequence, it is an ultimate ideal that seamless economic and political integration is intended to be achieved. 'Tax harmonisation' therefore should be seen as one of the policy instruments towards full economic integration.

From the theoretical standpoint of integration, the options available for removal of fiscal barriers to integration are varied. Pinder, taking and reformulating an idea first advanced by Tinbergen, in 1968 distinguished between "negative integration" which essentially is an obligation not to do certain things, with a view to eliminating discrimination among economic actors and "positive integration" which involves the design and application of common and coordinated policies.[484] On the other hand, Gonzalez Cano argues that there are two tax harmonisation mechanisms:

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[482] The most straightforward tax harmonisation scheme: i.e. adoption of a common rate." See Krugman, P. and R. E. Baldwin (2002)."*Agglomeration, Integration and Tax Harmonisation*". NBER Working Paper 9290.
[483] Kopits, George. 1992. "*Tax Harmonisation in the European Community*." IMF Occasional Paper 94, p. 2.
[484] For a detailed analysis, see Martin Jimenez (1999). *Toward Corporate Tax Harmonisation in the EU*, Boston: Kluwer. p. 6.

uniformity and compatibility. He opines that the second is the one to be applied at the early stages of economic integration such as in the case of EAC 2.[485]

Martin Jimenez analyses the relationship between the aims and instruments of fiscal integration when he examines the role of "soft law" in the EU scheme of tax harmonisation instruments, but he does not do so in order to establish a classification of tax harmonisation or levels of action. Nor does he seek to analyse the relationship between the phases of integration, the degrees of harmonisation and the instruments most commonly used to attain each successive level.[486] The EAC has established the EACJ whose role is to interpret the Treaty provisions. Any regional Protocol, legislation or directive is subject of interpretation by the EACJ. The existence of this institutional framework would therefore play a significant role in dealing with potential areas of conflict. This is in contrast to the EAC 1 where such challenges were resolved politically.

Calderon and Caamano, like Jimenez, note that developments in the international context foster greater sophistication in the instruments available to the authorities in their efforts to bring tax policies closer, thereby avoiding distortions or simply in response to an aggressive environment.[487] Though they provide an interesting description of examples of what they call 'tax coordination', they neither define the term nor establish its distinctive features relative to other mechanisms for approximating or harmonising taxes.

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485 Gonzalez Cano, J. 1996. *Tax Harmonisation in the Latin America:* Buenos Aires: The International Institute of Finance, Argentina.
486 *Ibid.*
487 Caamano, M. A. and J. M. Calderon (2002). "*Tax harmonisation and Regional Integration: Issues and experiences in Latin America*" IMF Occasional Paper 94, p. 2.

In contrast, James ventures a classification of the degrees of harmonisation, which in his view range from 'no harmonisation' to complete 'standardisation'. His analysis is based on the notion that the first step towards harmonisation is to define a common set of taxes. That is, it is important to start by harmonising the base or object of taxation.[488] He classifies tax harmonisation in the form of a scale, that is, with various possible steps. His review of the degrees of harmonisation describes the results obtained, the guiding criterion being the degree of standardisation attained.

Further, Barreix and Villela have explored the possibility of adding a new feature to the four classical cannons of taxation as set out by Adam Smith (sufficiency, efficiency, simplicity and equity). They have considered the feature of 'coordinability' of the system which refers to the ability of a tax jurisdiction to coordinate with the jurisdictions of its main economic partners.[489] This additional canon explains the minimum standard for tax harmonisation on a regional scale.

Coordinability issues need to be well thought out in order to ensure that the EAC Member States do not strike in different directions while adopting the agreed-upon common tax measures. This needs to be conversed and entrenched within the conceptual framework and beyond the agreement that will be arrived at in the long run.[490] As noted in Chapter Four herein, the differences in taxes have led to administrative challenges which must be addressed. In essence, however, the idea implies the existence of a range of harmonisation actions, from uniformisation

[488] James, S. 2000. "*Can We Harmonise Our Views on European Tax Harmonisation*?" International Fiscal Documentation Bulletin. June, 2000.
[489]Barreix, A. Valencia, and L. Villela (2004). "*The Harmonisation of Indirect Taxes in the Andean Community.*" Buenos Aires: Inter-American Development Bank/INTAL, p.4.
[490] It is expected that a consolidated Income Tax and Coordination Act for the EAC will be enacted. A harmonised policy is also envisaged.

to mere cooperation and the best alternative must be chosen from this wide array of possibilities for the EAC countries to use, keeping in mind their impact on the traditional features of a good tax system. The EAC member states should therefore agree on these policy steps. The next part of this chapter examines the various degrees of harmonisation that can inform corporate income tax harmonisation in the EAC. At a glance, harmonisation can be attained systematically through five scales. These are, Convergence, cooperation, coordination, compatibility, and standardisation.

5.2.2.1 Step one: Convergence

This is a spontaneous movement towards the same type of solution, as a result of globalisation and competition seen to threaten the existing framework. Convergence is classified as the first step from the standpoint of voluntary political commitments to strike in the same direction tax-wise. This degree of harmonisation is useful to negotiate towards the adoption of similar taxes and administration. In a bid to combat harmful tax competition and administrative challenges on transfer pricing,[491] Member States of the EAC should adopt convergence policies. This could be achieved through agreements to adopt international models applicable in other blocs, for example the OECD guidelines on transfer pricing. The third integrative step of an EAC Monetary Union envisages a regime of fully harmonised fiscal laws and policies. This cannot be attained if the Member States continue the distortive measures characterised by suspicious treatment witnessed in the past decade.[492]

[491] As transfer pricing by definition is a "two-way" exercise, different transfer pricing rules will cause disputes between Member States, potential double taxation for business and a negative effect on business compliance costs.

[492] Barreix *et al*, *ibid*, p. 7.

On the basis of the harmonisation actions described and classified above, it may be inferred that the member states have already identified or in the process of identifying challenges of maintaining disparate incomes taxes within the region. This step is therefore an important policy tool as the region seeks full fiscal integration through standardisation of both CIT bases and rates.

5.2.2.2. Step two: Cooperation

Cooperation, on the other hand, is the provision of mutual assistance, either for reasons of reciprocity or out of mutual interest amongst members of a regional grouping. For instance, one country supplies tax information in the expectation that it will receive reciprocal information from its counterpart at some other time or out of mutual interest such as when double taxation is detected and the two countries undertake to cooperate. A distinction can also be drawn between practical cooperation and theoretical cooperation for example, providing assistance or sharing best practices in taxation. In the overall, cooperation does not as a matter of priority entail the sharing of common tax policy except for the reason that cooperation is a policy in itself. It is strongly advocated in this study, however, that the Member States strike in one direction policy-wise as an antecedent to harmonisation of the law. Cooperation could be achieved gradually through the creation of bilateral and multilateral cooperation mechanisms, aimed at a more homogeneous tax administration and contributions towards a more consistent application of tax systems therefore ensuring greater horizontal equity and leveling the playing field for the economic actors. In addition, the creation of cooperation mechanisms allows the member states to identify common problems and collectively seek solutions, both in terms of tax administration and in policy.

5.2.2.3. Step three: Coordination

This refers to the synchronisation and integration of tax activities, responsibilities and control structures to ensure that the tax system adopted operates efficiently. Coordinability of national tax systems with other jurisdictions within a single market is a desired feature of a modern tax system. This means that the tax system is capable of including a significant number of harmonisation actions especially with its major trade and economic partners without jeopardizing the traditional canons of taxation (that is, sufficiency, efficiency, simplicity and equity). Hence, a new and desirable feature of a modern tax system, and one that is unavoidable if regional economic integration is to be deep, is its capacity to adapt to other tax jurisdictions while maintaining the spirit of regionalism.

The EAC Member States should coordinate various corporate tax issues, for instance, measures to curb harmful tax competition, double taxation, trade distorting fiscal barriers and on general tax policy. International tax concerns such as transfer pricing, tax avoidance and evasion should be approached collectively hence the need for coordination. To some extent, this is a form of harmonisation, since it ensures that more similar efforts are made to combat, for instance, tax fraud and evasion, thereby achieving horizontal equity.[493] There are various examples of coordination: codes of conduct are a case in point. As the EAC marches towards the establishment of a Monetary Union, the Member States must strive to coordinate in all CIT activities towards that objective. If history is to be remembered, the lack of proper coordination on the issue of transfer taxes and a policy on economic imbalances have been identified as part

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493 Barreix et al, *ibid*, p. 7.

of the reasons that lead to the collapse of EAC 1 in 1977.[494] This should serve as a lifetime lesson for the EAC as it assembles the instruments of a political Federation.

5.2.2.4 Step four: Compatibility

This involves the adjustment of the tax structure in order to counteract or compensate for the distortionary effects caused by tax burden disparities once the member states have agreed to integrate.[495] This is done in recognition of the fact that once the member states have fully integrated, their domestic tax systems should be adjusted to be in tandem with the prevailing regional thinking tax wise. The adjustment, however, needs not be aimed specifically at having identical taxes. The main distinction between this stage and standardisation is that identical tax rates may not be attained. This form of harmonisation therefore would leave room to policy makers on the extent of harmonisation required.[496]

The EAC has developed a *Code for Harmful Tax Competition* and it has singled out some tax bases that should be harmonised on priority basis.[497] The EAC, therefore, can consider coordination on the basis of tax bases but leaving some maneuvering room for tax rates, or even for exemptions. Compatibility, then, is somehow associated with more advanced integration objectives and that is, when internal tax distortions are detected. In addition to laws, regulations should also be made compatible in a fully operational Common Market. Mutual tariff benefits do not need to be granted uniformly (that is, some countries can grant benefits on some products, while other countries do so for others), as long as all parties respect the 'global reciprocity'

[494] See Chapter two, (*ibid*).
[495] *Ibid*, Gonzalez Cano, 1996, p. 87.
[496] Barreix *et al*, ibid, p. 6.
[497] See Appendix 5 on laws that need to be aligned with the Code against harmful tax competition.

principle in the concession of fiscal benefits and the gradual trend towards enhancing the benefits granted.

Ideally, any compatibility scheme should involve an institutionalised follow-up mechanism to ensure its effective enforcement. Unlike the equalisation scale under which the harmonisation scheme is less complex, with compatibility, since there are no strict definitions to determine what has and has not been made compatible; that is, some state decisions comply with harmonisation objectives but others do not, it is highly advisable to establish a follow-up mechanism to keep track of what each country does in this respect, so as to ensure that the goal of harmonisation is not adversely affected. Within the EU, the *Directive on VAT Harmonisation* exemplifies this degree of harmonisation.[498]

This degree of harmonisation, however, may be appropriate when a strong common discipline is required to avoid distortions. Preferential tax regimes and practices can lead to harmful tax competition and result in adverse consequences, hence there is need for Member States to urgently take measures to avoid any distortionary preferential treatment within a fully functional Common Market. In reaction to this challenge, the EAC Member States have commenced discussion towards the development of a Code of Conduct against Harmful Tax competition and a model for a bilateral tax Treaty (BTT) for the avoidance of double taxation.[499] The former is modeled along the EU and OECD trade blocs that have put such a regulatory framework in place

[498] Barreix *et al*, *Ibid.*, p. 6.
[499] For instance, consider that country B has a branch of a bank belonging to a financial institution domiciled in country A, and that the branch is earning interests on a loan, the debtor of which resides in country C. there is need to set up clear rules on how tax should be levied as both B and C may argue that the income originated in their territory.

in a bid to reduce the harmful practices. These belong to the sphere of compatibility because, even though rates are not harmonised, progress needs to be made with regard to pooling tax sovereignty, the technical definition of some concepts and a shared vision of the need to eliminate double taxation and harmful tax competition.

Once the tax code on harmful tax competition and agreement on avoidance of double taxation are adopted, the EACJ should be seized with jurisdiction to enforce its provisions as the regional highest dispute resolution body. On the issue of policy, the EAC Member States should agree on matters that can challenge compatibility, as for instance, the classification of enterprises in terms of the value they add in order to be eligible for greater or lesser incentives. They should also agree on control and reporting obligations assumed on behalf of the EAC by the representative administrations responsible for the application of those incentives in each Member State.

5.2.2.5 Step five: Standardisation

This consists of having the same tax within the single market. As Gonzalez Cano describes it, it entails "equalising the tax burdens imposed on the same item, under equal circumstances."[500] This is considered as the highest degree of harmonisation. The EAC has already demonstrated the utility of standardisation under the Customs Union where there exists a Common External Tariff applied by all the Member States. The Common External Tariff, customs procedures with a harmonised institutional framework exemplify the standardisation degree. A Customs Union refers to the merging of several customs territories into a single customs territory in order to consolidate the free movement of goods, regardless of their origin, provided the goods originating in third countries are cleared in any of the Member States as an economic integration

[500] Barreix et al, ibid, p. 6. Gonzales Cano, *Ibid.*

objective. The key element in any true Customs Union is the adoption of a CET. This must be the same across the union's whole external border, because, otherwise, trade diversion and other perverse phenomena would occur. Borrowing from the operational CET for the EAC, it is proposed that any initiatives towards income tax harmonisation should be based on this criterion. It is noteworthy that the EAC Customs Union has used legal instruments to ensure the most uniform possible application of the CET and of the other measures specified in the regime.[501] The EAC Member States should consider these policy options and steps in detail in order to appropriately direct the EAC drive towards a regime of harmonised fiscal laws and policy as provided for in the Treaty and its corresponding Protocol.[502]

5.2.3 The case for EAC (corporate) income tax harmonisation

While the definition of the tax base is complicated for a VAT system, in case of income and corporation tax, the task is even more complex. Regarding direct taxation, the dominating view is that the *subsidiarity principle* has to be applied, because differences in direct taxation are very strongly determined by national attitudes and preferences. Therefore, even in an integrated union such as the EU, comparatively-speaking, the harmonisation measures have focused on eliminating tax discrimination and double taxation, preventing zero taxation and the fraudulent usage of tax regulations as well as decreasing the compliance costs for taxpayers who are taxable in more than one member country. As such, double taxation agreements (DTAs) form an integral part of the Member States' tax rules, and the personal tax rules included in these agreements have to remain within the boundaries set by the EU Treaty, just like any other national laws.

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[501] The EAC Treaty and the EAC Customs Union Protocol are the main instruments of harmonisation of the EAC Customs. The *East Africa Customs and Management Act* enacted in 2004 is an implementational legislative tool providing for the application of the CET.
[502] Article 83(2) (e) of the EAC Treaty and Article 32 of the EAC Common Market Protocol.

As noted in Chapter Four under the features of tax heterogeneity, corporate income taxation needs a clear definition in terms of taxable persons and tax bases as well as the schedule of taxes and tax bases. Regarding the tax base, the income definition, the sources of income and the tax period are of specific interest. Within the tax schedules, marginal rates are important because these directly influence tax avoidance, evasion, the supply of effort and the mobility of production factors (labour and capital, where capital, without doubt, has the highest mobility).[503]

Comparatively-speaking, in so far as the EU has been involved in direct taxation[504], the same mainly pertains to capital income and corporate taxes because in this field mobility of the tax base (that is, the *personae,* whether natural or legal/corporate) plays the most important role.[505] Regarding capital income, many sources belong to the personal income tax base (dividends, income from rentals and leases, interest, capital gains etc). Because of a remarkable mobility of private capital partly due to evasion reasons, the EU adopted a saving tax directive in June 2003.[506]

With regards to corporate taxation in the EAC, the coordination problems are almost innumerable. Therefore, one has to concentrate on the most important issues. If the definition of the tax base is taken into consideration, accrual as well as cash basis accounting methods are

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503 Petersen, GTZ Report*, ibid.,* p. 67.

504 As appreciated earlier, income taxation is a form of direct, rather than indirect, taxation.

505 For distinctions between legal persons in the eyes of the law including taxation, see Chapter 8 of JJ Ogola, *Business Law* (Nrb: Focus, 2010).

506 The directive has been applicable since 1 July 2005. It applies to interest paid to individuals resident in an EU member state other than the one where the interest is paid. Member States had to transpose its provisions into national legislation. The European Commission on 13 November 2008 adopted an amending proposal to the savings taxation directive, with a view to closing existing loopholes and better preventing tax evasion. The most important component is the information exchange. During a transitional period some Member States, not taking part in the information exchange, have to apply a withholding tax, which has to be partly transferred to the residents' countries. Similar agreements have been made with third party countries.

used on residence/source issues. For different sectors (for example, agriculture) specific tax rates often apply. Generally, the following questions arise: which business expenses are deductible? Can different depreciation provisions and evaluation methods be applied? Because of these complexities, only some core elements are named, which have to be taken into consideration for the necessary coordination processes within a Common Market.[507] They are as follows:

1) The differences in the definitions of the income tax bases, as seen in Chapter Four, often lead to differences between the statutory tax rates expressed in the law and the effective tax rates actually applied on the ground. As such, the EAC citizens can engage in territorial mobility in order to settle in a Member State with the lowest income tax rate as a result of a 'race to the bottom'.[508] Therefore, a certain degree of coordination of tax rates is necessary.
2) Transfer prices can be used as a vehicle to shift the company tax base into low tax Member States or third party countries. The deepening of the internal market and the growing number of new technologies and business structures at national and international levels aggravate these problems. There is convincing evidence that applying transfer prices for tax purposes is complicated, and a serious problem in practice can ensue.[509]
3) Between parent companies and their subsidiaries, the conditions for exempting dividends from withholding taxes[510] have to be relaxed and double taxation for the subsidiaries of subsidiary companies eliminated.
4) On the other hand, the profit shifting between affiliated companies by internal credit operations (that is, shareholder borrowing) has to be controlled.[511]

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[507] *Ibid.,* GTZ Report.
[508] This would constitute a physical 'race-to-the-bottom.'
[509] See Chapter Four for the difficulties posed by transfer pricing. The EAC Member States are yet to harmonise the transfer pricing rules.
[510] See the first quotation by Kenya's Minister for Finance on p. 2 (*ibid.*).

5) There is an urgent need for some operating rules in respect of mergers, acquisitions and amalgamations of companies located in different member countries.
6) There is also need for coordination of the taxation of interest and royalty payments made between companies of the different EAC Member States.
7) Finally, it is imperative to conduct periodic and regular updates of the DTA between the EAC Member States once fully ratified.

The EAC, with an estimated population of approximately 150 million people and a combined GDP of approximately $50bn, has a strong potential to participate effectively in the world economy and thereby support the social and economic development of the region.[512] Article 83(2) (e) of the EAC Treaty requires that the Member States harmonise their tax policies and reform them to remove distortions and promote investment. The Customs Union, a CET and a Common Market were introduced in the year 2010. A Monetary Union and a Political Federation are envisaged. At present, the Member States have huge differences in their tax systems and these disparities sometimes result in unfair tax competition and the unequal treatment of taxpayers, goods and services which if not addressed will distort the functioning of the Common Market.[513]

The harmonisation of tax policies and laws on domestic taxation is, therefore, an essential aspect of microeconomic convergence and is one of the benchmarks to be attained for the effective

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511 This is in reference to the earnings stripping rule in the US and interest deduction limit in Germany.

512 Rwanda joined the EAC in 2007. Although Rwanda's accession to the EAC is expected to bring considerable economic benefits in the medium to long term, membership also imposes fiscal constraints. Rwanda is already experiencing a reduction in customs revenue (RRA 2011).

513 IPAR, *East African Taxation Project: Rwanda Country Case Study* June 2011, p. 19. The report is available at http://www.taxjustice.netcmsupload/pdfRwanda_Case_Study_Report.pdf, (accessed on 12th January 2013).

functioning of the Common Market. The Member States of the EAC have already committed themselves to eliminate harmful tax competition. As stated above, Article 83(2) (e) of the EAC Treaty commits the Member States to harmonise tax policies with a view to removing tax distortions in order to bring about a more efficient allocation of resources. This commitment is informed by research findings which suggest that providing tax incentives and exemptions can be self-defeating and result in a 'race to the bottom'.

In a study commissioned to look into the issues of tax harmonisation or tax coordination in the EAC[514] the authors define 'harmful tax practices' to mean the "tax measures by tax havens and/or preferential tax regimes that affect the location of financial and other service activities, erode the tax base of other countries, distort trade and investment patterns and undermine the fairness, neutrality and the broad social acceptance of systems."[515] If adopted the Code would require the Member States not to introduce any new tax measures which are harmful within its meaning and to amend existing laws and practices with a view to eliminating harmful measures within three years of the signing of the Code. It explicitly requires that in order to eliminate potentially harmful practices: (a) any provisions for the negotiation of the tax rate or the tax base be reviewed; (b) any tax laws which exempt foreign-source income from residency country taxation be reviewed; (c) with respect to VAT, that an EAC common VAT model be developed and that zero-rated regimes and exempt transactions be harmonised; (d) with respect to income tax that initial capital allowances of more than 50% be abolished, that all tax incentive regimes in the CIT system, especially EPZs and SEZs, are reviewed and harmonised, that the treatment of losses and withholding taxes on dividends, interest payments, royalties and services are also

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[514] Petersen, 2010. The consultancy was commissioned by the EAC in order to assess the fiscal impediments to integration process in the EAC. See report, 2009.
[515] *Ibid.*

harmonised and that capital gains from capital sales be treated as normal profit. With respect to excise duty that a harmonised legal base be developed which defines the categories of taxable goods, defines taxable items in a uniform way, replaces *ad valorem* rates with specific rates and defines the lower and upper ceilings for national tax rates.

The Code provides for special consideration to be given to tax measures that are designed to support the economic development of a particular region, including paying special attention to the particular features and constraints of the Member States which are geographically disadvantaged. Rwanda and Burundi both suffer size and geographical handicaps, being small countries, landlocked and distant from the ports. They are also disadvantaged by the high non-tariff costs of exporting and importing goods.[516] It should, however, also be noted that in marketing the proposed Kigali Free Trade Zone, the Government of Rwanda should emphasize access to a large market accessible from the location that is not easily served by other trade routes in the region.

5.3. Some accomplished aspects of harmonisation within the EAC

The EAC has with measurable success, attempted and achieved integration and harmonisation in some tax and non-tax areas. These include tourism, customs, competition, higher education, standardisation, quality assurance, metrology and testing.

The most common form of harmonisation has been in the area of customs, where the *EAC Customs Union Protocol* has been domesticated vide the *EAC Customs Management Act of*

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[516] Rwanda, Ministry of Trade and Industry and Private Sector Federation 2010.

2004.[517] This underpins the establishment of common external tariffs (CETs) and elimination of internal tariffs. The Protocol also brought about the harmonisation of customs principles and procedures and the removal of suspended duty.[518] Indeed the findings from questionnaire response widely acknowledge the successes in the harmonisation of customs and that suggests that any forms of corporate income tax harmonisation should not loose sight of the implementation mechanisms of the EAC customs.[519] As regards competition, the *EAC Competition Act, 2006* has been adopted to, promote and protect fair competition in the Community, to provide for consumer welfare and, to establish the EAC Competition Authority. The applicability of this statute is directed to all economic activities and sectors having cross-border effect.[520]

Progress has also been made on standardisation, quality assurance, meteorology and testing. The *EAC Standardisation, Quality Assurance, Metrology and Testing Act, 2006*[521] has been adopted and covers products produced or traded in the Community. This statute supports trade within the EAC region and, to that extent, buttresses the operations of the *EAC Customs Management Act, 2004* with a view to ensuring that the goods traded within the EAC are standardised and meet the

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[517] For an analysis of the Act, see K. Bagamuhunda, '*The EAC Customs Management Act 2004, its Application and Impact on Trade in EAC*', The *East African Lawyer* Issue No. 8 (Oct 2009), pp. 15-16.
[518] ADB Group, *Domestic Resource Mobilization for Poverty Reduction in East Africa: Burundi Case Study,* November 2010, p. 20.
[519] See Appendix 2.
[520] See s 4(1) of the Act.
[521] According to Section 3, the objects of the Act are to: *"(a) protect and improve the health and safety of consumers and the public in general; (b) protect the environment and reduce waste; (c)enhance consumer confidence and limit consumers exploitation by increasing the number of products and processes that conform to established standards; (d)enhance the quality, reliability and reputation of products produced or traded in the Community; (e) harmonies national and East African Standards with international standards to reduce costs, enhance compliance and develop trade opportunities; (f) increase opportunities for companies within the Community to participate in international technology transfer through standardisation, quality assurance, metrology and testing programmes; (g) facilitate regional and international trade."*

tests of quality and metrology. The other aspects including higher education and tourism shall also be harmonised progressively. There exists legislative framework to guide this process.

These accomplishments form an analogical and comparative basis for making a case for income tax harmonisation, of both law and policy.

5.4. The EU tax harmonisation experience

5.4.1. Background

At the EU, the control of the negative effects of tax competition remains a topical issue. Since 1977, the Member States have adopted a coordinated approach to control these negative effects with a focus on company taxation and the taxation of both savings and royalty payments between companies respectively.[522] To combat and effectively deal with harmful tax competition, the EU Council adopted a Code of Conduct for Business Taxation in December 1997 as an instrument to reduce distortions in the taxation of savings and to eliminate withholding taxes on cross-border interests and royalty payments.[523]

The Commission's study of 2001 highlighted the main tax obstacles to the EU-wide economic activities.[524] The coexistence of about twenty five (25) separate tax systems within the EU

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[522] Glossary of EU taxation and tax harmonisation, 2009, available at: www.europa.eu/legislation_summaries/glossary/tax_harmonisation_en.htm. (Accessed on 20th December 2013).

[523] Commission of the European Communities, *Company taxation in the internal market Report, 2001*, (COM, 2001,582), p. 19. Available at: http://ec.europa.eu/taxation_customs/resources/documents/company_tax_study_en.pdf. (Accessed November 1, 2012).

[524] Malcolm Gammie *et al*, "*Achieving a Common Consolidated Corporate Tax Base in the EU*", Commission Report for The Centre for European Policy Studies (CEPS), December 2005, pp. 1-2.

presupposes additional tax burdens on cross border activities. The spectrum of unique municipality rules and conventions for each Member State covers financial accounting, determination of taxable profits, collection and administration of tax and network of tax treaties. Consequently, huge compliance costs are involved in meeting the multiplicity of legal requirements which represents a significant barrier to cross-border economic activities especially of small and medium sized enterprises (SMEs). In the case of multinational enterprises, this amounts to 1.9% of the tax payments compared to 30.9% for medium sized companies.[525]

The distinctiveness of tax jurisdictions for each Member State attracts a host of negative consequences such as the non-allowance of cross border relief for losses incurred by associated companies located in other Member States, double taxation and methodological problems resulting from the allocation of profits of multinationals to different jurisdictions on an arm's length basis by transaction based transfer prices, capital gains taxation resulting from cross border reorganizations and conflicting taxing rights, for example on thin capitalisation rules, deduction of headquarter costs, etc.[526]

Thus, tax harmonisation in the EU forms part of a much wider programme of integration[527] since the policy of establishing a common market, economic and monetary union promotes economic

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[525] Commission of the European Communities, *Company taxation in the internal market Report, 2001*, (COM, 2001,582), p. 223.

[526] *Ibid.,* p. 354.

[527] At a glance, income tax harmonisation has been considered in the following documents, Neumark Report, 1962; EU Commission Memorandum, 1967; EU Commission Memorandum, 1969; White Book on the Creation of the Common Market, 1985; Ruding Report, 1992; White Book on integrating associated nations of Central and Eastern Europe with the EU internal market that was approved at the EU Council meeting in Cannes, 1995; Code of Conduct for Business Taxation and the various Council Directives in various years covering avoidance of double taxation, taxing savings, dividends, shares and entities operating in various Member States.

and social cohesion. The EU Treaty explicitly states its intent to mark a new stage of creating an ever closer union among Europeans wherein decisions are taken as closely as possible to the citizens. The pressure for tax harmonisation presupposes economic prosperity within the top cadres of EU decision making.[528]

In 1960, the Neumark Committee was set up to examine taxation and public expenditure with recommendations on harmonisation of income tax, CGT, corporate tax and indirect taxes generally. The roadmap for harmonisation was three pronged. Stage one covering turnover tax, withholding taxes on dividends and interests, DTAs and Excise duty structures. Stage two entailed the harmonisation of PIT and CIT. Finally, stage three involved a common information system and a community tax court.[529]

The Segre Committee Report of 1966 proposed the establishment of an integrated capital market within the community.[530] Amongst other items, it dealt with fiscal obstacles to free movement of capital. The Report recommended the replacement of bilateral DTTs with a multilateral convention in addition to extension of credits for company tax paid to non-resident shareholders.[531]

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[528] See generally, Slot, '*Harmonisation*' (1996) 21 European Law Review 378 at 397 and Simon James and Lynne Oats, '*Tax Harmonisation and the Case of Corporate Taxation'*, Revenue Law Journal, Vol. 8 [1998], Iss. 1, Art. *3,* pp. 50-52.
[529] Commission of the European Communities, *Company taxation in the internal market Report, 2001*, (COM, 2001,582), p. 16.
[530] Commission of the European Communities, *Le Developpement d'un Marche European des Capitaux,* report of the Group of Experts established by the commission (1966 European Commission, Brussels).
[531] See also Easson, '*Harmonisation of Direct Taxation in the European Community: From Neumark to Ruding'* (1992) 40 Canadian Tax Journal 604, Hitiris T, *European Community Economics,* 3rd edn, 1994 Harvester Wheatsheaf, p. 125, Devereux M and Pearson M, *Corporate Tax Harmonisation and Economic Efficiency,* 1989 Institute for Fiscal Studies. See also Mavraganis H., '*Corporate Income Tax Harmonisation in the Nineties'* 1993, 47 Bulletin of International Fiscal Documentation, p. 224.

5.4.2. Current trends on EU income tax harmonisation

Since the number of the EU Member States has increased, there has been pressure on fiscal revenue facing the ageing population and excessive deficits. Concurrently, the need to change the structure of taxation systems in Europe has increased. Thus, the heterogeneity of tax policies in the Union has become more manifest leading to heightened tax rates competition.

The necessity of corporate tax bas harmonisation has been influenced by the decision of some new EU Member States to implement flat tax regimes.[532] Notwithstanding the need for compatibility between Member States' tax policies with European tax legislation, the principle of subsidiarity allows Member States to have tax sovereignty which extends to creating country-specific national tax policy. The divergence in the Member States' tax systems creates obstacles and consequent incompatibility with the internal market. The creation of a single market is achieved through the elimination of tax distortions.

5.4.3. A Common Consolidated Corporate Tax Base (CCCTB) in the EU

There has been no unanimity on the idea of a CCCTB for EU Companies amongst the Member States and the whole business arena.[533] It is a fact that the implementation of a CCCTB could

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[532] Estonia (1991), Latvia and Lithuania (1994), Slovakia (2004) as well as Russia (2001), Serbia (2003), Ukraine (2003), Georgia (2004), Romania (2005). See *The Economist*, 21st March 2005, available at <http://www.economist.com/agenda, (accessed 20th December 2013).

[533] The idea of corporate tax harmonisation was already known from the 1960 Neumark report and the first draft proposal for a common tax base for companies was written in 1988. 20 countries out of 25 supported the idea. Germany and France have largely supported the implementation of a common corporate tax base given that this would end "tax dumping" of Member States with very low company taxes. See Parker G., *EU Tax harmonisation plan "ready in three years"*, 25 May 2005, *Financial Times*. The Small and Medium Entrepreneurs Union, (SME Union of the European People's Party in the European Parliament), oppose tax harmonisation, saying that it would have negative impact on tax competition. See the *Entrepreneur News Magazine* No. 10, March 2005, p. 16.

imply harmonisation of tax rates which the EU Member states are reluctant to accept coupled with the complicated technical implementation of the tax base.

The CCCTB has been viewed as the only way of eliminating obstacles from the cross-border activities of the companies. The divergence of corporate tax systems between the Member States presents the problem of high compliance costs and cross border losses- offset. Hence, home state taxation of SMEs has been proposed as a panacea to the problem.[534]

The opposition by some Member States to the CCCTB is fuelled by the principle of subsidiarity which permits Member States to keep taxation within the purview of their national legislation in a complementary fashion. Furthermore, the Member States control the EU tax legislation due to the fact that the Treaty requires unanimous vote.[535]

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[534] The application of a home state taxation is also optional. See European Parliament, 'Taxation in Europe: Recent Developments', Working Paper by the Directorate-General for Research, Economic Affairs Series, ECON 131 EN, 2003; EU Council, COM (2003) 726; European Commission, '*An internal market without company tax obstacles, achievements, ongoing initiatives and remaining challenges'*, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Brussels, 24/11/2003, COM (2003) 726 final, p.16. The use of International Financial Reporting Standards introduced by Regulation (EC) No 1606/2002 (OJ L 243, 11 September 2002) is compulsory since 2005 and Aujean Michel, European Commission DG Taxation and Customs Union, Director of Analyses and Tax Policies, '*The EU Company Tax Initiatives – Where are we*?'*,* Dublin, 10 March 2005, p. 36.

[535] According to the EU's Tax Commissioner, "*a Franco - German sponsored plan for more harmonisation of company taxation could be ready in three years*". See Parker G., *EU Tax harmonisation plan "ready in three years",* 25 May 2005, *Financial Times*. See the Council Directive 2003/72/EC and the Council Regulation EC 1435/2003. See also The New Mergers Directive 2005/72/EC (on taxation of companies operating within the EU, applicable to cross-border mergers, divisions of companies, transfers of assets and exchange of shares) is helpful to the establishment of cross-border mergers, particularly for SMEs that want to operate in more than one Member State, but not throughout Europe and thus can't operate under the European Company Statute. The Directive is based on the Commission proposal COM (2003) 613 which was replaced by an updated version in February 2005. Also consult European Commission, 'An Internal Market Without Company Tax: Obstacles, Achievements, Ongoing Initiatives and Remaining Challenges', Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Brussels, 24/11/2003, COM (2003) 726 final, p. 24. Overall, see Articles 93, 94 of the EC Treaty.

Recently,[536] the EU through its communication proposed a package of measures to create transparency in the corporate taxation within its jurisdiction. The Common Consolidated Corporate Tax Base (CCCTB), proposed by the Commission in 2011, was identified as one of the tools to meet the objectives of fairer and more efficient taxation. The major benefits of a CCCTB system include: improvement of the environment for businesses in the EU, reducing administrative burdens and simplifying the Single Market for businesses, reduction of complexities and compliance costs for cross-border companies who would only have to follow one set of rules when computing their taxable income, rather than face up to 28 different systems, efficiency in offsetting losses in one Member State against profits in another and the fact that it could be highly effective in tackling profit shifting and corporate tax abuse in the EU.[537]

On the other hand, the common base would eliminate mismatches between national systems which aggressive tax planners often exploit, and remove the possibility of using preferential regimes for profit shifting. The CCCTB could also be a useful instrument to address the debt bias. Moreover, the common base would introduce complete transparency on the effective tax rate of each jurisdiction, thereby reducing the scope for harmful tax competition.[538]

In addition, the CCCTB would allow Member States to implement a common approach in relation to third countries and defend the Single Market against aggressive tax planning. For

[536] At the European Council meeting in Brussels on 18th March 2015.
[537] COM (2015) 302 final, Brussels, 17.6.2015, Communication from the Commission to the European Parliament and the Council, a Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, p. 7. Available at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/fairer_corporate_taxation/com_2015_302_en.pdf. (Accessed November 1, 2012).
[538] *Ibid.*

instance, Member States would have a unified response to controlled foreign companies to prevent profits from being shifted to non-cooperative tax jurisdictions. Given the benefits that the CCCTB can offer, and taking into account the comments of Member States, businesses and other stakeholders, the Commission made a resolve to re-launch the CCCTB. The aim being to strengthen the CCCTB so that it addresses the current challenges faced by the EU in regards to corporate taxation. Two fundamental changes were proposed firstly through making the CCCTB mandatory and the development of a staged approach to implementing the CCCTB.[539]

Since the existing proposal is for an optional CCCTB, the EU considers that this would limit its effectiveness as a tool for preventing profit shifting, as multinational enterprises that minimise their taxable profits through aggressive tax planning would be unlikely to opt to the CCCTB. The Commission therefore proposed to make the CCCTB compulsory, at least for multinational enterprises. The Commission further considered that since it would be difficult to implement the CCCTB at once, it was proposed that a step-by-step approach to agreeing on the different elements of the CCCTB was to be adopted.[540]

Considering that since consolidation has been the most difficult aspect in Member States' negotiations on the CCCTB, the Commission proposed that work on consolidation is postponed until after the common base has been agreed and implemented. In addition, since the primary focus was to secure a common tax base, the Commission proposed to review the elements in the proposed base, to reflect Member States' discussions so far and to ensure it contributes to the growth and jobs agenda in the EU. Further, a common legislative agenda to be tabled in the EU

[539] *Ibid.*
[540] *Ibid,* p. 8.

Parliament in 2016 was proposed. The proposal would introduce the mandatory aspect and provide for a staged approach to the CCCTB. This would include an element of cross border loss relief initially, until consolidation is re-negotiated at a later stage.[541]

5.4.4. Enhanced cooperation on tax policy

Decision-making in tax policy in Europe has been difficult following the legal requirement of unanimity. Enhanced cooperation buttresses the subsidiarity principle by representing the initiatives of Member States to circumvent the difficulty in attaining the unanimous vote required in the field of taxation. Such cooperation is authorized and facilitated by the Nice Treaty[542] and amplified by the Treaty establishing a Constitution of Europe. Pursuant to Article 95 of the EC Treaty, the Union can adopt measures in qualified majority and the role of the European Parliament in the legislative procedure.

5.4.5. The EU competence on tax matters

Though the EC Treaty excludes fiscal provisions, there are tax measures of an administrative nature which have been adopted under Article 95 (2).[543] The approximation of the legal,

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541 *Ibid.*

542 See Title VII of the Treaty on EU. The enhanced cooperation in accordance with the Treaty of Nice, shall reinforce the process of the EU integration, shall respect the *community acquis*, does not undermine the internal market, does not constitute discrimination nor does distort competition, does involve a minimum of 8 states (the EU Treaty required the participation of majority of Member States) and does not fall in the area of Union's exclusive competence. If a Member State wishes to participate it shall notify the Council and the Commission. The Commission shall give its opinion to the Council and shall take a decision within 4 months of the date of receipt of that notification. Also in any area of the Common Foreign and Security Policy, but then it requires unanimity from the Council. The Council does this while acting unanimously in accordance with Article I-44 – general procedure of establishment of enhanced cooperation. This does not apply to decisions related to military or defence matters. However, a "structured cooperation" in the area of defence may be established which is a significant progress since the EU Treaty prohibition against including such an area.

543 Groenendijk Nico, '*Limited Ambitions. The European Convention and Decisions Concerning Taxation in the EU after Enlargement*', Centre for European Studies, University of Twente of Netherlands, 2004,

regulatory or administrative actions aim at better functioning of the internal market. A tax relief which distorts or threatens to distort competition is incompatible with community law as it affects inter-state trade and therefore the economic functioning of the internal market. In case of violation of community law by a Member State, the Commission can initiate an infringement procedure against the violation.[544]

Furthermore, the flexibility clause in the EU Constitution allows the Council to act on a qualified majority rather than unanimity which, as observed earlier, is a tall order for the Council.

5.4.6. The EU primary tax law and tax harmonisation

The primary tax law in the area of taxation comprise of the EC Treaty Articles which are subject to unanimous Council decisions and the subsidiarity principle.[545] The imposition of direct or indirect excessive taxation is prohibited as it may afford indirect protection to other products.

The harmonisation of legislation on turnover taxes, excise duties and other forms of indirect taxation is necessary for the establishment and functioning of the internal market. In addition, the

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<*http://www.eurofaculty.lv/taxconference/files/tp_A1/groenendijk.pdf*>. From 1976 to 2003, 10 measures were adopted by co-decision and 131 by consultation with the EP. Although Articles 93 and 94 EC Treaty represent the tax legal basis, some provisions on indirect taxation were adopted using the article 95 EC Treaty that requires the co-decision procedure. Article 251 EC Treaty refers to the co-decision procedure of the European Parliament and the Council of Ministers following a proposal from the Commission. Under Article 14 EC Treaty, the measures proposed by the Commission must be in accordance with the rules of good functioning of the internal market and the Council shall adopt them on a qualified majority.

[544] These are aids having a social character, aids granted to economically weak regions, aids granted to places damaged by natural disaster, aids to finance an important project of common European interest. Other categories of aids may be specified by the Council acting by a qualified majority on a proposal of the Commission. Within the framework of the policies defined in Part III of the Treaty establishing a Constitution for Europe.

[545] See, for instance, Articles 94 and 95 of the EC Treaty. Although Article 95 of the EC Treaty excludes fiscal provisions from its field of application, it has been used for the adoption of some administrative measures on taxation.

subsidiarity principle[546] allows Member States to maintain taxation under their respective national legislations and direct taxation in particular to be subject to the remit of national law.

5.4.7. The subsidiarity principle

The EU Member States enjoy or possess sovereignty and independence in the creation of policy and legislation. This aids policy development within the EU. Tax sovereignty affords each state direct control over tax rules and revenues. The harmonisation of direct taxes (for example corporate tax rates) has an impact on business activities, especially on SMEs.[547]

Tax sovereignty has been limited with regards to the resolution of distortions in the tax field. Harmonisation of direct tax legislations is relevant so far as national tax policies are incompatible with the EU tax legislation. There is need for primary direct tax law.

With regards to tax coordination, the principle of subsidiarity calls for the need for alignment of national legislation to treaties. A succinct level of coordination is needed for corporate taxation. Such coordination helps to avoid tax losses due to capital mobility across the EU countries.

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[546] Under this principle, the Union shall act in the areas which are not in its competences given by treaties, only if such an action could be better achieved on the EU level instead of a national, local or a regional action of the Member States. The principle is defined in Article 5 of the Treaty on European Union. It ensures that decisions are taken as closely as possible to the citizen and that constant checks are made to verify that action at the Union level is justified in light of the possibilities available at national, regional or local level. Specifically, it is the principle whereby the Union does not take action (except in the areas that fall within its exclusive competence), unless it is more effective than action taken at national, regional or local level. It is closely bound up with the principle of *proportionality*, which requires that any action by the Union should not go beyond what is necessary to achieve the objectives of the Treaties.

[547] Entrepreneur News Magazine, *ibid.,* available at: www.entrepreneur.com/magazine//. (Accessed on 20th December 2013).

The ECJ has come up with the scheme of division of structure of harmonisation of income taxes. In addition, the 1997 EU Code of conduct for business taxation aims at the abolition of harmful tax measures as supplementary to the elimination of distortions in the single market.

The achievement of some approximation via cooperation has been hailed through the restructuring of tax systems. This is imperative considering the necessity for harmonisation which militates against the operation of twenty five (25) different corporate tax regimes within Europe.

5.4.8. The EU Direct tax law and the role of the ECJ

The ECJ, through the use of both treaties and case law[548], has supported tax harmonisation in the form of the convergence of the respective tax systems of the Member States.[549] Some legal tax matters have authorized the application of domestic taxation rules as a facilitator to the effective functioning of the internal market.

The Greek is an example of how the ECJ deals with infringement under Article 226 of the EC Treaty. Greek fiscal authorities can impose tax on capital to a company transferring its registered office or place of effective management to the country from another EU member state. The Commission considers these rules to be incompatible with the EEC Directive 69/335 which

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[548] Analogically-speaking, Kenya has a multiplicity of official sources of law. The underlying provision is Section 3(1) of the Judicature Act, Chapter 8 of the Laws of Kenya which stipulates that *"The jurisdiction of the High Court, the Court of Appeal and of all subordinate courts shall be exercised in conformity with- … the substance of the common law [i.e. case law]…"* In addition, Article 2(6) of the Constitution of Kenya, 2010 provides that *"Any Treaty or convention ratified by Kenya shall form part of the law of Kenya under this Constitution."*

[549] For an exposition on the impact of ECJ decisions, see Gerhard Laule and Robert Weber, '*Harmonisation of the Tax Systems in Europe Judgments of the European Court of Justice*', available at: www.whitecase.com/files/Publication/.../tax_harmony_english.pdf (accessed on 10th June 2012).

imposes tax duty only in the case of the establishment of companies. Greek law exempts maritime and agricultural companies from taxation.

The *Marks and Spencer Case*[550] of April 2005 is another example of incompatibility with the freedom of establishment. The case illustrates the incompatibility of the UK tax relief scheme with Community law. This law restricts company's freedom of establishment to the extent that the creation of subsidiaries in other member state is curtailed. The relief may be granted only to a surrendering company operating in the UK because offsetting losses at foreign subsidiaries offends the UK corporate law.

There is need to harmonise the tax treatment of losses between domestic and foreign subsidiaries in the UE. Therefore, the Commission has adopted a directive in this area as well as the review of The European MTTs on double taxation dealing mainly with taxation of cross border workers.

5.4.9. Conclusion on the EU experience

The efficiency of direct tax legislation in the EU has been doubted. The soft law approach[551] encapsulated in instruments such as the *Code of Conduct of Business Taxation* suffers from weak enforceability and insufficiency of member states political will to spur wide respect for the code.

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550 Case C-446/03 Marks & Spencer Plc v David Halsey (Her Majesty's Inpector of Taxes), Judgment of 13.12.2005. Available at: http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:62003J0446:NOT. (Accessed November 1, 2012).
Other UK taxes that have been criticised by the EU include oversees dividends, transfer pricing, anti tax haven legislation (CFCs taxes) and taxation deducted from savings income (withholding Tax).

551 Such as Commission communications, guidelines, recommendations; *The Code of Conduct for Business Taxation of 1997 and of 2004*. For the non-binding nature of soft law, see, for instance, DJ Harris, *Cases and Materials on International Law* (London: Sweet and Maxwell, 2004).

The European Parliament is hardly involved in the tax field in spite of the ECJ cases, some of which have been sampled above, the removal of cross-border obstacles has been slow and has not necessarily meant the convergence of the policies of member states.

Furthermore, the tax harmonisation goal within the EU is jurisdictionally hampered by the fact that the ECJ only decides on interpretation of European law related to cases that create distortions in the internal market. Sadly, the court has no authority to order any restructuring of the direct tax systems of the member states. Consequently, the ECJs impact on the municipal tax regimes of the EU member states is low.

Diana Claudia *et al* have summarised the EU position thus:

> With the intensification of European economic integration, persons and individuals gain a greater freedom to benefit from the opportunities given by foreign economies. Thus, international fiscal competition increases together with the increase of capital and workforce mobility. Fiscal harmonisation proves indispensable for assuring loyalty in the competition on the EU single market, given the fact that the different [national] systems of taxation have a direct and powerful impact on the level of prices and on the choice of the investments location. At the same time, it is an extremely complicated process because the modifications agreed on the taxes [such as tax harmonisation] affect the entire national fiscal system.[552]

5.5. The NAFTA tax harmonisation experience

The choice of NAFTA as a comparative aspect was inspired by its efforts in balancing the sovereign interests on the one hand and the need for fiscal integration on the other. Policy and limited law reforms have informed the fiscal coordination efforts in the North America. Those initiatives provide insights to the EAC in its quest to harmonise its income tax regimes. NAFTA

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[552] Sabau-Popa Diana Claudia, Kulcsar-Pop Edina and Gherman Adela-Teodora, '*Current Trends in Tax Harmonisation and Competition within the European Union'*, p. 637; available at: <www.econpapers.repec.org/article/orajournl/default1.htm, (accessed 10th June 2012).

is the world's largest regional economic bloc. Collectively, the NAFTA Member States produce 30% of the world's GDP, equivalent to US $6.690 billion. Under NAFTA, economic and institutional barriers to cross-border trade and investment continue to decline, and mobile factors such as capital, goods and services move progressively more freely across-borders. As this process goes forward, trade and investment flows among the NAFTA Member States become increasingly sensitive to "barriers" created by the Member States' disintegrated tax regimes. As NAFTA matures, the Member States increasingly need to weigh the economic benefits of tax integration against the costs associated with the loss of sovereignty that inevitably comes with tax integration.[553]

NAFTA is an agreement to cooperate in trade and investment matters by lowering international economic barriers. The pact has already limited each Member State's sovereign power in some areas. However, the question remains to be answered is whether a further reduction in sovereignty through NAFTA-wide tax integration is desirable and, perhaps more importantly, feasible.[554]

Unlike the EU, NAFTA is merely a trade pact; it contemplates only negligible political integration by its membership. Nevertheless, a good argument can be made that the movement toward freer regional trade and investment under NAFTA ought to be complemented by the gradual harmonisation of the North American tax regimes. Such gradual harmonisation enhances the North American economic efficiency, while acknowledging and respecting the desire of

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[553] Arthur Cockfield, "*Tax Integration under NAFTA: Resolving the Conflict between Economic and Sovereignty Interests*" (1998) 34 *Stan. J. Int'l L*, p. 2.
[554] *Ibid.*, p.41.

NAFTA's members to maintain sovereign control over domestic tax policies.[555] This shows a resolution of the tension between tax harmonisation and the sustenance of state sovereignty as seen in the introduction to this chapter.[556]

The lack of clarity on the harmonisation of taxes generally in the NAFTA has seen the continued application of different income tax regimes by the member states. For instance, whereas the US taxes its corporations on their worldwide income, Canada and Mexico have adopted the source based principle. As such, the US gives tax credit for foreign income taxes paid on foreign source income at the instance when the income is repatriated while Canada and Mexico exempts foreign source income from taxation.[557]

The past efforts towards coordination of taxes are however notable for instance, the member states have adopted the OECD model convention on taxation of income and capital.[558] Other efforts include the coordination of their CIT systems through Bilateral Tax Treaties and the expansion of the scope of the GATT National Treatment principle under Article 2103 of the NAFTA to include taxation. Under the Bilateral Treaty framework, Canada and Mexico for instance signed a Bilateral Tax Treaty in 1991. The Treaty focused on the enhancement of fiscal integration through the extension of National Treatment and the MFN principles on taxation matters.

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555 *Ibid.*

556 Part 6.2. on p. 2, *Ibid.*

557 Lorraine E. *Deep integration: National Treatment and tax harmonization in North America* , 1996, in Pierre Sauve and Daniel Schanen, eds. , *market access after the Uruguay Round: investment and competition perspectives,* (Toronto), C.D Howe Institute, pp. 293-323 at 308. Available at: https://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf. (Accessed on 22nd September 2016).

558 OECD model Tax Convention on Income and on Capital, OECD publishing, ISBN 978-92-64-21115-5. Available at: https://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf. (Accessed on 22nd September 2016).

In 1992, the US and Mexico signed yet another tax treaty with the effect of lowering withholding tax rates from those which had been negotiated under the 1991 Canada – Mexico tax treaty.[559] The treaty also included a National Treatment clause on taxation matters generally with similar treatment extended to the NAFTA investors. In addition, the Treaty provided that in instances where the US negotiated lower withholding taxes on direct dividends with a third country, both the US and Mexico would adopt that lower rate.

In 1994, a convention between the US and Mexico for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes on income was signed.[560] Under the Convention, the two governments agreed to exchange information on taxation matters.[561] The Convection also provided a framework for the establishment of a binding arbitration procedure for the resolution of disputes arising from the implementation of the treaty.

In 1995, (17th March), the US and Canada signed the Income Tax Treaty.[562] The main contribution of the treaty is its inclusion of a non- discrimination clause to all forms of taxes between the two countries. Consequently, neither government would adopt tax policies that would discriminate against firms located in a territory but owned by residents of the other country.[563] The Treaty also substantially reduced withholding taxes on cross-border financial flows and reduced the costs of remitting funds from foreign affiliates.[564] In addition, the Treaty

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559 Ibid. p. 311.
560 The Convention came into effect on 1st January 1994, available at: https://www.irs.gov/pub/irs-trty/mexico.pdf.
561 Article 27 of the Convention.
562 The Canada- US Income Tax Treaty came into operation on the 17th day of March 1995. A available at: https://www.irs.gov/pub/irs-trty/canada.pdf.
563 Article XXV.
564 Article XVII.

allowed the two taxing authorities to exchange information on all taxes imposed on estates and gifts under income tax Act and Internal Revenue Code.[565] Article XXVI provided for mutual assistance in tax collection where the countries undertook to collect the others finally determined taxes as if they were its own.[566]

A closer examination of the NAFTA Treaty[567] reveals that it has exempted its application on taxation matters as provided for under Article 2103. However, the Treaty provides that in instances where there is inconsistency between the treaty and a bilateral tax convention, the tax convention prevails to the extent of the inconsistency. Despite this general rule, the same article provides for exceptional instances when the NAFTA Treaty applies on taxation matter.[568] These are:-

1. The application of Article 301 of the Treaty on market access on the basis of National Treatment as set out in Article III of the GATT.
2. Article 314 on export taxes to facilitate market access and Article 604 on energy export taxes applicable on the basis of the principle of non discrimination.
3. Article 1202 and 1405 on the application of National Treatment principle to cross- border trade in services and financial services respectively and,
4. Article 1102 and 1103 on investment, Articles 1202 and 1203 on cross border trade in services where National Treatment and MFN principles should apply respectively.

Despite the lack of competence on taxation matters, NAFTA Treaty has obligated the members to abide by the National Treatment principle on taxation matters relating to cross border taxation

[565] Article XXVII.
[566] Lorraine, *ibid.,* p. 314.
[567] Canada, Mexico and the United States entered into the North American Free Trade Agreement' on December 17, 1992.
[568] Article 2103(3) of the NAFTA treaty.

including tariffs and export taxes, taxes and incentives, direct and indirect taxes that affect cross-border trade in business services and taxation relating to expropriation.

According to Lorraine, the three NAFTA countries have adopted the National Treatment norm, reduced their withholding tax rates and have sought to link their bilateral tax treaties with the NAFTA. She suggests a multifaceted approach to enhance deeper fiscal integration under NAFTA.[569] First, that the three federal tax authorities should establish a consultative committee of senior tax officials who should meet regularly to exchange information on tax policy proposals, discuss the problem areas and subsequently be tasked to harmonise national tax policies on a regional basis.

The second proposal is that the three countries should extend their bilateral treaties to trilaterise them. Accordingly, the multilateral treaty adopted should include clauses on the MFN, National Treatment, information exchange, tax collection assistance and binding arbitration alongside the functional framework of the GATT trade agreements. Thirdly, she suggests that the NAFTA member states should adopt a free trade area in taxation through the elimination of withholding taxes within the region while allowing each country to maintain its own tax rates in relation to the other treaty partners. Fourthly, that the NAFTA member states could move to a single North American CIT with common tax bases and common rates. Here, a working group should be formed to evaluate the merits of adoption of common bases and rates through a formulary apportionment method. Finally, that the three countries could rewrite Article 2103 of the NAFTA and eliminate the provisions exempting its application on taxation matters.

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[569] Lorraine, *ibid.*, p. 318.

On the other hand, Cockfield argues for three possible approaches to evaluating the existing tax integration among the NAFTA Member States. He also discusses whether these approaches are possible in the present economic, social and political environment of NAFTA. Under the first approach, the NAFTA Member States could decide to maintain the *status quo* that is, coordinating the taxation of cross-border activities through existing bilateral tax treaties (BTTs). Under a second approach, the NAFTA Member States could undertake immediate comprehensive tax integration by harmonising their tax systems or adopting another far-reaching mechanism, such as a NAFTA-wide formulary approach toward taxing the profits of business entities operating in two or more NAFTA countries. Finally, that the NAFTA Member States could pursue a policy of gradualism, slowly harmonising their tax regimes and coordinating their tax policies. Under the current environment, Cockfield argues that gradualism is the most appropriate approach to resolving the tension that exists in each state's desire to obtain greater economic efficiencies while still preserving sovereign control of tax policy.[570] These options for NAFTA are crucial learning points for the EAC.

5.6. Comparative lessons for the EAC

Regional integration is a key cornerstone of today`s globalised economic order. The concept of inter-state integration has been embraced in most regions of the world such as Europe, North America and, as seen in the thesis, East Africa. This is because it offers the attractions of enhanced regional co-operation through integrated institutions and infrastructure. The modern-day challenges facing states such as terrorism and economic crimes have increased the attraction for integration and co-operation between states. This is because the concept, at its very basic,

[570] Cockfield, ibid., p 10.

provides the comfort of peaceful co-existence between neighbouring states and a concerted effort in tackling the modern global and regional challenges.

The EAC has made significant steps towards integrating both the inaugural Member States of Kenya, Uganda and Tanzania and the later entrants Rwanda and Burundi. South Sudan has recently applied to join the community, but this intent remains in limbo considering the devastating effects of the December 2013 attempted coup. One of EAC's milestones was the establishment of the Customs Union in 2005. This was touted as a major move towards enhancing cross-border trade and the fiscal movement of investments within the community.

Over eight years after the establishment of the Customs Union, Member States can attest to benefits derived from this harmonised system in the form of increased trade within the community and with the rest of the world. Harmonisation of taxation, as a key fiscal tool, has a major role to play in facilitating full economic integration.

The EAC needs to widen the scope of tax harmonisation from the current common Customs Union to encompass the whole tax spectrum including income tax which is the focus of this thesis. Such harmonisation should aim at finding a common ground in other areas of taxation including CITs.

As seen in the previous discussion, the EU is a great example of a regional bloc that has harmonised cross-border taxes between its Member States to the overall benefit of the region. Indeed, the empirical findings from the questionnaire responses herein supports the view that the

EAC can draw important lessons from the EU harmonisation experiences.[571] In recognition of the challenges of globalisation and global tax competition, the EU identified tax integration as one of its key goals. Prior-existing tax rules were found to hamper the free movement of goods, labour and capital within the region. These challenges and a genuine effort to reap the benefits of a seamless tax system within the Union led to the development of various harmonised tax institutions and rules.

The current situation in East Africa is not much different from the past EU experience. There is a genuine fear within the EAC that failure of tax integration may lead to the erosion of fiscal tax base of the member countries through increased mobility of the tax base, as corporations and individuals seek to migrate to more tax-optimal destinations within the region. Tax must be seen for what it really is: a cost of doing business and the price we pay for living in a civilized society.[572] It is understandable that governments will seek to protect their tax base and will not kindly admit any overtures that lead to the opening of that base to competition. However, it must be remembered that the freedom of establishment is a right of every business entity.[573] Greater tax mobility leads to tax competition, and will inevitably lead to a lower tax burden on consumers and companies in a "race to the bottom".

The EAC explicitly recognizes the role of tax harmonisation in the region's integration. In fact, the EAC Treaty clearly stipulates that the Member States will undertake to harmonise tax

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571 See Appendix 2.

572 Attiya Waris, '*Taxation without Principles: A Historical Analysis of the Kenyan Taxation System*', *Kenya* Law Review 272-304, p.272 (available at <www.kenyalaw.org>) writes that *"A State cannot run a democracy well without taxation and a taxation system cannot be run well without democracy. As Oliver Wendell Holmes has said on one occasion, 'Taxes are what we pay for civilized society'."*

573 This is the gist of the standard Article V of the DTTs between Kenya and the UK, Germany, Norway, Sweden, Denmark, India, Canada, Zambia and France.

policies. According to the Treaty, tax harmonisation will lead to the removal of tax distortions and bring about a more efficient allocation of resources within the Community. The EAC has taken steps towards actualizing tax harmonisation including partnering with development partners to coordinate the harmonisation process, and engaging the private sector in discussions on this issue. The EAC, in partnership with East African Business Council (EABC), held a Conference on Tax Harmonisation in Arusha on May 28th and 29th, 2009 whose objectives were to discuss the challenges faced in the process and a possible new direction for the EAC tax policy and administration.

The discussion on tax harmonisation should include, but not be limited to, harmonisation of tax base, tax rates, and taxation procedures; sharing of taxation information between governments, and establishing common standards for tax administration.[574] The income tax laws of the three inaugural EAC states, though tracing their origins to English laws, have quite marked differences. For example, the Tanzanian *Income Tax Act* of 2004 has a modern outlook and incorporates tax concepts developed for the modern business environment. On the other hand, the Kenyan *Income Tax Act* of 1973 has lagged behind in recognizing generally accepted best tax practices suitable for the 21st century. A consolidated law is thus necessary in the premise.

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[574] Currently there is marked heterogeneity in the EAC tax structures. Comparatively-speaking, at present, the VAT rates in Tanzania, Uganda and Kenya are 20%, 18% and 16% respectively. This variance in VAT rates, in effect, translates to different prices and costs to consumers for similar items.

5.7. Proposal for EAC CCCTB

The Common Consolidated Corporate Tax Base (CCCTB)[575] is a system of standardised rules of computing the tax base of a corporate group of companies with subsidiaries and/or permanent establishments in a Member State of the Community. The CCCTB allows a particular group of companies to consolidate its profits and losses. This consolidated figure is then allocated by means of an apportionment formula to the group members in the Member States in which the group has a taxable presence. The Member States then apply their own national tax rates to the allocated amounts to calculate the tax due in each Member State.[576] A major benefit of the introduction of the CCCTB is a reduction in the compliance costs for companies.[577]

The Common Consolidated Corporate Tax Base (CCCTB) is a single set of rules that companies operating within the Community could use to calculate their taxable profits. In other words, a company would have to comply with just one EAC system for computing its taxable income, rather than different rules in each Member State in which they operate. Specifically, this

575 The term 'Common Consolidated Corporate Tax Base' provides for the three basic factors of the proposed system. The first C in CCCTB stands for common. A common or uniform system would counteract the effects of heterogeneity. The second C in CCCTB stands for consolidated. Consolidation of the activities of corporate groups for tax purposes would alleviate the problems inherent in taxation based on separate accounting and the arm's length standard, which has posed challenges in the EAC as well as in international taxation more broadly. Finally, the third C stands for corporate, which means that corporations established under the EAC or third states being subject to the corporate tax in at least one Member State would be eligible to apply the system. (See generally, Dank Z.F., *Corporate tax harmonisation in the EU*, MPRA Paper No. 40350, August 2012, p. 21. Available at: http://mpra.ub.uni-muenchen.de/40350/). (Accessed November 1, 2012).

576 The KPMG Guide to CCCTB, p. 1. Survey evidence points to a reduction in the compliance costs for recurring tax related tasks in the range of 7% under CCCTB. The reduction in actual and perceived compliance costs exerts a substantial influence on firms' ability and willingness to expand abroad in the medium and long term. The CCCTB translates into substantial savings in compliance time and outlays in the case of a parent company setting up a new subsidiary in a different Member State. On average, the tax experts participating in the study estimated that a large enterprise spends over €140,000 (0.23% of turnover) in tax-related expenditure to open a new subsidiary in another Member State. The CCCTB reduces these costs by €87,000 or 62%. The savings for a medium sized enterprise are even more significant, as costs are expected to drop from €128,000 (0.55% of turnover) to €42,000 or a decrease of 67%.

577 Other benefits include intra-corporation unity within group members, apportionment of losses, the maintenance of fiscal /tax sovereignty and cooperation in computation of a corporate tax base.

common fiscal framework provides for rules to compute each company's (or branch's) individual tax results, the consolidation of those results, when there are other group members, and the apportionment of the consolidated tax base to each eligible Member State. The CCCTB is available for all sizes of companies. In fact, MNEs would be relieved from the fact of certain tax obstacles in the single market and SMEs would incur less compliance costs when they decide to expand commercially to another Member State. The system may be made optional at the inception and made compulsory gradually. Since not all businesses trade across the border, the CCCTB will therefore not force companies not planning to expand beyond their national territory to bear the cost of shifting to a new tax system.[578]

In the EU, the CCCTB aims to tackle some major fiscal impediments to growth in the Single Market. In the absence of common corporate tax rules, the interaction of national tax systems often leads to over-taxation and double taxation, businesses are facing heavy administrative burdens and high tax compliance costs. This situation is seen to create disincentives for investment in the EU and, as a result, runs counter to the priorities set in Europe 2020, a strategy for smart, sustainable and inclusive growth. The CCCTB is an important initiative on the path towards removing obstacles to the completion of the Single Market and was identified in the EU Annual Growth Survey as a growth-enhancing initiative to be frontloaded to stimulate growth and job creation.

[578] Under the CCCTB, groups of companies would have to apply a single set of tax rules across the Union and deal with only one tax administration (one-stop-shop). A company that opts for the CCCTB ceases to be subject to the national corporate tax arrangements in respect of all matters regulated by the common rules. A company which does not qualify or does not opt for the system provided for by the CCCTB Directive remains subject to the national corporate tax rules which may include specific tax incentive schemes in favour of Research & Development.

Against the backdrop of the EU example, this chapter seeks to evaluate the viability of a proposal for the CCCTB applicable to the EAC region as modeled along the EU example. The chapter considers the policy options to guide negotiations on the establishment of the proposed CCCTB. Indeed, the EAC region is geo-politically and economically different from both the EU and therefore any consideration of a CCCTB proposal for the region must proceed carefully taking into account the unique socio-economic and political factors of the EAC region. The chapter therefore evaluates the proposal for an EAC CCCTB against the backdrop of the lessons learnt from the EU experience.

5.7.1. Brief lessons from the EU

5.7.1.1. The legal framework for the EU model

Direct legislation in the EU falls within the ambit of Article 115 of the *Treaty on the Functioning of the EU*. This clause stipulates that legal measures of approximation under that Article shall be vested the legal form of a directive. The fact that the said legal measures are clothed with the title of "directive" does not in any sense take away the power or force of law from it. It is in this sense that such directives, read together, constitute the legal framework for the EU model.[579]

5.7.1.2. The Comparative options

The common approach proposed ensures consistency in the national tax systems but would not harmonise tax rates. Fair competition on tax rates is to be encouraged. Differences in rates allows a certain degree of tax competition to be maintained in the internal market and fair tax

[579] To assist Member States' tax administrations in the run up to the implementation of the CCCTB, it is planned that the fiscal EU programme is mobilised to assist Member States in the CCCTB implementation and administration.

competition based on rates offers more transparency and allows Member States to consider both their market competitiveness and budgetary needs in fixing their tax rates.

Indeed, the CCCTB is compatible with the rethinking of tax systems and the shift to more growth friendly and green taxation advocated in the Europe 2020 strategy. In designing the common base, supporting research and development has been a key aim of the proposal. Under the CCCTB, all costs relating to research and development are deductible. This approach acts as an incentive for companies opting into the system to continue to invest in research and development. To the extent that there are economic losses to be offset on a cross-border basis, consolidation under the CCCTB tends to shrink the common base. However, in general, the common base would lead to an average EU base that is broader than the current one, mostly due to the option retained for the depreciation of assets.[580]

Businesses operating across national borders benefit both from the introduction of cross-border loss compensation and from the reduction of company tax related compliance costs. Allowing the immediate consolidation of profits and losses for computing the EU-wide taxable bases is a step towards reducing over-taxation in cross-border situations and thereby towards improving the tax neutrality conditions between domestic and cross-border activities to better exploit the potential of the Internal Market.[581]

[580] EU Council Directive on CCCTB harmonisation.
[581] Calculations on a sample of EU multinationals shows that, on average approximately 50% of non-financial and 17% of financial multinational groups could benefit from immediate cross-border loss compensation.

The EU impact assessment[582] examines the different policy options relevant to a corporate tax base with the aim of improving the competitive position of European companies by providing them with the chance to calculate their EU-wide profits according to one set of rules and hence, appoint a legal environment that best suits their business needs and at the same time, eliminating tax costs related to the existence of twenty seven separate national tax systems. Four main policy scenarios are considered by the EU:

1. **An optional Common Corporate Tax Base (Optional CCTB)**

Here, the EU resident companies (and EU situated permanent establishments) would have the option to compute their tax base pursuant to a set of common rules across the Union rather than any of the twenty seven national corporate tax systems. Thus, 'separate accounting' per transaction (according to the arms-length principle) would remain in place for intra-group transactions which would not involve a consolidation of tax results.[583]

A key obstacle in the single market today involves the high cost of complying with transfer pricing formalities using the arm's length approach. Further, the way that closely-integrated groups tend to organise themselves strongly indicates that transaction-by-transaction pricing based on the 'arm's length' principle may no longer be the most appropriate method for profit allocation. The possibility of cross-border loss offsets is only made possible in a limited number

[582] Considered in the "Proposal for a Council Directive on a CCCTB", available at www.eur-lex.europa.eu (Accessed on 4th December 2015).

[583] The proposal will benefit companies of all sizes but it is particularly relevant as part of the effort to support and encourage SMEs to benefit from the Single Market as set out in the review of the *Small Business Act* (SBA) for Europe. The CCCTB notably contributes to reduced tax obstacles and administrative burdens, making it simpler and cheaper for SMEs to expand their activities across the EU. The CCCTB will mean that SMEs operating across borders and opting into the system will only be required to calculate their corporate tax base according to one set of tax rules. The CCCTB complements the European Private Company (SPE), which is still under discussion in the Council. A common framework for computing the tax base for companies in the EU would be particularly useful for SPEs operating across Member States.

of circumstances within the EU, which leads to over-taxation for companies engaged in cross-border activities. In addition, the network of Double Tax Conventions (DTCs) does not offer an appropriate solution for the elimination of double taxation in the single market, as it is designed to operate in a bilateral context at the international level, rather than within a closely integrated setting.

The CCTB proposal is not intended to influence the tax revenues and the impact on the distribution of the tax bases between the EU Member States has been analysed. In fact, the impact on the revenues of Member States will ultimately depend on national policy choices with regard to possible adaptations of the mix of different tax instruments or applied tax rates.

In this respect it is difficult to predict the exact impacts on each of the Member States. In this context, as an exception to the general principle, where the outcome of the apportionment of the tax base between Member States does not fairly represent the extent of business activity, a safeguard clause provides for an alternative method. Moreover, the Directive includes a clause to review the impacts after five years following the entry into force of the Directive.

For Member States, the introduction of an optional system will of course mean that tax administrations will have to manage two distinct tax schemes (CCTB and their national CIT). But it is compensated by the fact that the CCTB will mean fewer opportunities for tax planning by companies using transfer pricing or mismatches in Member State tax systems. There will be fewer disputes involving the ECJ or the mutual agreement procedure in double tax conventions.

2. **An optional Common Corporate Tax Base (Compulsory CCTB)**

Here, the qualifying companies and permanent establishments would be needed to compute their tax base pursuant to a single set of common rules across the Union to replace the present disparate twenty seven national corporate tax systems. Absent consolidation, separate accounting would continue to determine the profit allocation in intra-group transactions.

3. **An optional Common Consolidated Corporate Tax Base (Optional CCCTB)**

A set of common rules setting an EU-wide consolidated tax base would form an alternative to the present twenty seven national corporate tax systems and the use of 'separate accounting' (as defined above) in allocating revenues to associated companies. In this scenario, the tax results of each group member would be aggregated to achieve a consolidated tax base and re-distributed according to a pre-established sharing mechanism based on a formula.

4. **A compulsory Common Consolidated Corporate Tax Base (compulsory CCCTB)**

Here, the resident companies and permanent establishments owned by companies outside the EU would be required to apply the CCCTB rules as far as they fulfill the eligibility requirement for forming a group.

5.7.1.3. Proportionality and subsidiarity

The proposal for an EU CCCTB represented a proportionate answer to the identified problems posed by the indiscriminate application of the twenty seven separate national tax systems. This proposal was primarily based on the need to attract FDI in the single market as tax compliance costs decrease. The elimination of the transfer pricing (TP) formalities presents considerable

benefits to the companies. It is also possible to transfer losses across national borders within the same group as well as from tax free intra group reorganizations. The positive impact ought to outweigh possible additional financial and administrative costs borne by the national tax authorities.

The proposal is both suitable and necessary to the EU for achieving the desired end and is therefore proportionate. Indeed, to harmonise the corporate tax base is a prerequisite for curbing the identified tax obstacles and rectifying their market distorting elements. As far as the EU is concerned, there is no harmonisation of tax rates[584] (or setting of a minimum) as this has been left to the Member States' tax sovereignty through the instrumentality of national legislation.

As far as subsidiarity is concerned, this principle is set out in Article 5 of the *Treaty on the EU*. The CCCTB system intends to deal with fiscal obstacles resulting from the disaggregation of the Union into the twenty seven disparate tax systems which businesses operating within the single market face.

Lack of coordinated action, planned and implemented by each Member State individually replicates the current fragmented situation which unconscionably exposes the companies to deal with many tax administrations according to the number of Member States in which their tax liability falls.

[584] Tax harmonisation essentially involves the harmonisation of tax rates and bases. While the EU has adopted for the latter only, both are suggested for the EAC.

Harmonisation of the corporate tax base thus makes effective relief for cross-border losses and tax free group restructurings. Thus, double taxation or non taxation in case each Member State applied its own systems are avoided. In effect, also, a single set of rules for computing, consolidating and sharing the tax bases of associated companies lessens the market distortions caused by the present interaction of the twenty seven disparate national tax systems in the EU.

Therefore, the pillars of the system, particularly cross-border relief, tax free intra group asset transfers and the allocation of the group tax base through a formula, could only be effected under a common regulatory umbrella. Commensurate with this move, common rules of administrative procedure are necessary to pave way for a ‘one stop shop’ administration to function.

The combating of tax obstacles occasioned by the disparities of national systems in computing the tax base between associated companies also needs to be taken into account. In dealing with those obstacles, the best results would be achieved through a common framework to govern the calculation of a corporate base and cross-border consolidation.

As a governing framework, it is imperative for these matters to be governed by legislation at the EU level due to their cross-border nature. This is impinged into subsidiarity as Member States would fail to achieve the intended results through lack of consolidation which is inimical and counterproductive to the tenets or ideals of the Union.

5.7.2. The Proposed EAC Model

5.7.2.1. Legal basis for CIT harmonisation

The underlying legal basis for general tax harmonisation in the EAC is Article 83 (2) of the *EAC Treaty* under which the Partner States undertake to harmonise their tax policies with a view to removing tax distortions in order to bring about a more efficient allocation of resources within the community.

On the other hand, Article 32 of the *EAC Common Market Protocol*, the EAC *"Partner States undertake to progressively harmonise their tax policies and laws with a view to remove tax distortions in order to facilitate the free movement of goods, services and capital and the promotion of investment within the Community"* including FDI. The technical deficiency in the two provisions highlighted above is that even when jointly-interpreted, they do not point the EAC to any specific path of harmonisation, thus leaving a keen analyst to look for comparable solutions or options elsewhere such as the EU.

5.7.2.2. Scales/degrees of harmonising the EAC CTB

Harmonisation of the corporate tax base can be systematically attained through five scales. These are *standardisation*, *compatibility*, *coordination*, *cooperation* and, finally, *convergence*.

Through the Customs Union, the EAC has demonstrated the highest degree of harmonisation by standardising the application of a customs tax through the Common External Tarriff (CET). As far as this thesis is concerned, the standardisation scale is too ideal for the achievement of a CCCTB. This is because the thesis advocates for partial tax harmonisation of the tax base for

CIT only. Compatibility is relevant to the achievement of an EAC CCCTB to the extent that Member States should adjust their domestic tax systems to the agreed tax base. Identical tax rates may not be attained. Compatibility implies coordination on the basis of the tax bases but leaving some room for tax rates and exemptions. As a principle, it is thus relevant to the quest for a uniform EAC CCCTB.

To cushion against lack of proper coordination which partly accounted for the historical collapse of EAC 1, the present EAC ought to strive towards synchronizing and integrating the achievement and effective operation of the CCCTB so as to avoid running on slippery ground like EAC 1. Coordination should extend to the method of computation of the common tax base, its manner of application and the administration procedures.

Practical and technical cooperation, too, is necessary in order for the CCCTB to be applied uniformly by the resident companies and permanent establishments. Finally, convergence points the EAC Member States to the same direction in matters concerning the CCCTB. Convergence policies need to be clear and foolproof to ensure optimal functioning of the CCCTB and safeguard against the pitfalls of implementation encountered by the EU.

5.7.2.3. The Options: CCTB or CCCTB?

The policy options available to the EAC, like the EU, include the adoption of either a CCTB or CCCTB. The difference lies in the inclusion of the word "consolidated". The CCCTB requires the resident companies and permanent establishments to compute their tax base pursuant to a set of common rules applicable to the region rather than disparate national systems. On the contrary,

the CCCTB aims to enact a set of common rules establishing a consolidated tax base arrived at through the summation of the respective tax bases of the Member States. This is a more suitable route for the EAC considering the spirit of Article 83(2) of the *Treaty* and Article 32 of the *Common Market Protocol.*

As far as the techniques of arriving at the tax base are concerned, the calculation may be done as follows:

Revenue[585]		XXXX
Less: Exempt Revenue	XXX	
Less: Deductible expenses	XXX	
Less: Other deductible items	XXX	
TOTAL DEDUCTIBLES		XXX
(NET) CCCTB[586]		XXX

The revenue of a company compromises the shareholders' equity as divided into the share capital and reserves. The exempt revenue (exempt from corporate tax) comprises the subsidies directly linked to the acquisition, construction and improvement of fixed assets (subject to depreciation), proceeds from the disposal of pooled assets (including the market value of non-monetary gifts) received profit distributions, proceeds from disposal of shares and the income of a permanent establishment in a third country.

[585] See Article 83 of the EU Council Directive on CCCTB for technical aspects of computation of income
[586] See Article 57 of the EU Council Directive on the scope of consolidation under CCCTB.

The deductible expenses include all cost of sales and expenses net of deductible VAT incurred by the taxpayer with a view to obtaining or securing income. To this, the cost of research and development and costs incurred in raising equity or debt for business purposes are added. In terms of other deductible items, a proportional deduction may be made in respect of depreciation of fixed assets. The expenses to be treated as non-deductible are profit distributions and repayments of equity or debt on agreed proportion of entertainment costs, transfer of retained earnings to a reserve which is part of the company's equity, corporate tax, fines and penalties and costs incurred in deriving exempt incomes, monetary gifts and donations, costs related to acquisition, construction or improvement of fixed assets and taxes.

5.7.2.4. Harmonisation of the institutional framework

In the administration of a CCCTB, it is important to have a common or centralised institutional framework to enforce the CCCTB and uniform procedures to govern its operationalisation and relevant tax processes. The range of procedures extends to the mode of application to become a member of the CCCTB system, the information necessary for the application for membership, the term of a group of companies, the relevant tax year, the filing of tax returns and the relevant content of the return, amendment of tax assessments, data storage of tax information, the identification of the principal taxpayer, furnishing of information to competent authorities, information sharing, communication and dispute settlement between group members including the handling of both administrative and judicial appeals.

It is imperative for the above procedures to be harmonised so as to achieve uniformity in the conduct of corporate income taxation matters generally in the EAC and with regards to the

CCCTB in particular. Thus, as far as the concept of harmonisation goes, the procedures must be known before hand to the taxpaying company and the central authority administering the CCCTB.

At the moment in the EAC, the heterogeneity of the CIT laws, policies and practices generally means that the procedures adopted by the EAC companies with regard to the accounting and/or computation of the CCCTB are diverse and disparate leading to counterproductive and inimical effects such as tax avoidance and revenue erosion. The CCCTB implies a straightforward formula towards calculation of the tax base of group and/or associated companies including permanent establishments. It is thus imperative for the current heterogeneous procedures to be synchronized into a set of common rules in order to enhance integration generally and harmonisation in particular.

In terms of practical application, it is advisable for a proposed institutional body called "*the EAC Income Tax Authority" (EACITA),* to manage the above procedures for purposes of uniformity in the institutional management.

The adoption of a CCCTB would provide corporations operating in more than one EAC member state with the option to compute group taxable income according to the agreed EAC set of rules based on the agreed base. Apart from reducing tax compliance cost, an EAC CCCTB would prevent instances of tax planning, harmful tax competition, double taxation and other trade distorting effects of heterogeneity of corporate income. In addition, the objectives of the EAC common market seeking freedom of movement of goods, services, capital, labour and right of establishment may be attained. Further, the new framework would abolish the current system of

separate accounting where each of the five EAC member states apply independent accounting rules for cross border transactions within a group of companies. As is currently, this separate system of accounting provides a loophole for tax evasion and fraud due to the heterogeneous accounting systems within the context of a common market.

The administrative and compliance cost associated with heterogeneous corporate tax systems of the EAC is costly to the tax authorities and corporations of the member states. The importance of having a compulsory tax base is that it would in the long run replace the existing tax base and therefore enhance efficiency amongst the tax authorities and the corporations within the EAC. The exposure to tax evasion, avoidance and fraud will be minimized and harmful tax competition will be prevented. The adoption of a compulsory model, it is conceded will be difficult since it may not be practically possible for the member states to suddenly agree to the CCCTB model due to the divergence of their national legislation and procedures.

On the other hand, the optional CCCTB would allow the EAC member states to choose between the existing national base and the common EAC base. The advantage of this model is that the member states and corporations would gradually adopt the CCCTB model and therefore avoiding a drastic change. Further, in tandem with Article 32 of the Common Market Protocol, it is expected that harmonisation should target the trade distorting taxes that have cross-border presence and therefore making the optional model the desirable design.

With regards to the corporations to which the CCCTB should apply, it is advisable that an appropriate categorization based on the IAS or IFRSs be adopted. Here, large corporations

identified on the basis of a set of agreed threshold would be subject to CCCTB in the initial stage and gradually applied by all the corporations with cross border presence.

With the options of CCTB or CCCTB, this thesis argues that the long term strategy for the EAC would be the consolidation of the tax base. Consolidation would require the drafting of detailed rules and agreement on the sharing of the tax base between the member states. The short term strategy however is the adoption of the same tax rules in each member state without the requirement of consolidation i.e. a common tax base (CCCTB).

In terms of practical implementation/ application, the harmonisation process, could be split into two stages, firstly being the development of the common corporate tax base and secondly the development of a consolidated corporate tax base. For successful implementation of Article 32 of the common Market protocol and Article 83 (2) of the Treaty, this thesis advocates that the EAC should adopt these strategies.

Turning to the harmonisation of the corporate income tax rates, the treaty and its attendant protocol is not explicit on whether it should be harmonised. This thesis proposes that corporate income base harmonisation should be extended to rate harmonisation. With the challenge of harmful tax competition, harmonisation of corporate tax rates would provide a long term solution. This could take different forms i.e. uniform tax rates, minimum tax rates, maximum tax rates, or tax bands. Indeed, based on successful harmonisation of customs band the adoption of EAC CET, similar initiatives should be explored with regard to corporate income taxes. A

framework in furtherance with the CCCTB should be explored with respect to rate harmonisation.

This thesis proposes that the next step should be the setting up of a working group consisting of experts in this area for whose task would be to find a suitable definition of tax base, develop a common tax base, reflect on the EAC Treaty objectives and develop principles to guide the harmonisation process and to developed a framework for negotiation and conclusion of a protocol on EAC corporate income tax harmonisation in compliance with Article 83 of the Treaty.

Based on the proposed EU directive on a CCCTB framework,[587] this thesis proposes that the EAC should enact a Protocol on harmonisation of corporate income taxes with the following features:

1. ***The scope of harmonisation***

   Here, the protocol should spell out the eligibility of corporations whether from the member states or from the third member states, the extent of harmonisation ie from CCTB to CCCTB and ultimately to rate harmonisation.

2. ***Interpretation of key terms***

   This part constitutes the interpretation section for key concepts such as consolidated tax base, permanent establishment, resident and nonresident tax payer etc.

3. ***The application of CCCTB model under the Protocol***

[587] See the EU Council Directive, available at: *data.consilium.europa.**eu**/doc/document/ST-14509-2015-INIT/en/pdf, (accessed on 20th January 2016).*

This part should provide mechanisms for operationalisation of the CCTB or a CCCTB model. In addition, the section should determine the dominant law in instances where there exists a conflict between a national legislation and the protocol and also conflicts between the Protocol and the DTTs signed between the EAC member states and the third party states.

4. ***The computation of the tax base***

   This part should indicate the period of accrual of revenue, the time of incurrence of deductible expenses, costs related to non depreciable assets, valuation of assets, hedging, transfer of assets to a third country etc

5. ***Depreciation of fixed assets***

   Here, provisions should be made on depreciation of fixed, other tangible and intangible assets for tax purposes. Exemptions may also be considered in certain circumstances.

6. ***Losses and its effects on the tax base***

   Provisions should be made on whether the CCCTB group will be allowed to carry losses forward and for what period or whether no loss carry back would be allowed.

7. ***Provisions relating to exit from the CCCTB***

   Provision should be made on how computation is made when a taxpayer opts-in to the CCCTB system, where a taxpayer incurred losses before opting into the system and also the treatment of assets and liabilities when a taxpayer leaves the CCCTB system.

8. ***Scope and timing of consolidation of tax base***

   Here, the Protocol should provide rules to determine eligibility for consolidation and the appropriate criteria for calculation bearing in mind the elements of control and ownership.

9. ***Anti- abuse rules***

The Protocol should provide for general anti-abuse rules, supplemented by measures designed to curb specific types of abusive practices. These measures may include limitations on the deductibility of interest paid to associated enterprises resident, for tax purposes, in a low-tax country outside the EAC which does not exchange information with the Member State of the payer.

10. ***Rules on the apportionment of consolidated tax base***

Here, a suitable formulary apportionment system for the EAC should be designed under the Protocol.

11. ***Administration and procedure***

This section will provide the framework for harmonisation of the EAC CIT administration and procedure , proposal for establishment of an authority (EACITA) to oversee the collection, administration and apportionment of the consolidates corporate income taxes. It should determine the fiscal year, the content and the timelines for filing tax returns, the penalty for failure to file returns, audits, appeals and the role of the EACJ in the determination of judicial appeals.

12. ***Miscellaneous provisions***

5.8. Conclusion

This Chapter has endeavoured to make a case for the harmonisation of the EAC's income tax law and policy. Various reasons have been given for this proposition including the treatment of incentive schemes in the CIT system especially EPZs and SEZs, initial capital allowances, and capital gains from asset sales, treatment of losses (carry forward), and foreign losses and

withholding taxes on dividends, interest payments, royalties and service fees; transfer pricing and thin capitalisation rules. In the vein of this proposal for harmonisation and consolidation of income tax law and policy, the Chapter has also adverted to the need for the EAC Member States to form good outward or external linkages with third party states in the area of taxation generally. Chief in this regard is the avoidance of double taxation.

The Chapter has also surveyed selected areas in which the EAC as a region, despite challenges, has managed to achieve some sort of harmonisation, integration and/or coordination. These areas include tourism, customs, competition, higher education, standardisation, quality assurance, metrology and testing.[588] The simple thesis proffered in this miniature comparative study is that if harmonisation has been possible in these areas, then it is equally achievable for corporate income tax law and policy.

Further, the chapter has examined the tax harmonisation experiences of the EU and NAFTA regional organisations.[589] The objective of the section (that is, to find support for the EAC reform initiatives by reflecting more closely on the EU and NAFTA approaches to managing the pressures of increased globalisation and regional integration) has been achieved thus making a case for harmonisation.

Consequently, a combined review of the respective income tax laws of the EAC Member States would reveal deficiencies in one tax system which may be plagued by adopting procedures

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588 The EALA laws matrix is included as an Appendix 5 to this thesis to show the catalogue of statutes enacted for the EAC which, in their tenor and effect, evince harmonisation, integration and/or coordination in their respective subject areas.

589 Other germane experiences for further study include the Central American, OECD and ASEAN experiences.

available in another tax system. Such a review should be targeted towards identifying the discrepancies and gaps in the national tax systems and providing recommendations on the relevant areas to be harmonised, of course with emphasis on corporate income tax. The government of each Member State must be willing to cede some sovereignty for the regional good. It is therefore trite that insufficient tax harmonisation between the East African countries has been, and will invariably continue to be, a barrier to progress in regional economic integration.

Finally, the chapter has evaluated the proposal for an EAC CCCTB. Comparatively-speaking, the EU has had a near successful attempt at achieving the same. Consequently, the chapter has endeavoured to model the proposed EAC CCCTB along the lines of the EU CCCTB. The chapter also considered whether the EAC ought to develop a CCTB or CCCTB and upon critical evaluation, the study opted for the latter. This is the core of the recommendations of the study proffered in Chapter Six. It emerges that the decision regarding the application and choice of a CCCTB to the EAC region is a technical one involving legal, economic, policy and, perhaps, political considerations. The EAC ought to proceed very carefully but decisively regarding this choice.

CHAPTER SIX

CONCLUSION AND RECOMMENDATIONS

6.1. <u>CONCLUSION</u>

The EAC represents the desire of its citizens to reap the full benefits of a single market by reducing barriers to the freedoms established under the Treaty and the Common Market Protocol. Tarriff and non-tarriff barriers have curtailed these freedoms. Economic integration is a significant step towards a political federation of the EAC. It has emerged that whereas the harmonisation of customs has been made possible through the ratification of the EAC Customs Union Protocol and its implementation through the *EAC Customs Management and Coordination Act*, such legislative interventions have not been made in respect to income and other taxes despite their effect on the operationalisation of the EAC common market. This thesis has argued that the existing differentials in income taxes, as exemplified through corporate income taxes are harmful to the future economic integration of the EAC. This problem is attributable to the provisions of Article 83 of the Treaty which provide in general terms for harmonisation without specifically making reference to income taxes. This gap has caused the member states to maintain their national corporate income taxes with adverse effects on the full operationalisation of the EAC Common Market.

Further, whereas Article 32 of the EAC Common Market Protocol provides for fiscal harmonisation generally, again, it is not specific as to the taxes that should be harmonised. In addition, there is continued reluctance in embracing that intended change which highlights the distinct and important role that tax policy plays within each EAC member state. This thesis has

argued for harmonisation of income tax policy as an antecedent to adoption and implementation of a consolidated income law of the EAC. Some focus was made on corporate income taxes.

This study was guided by four main objectives[590] which have been addressed in the various chapters of the thesis. Chapter one of this study highlighted the challenge of attempting corporate income tax harmonisation in East Africa. It did so in order to lay the basis for the entire thesis. The chapter contained the statement of the problem, justification for the study, conceptual and theoretical framework of the study, objectives of the study, hypotheses, research questions, research methodology, limitations of the study, literature review and the outline of the chapters.

The subsequent chapters have proposed a heightened community tax co-ordination approach as the most appropriate measure to be undertaken by the EAC Member States. The Treaty provisions, convergence of Member States' tax burdens and the uncertainty surrounding the international tax principles on tax competition *vis-a-vis* tax harmonisation and the desire by the Member States and governments to preserve their tax autonomy informs the recommendations addressed herein.

Chapter Three has highlighted the distinct heterogeneity in income taxes and some policy aspects in the EAC while Chapter Four has described the effects of such heterogeneity. The sovereignty concerns addressed in Chapter Four points to a complex regime that if not well managed could erode the desires of the EAC fiscal harmonisation as contained in the Treaty and reinforced by the Common Market Protocol. The recommendations are intended to benefit the Member States in resolving some outstanding and future tax integration issues that confront the Member States

[590] See Chapter One, part 1.5.4., of this thesis.

in an environment of increased economic integration. The Member States would make better use of the recommendations with enhanced consensus at the community and national levels.

Chapter Four describes the challenges encountered in maintaining five (5) different regimes of income taxes in a Common Market, ranging from harmful tax competition, tax avoidance and distortions to the organisation of integrated economic activity. Plans to expand the EAC in the long run are likely to complicate the already problematic tax matters. The expansion includes a more heterogeneous group of countries which might make it difficult to reach agreement underneath the current concerns about trade distortion. This requires explicit definition and agreement on corporate income tax matters at this stage to give the new entrants an opportunity to assess the viability and benefits of joining the Community. For instance, in respect of a Kenyan registered company owning a Tanzanian subsidiary which sells products in Uganda and which is owned by East Africans of all nationalities, it is not obvious which government should receive the corporate income tax revenue from those activities, nor how it should be allocated between them. The difficulty in resolving these issues should not be underestimated.

It was the contention of Chapter Three that there is need for a tax policy to conceptually underpin a new harmonised and consolidated law. This position was supported by empirical findings that income tax policy should precede the law harmonisation. The tenets of such policy are constitutional and fiscal in nature, tenure and effect. It is this proposed policy that will deal with the negative and deleterious effects of heterogeneity in corporate income taxation in the EAC.

Drawing parallels from the success stories of the EU and NAFTA, Chapter five sought to establish a case for the harmonisation of corporate income tax law and policy. The EU for instance has been struggling with the issue of harmonisation for decades with uneven progress. VAT harmonisation has been adopted within the EU, but the Member States continue to resist the adoption of similar rules in respect to income taxes. These member states continue to fear the intrusion on their ability to use tax policy as a domestic policy tool. Significant progress has however been made through Council Directive on adoption of the CCCTB as recommended in the EU Report on company taxation. These comparative studies provided useful lessons that if the challenges of fiscal integration can be overcome, then harmonisation and consolidation of income tax law and policy can be a practical and achievable reality for the EAC in the present and future circumstances.

In addition, the chapter evaluates the proposal for a CCCTB to be applicable within the EAC region. The chapter has weighed various options considered by the EU, and partly NAFTA, in assessing the best model for adoption by the EAC to counter the negative effects of heterogeneity resulting from the application of different modes of computation of the corporate tax base. The CCCTB is suggested as an umbrella solution to resolving the problems posed by the diverse corporate tax base (CTB) systems. Chapter six of the study has made various suggestions for reforms which include general, policy, legislative and institutional reforms.

This study was conceptually hinged upon four hypotheses which were tested. The following findings emerged: Firstly, the existence of heterogeneous CIT systems in the EAC has caused adverse effects on the economies of the EAC and has slowed the steps towards the full economic

integration based on the ideals of an EAC common market. Secondly, the full operationalisation of the common market may become a pipe dream if fiscal integration is not achieved. Corporate income tax harmonisation is thus one step in overcoming the fiscal distortions in a single market. Thirdly, the EAC initiative on corporate income tax harmonisation should target the law, policy and institutional reforms. Various policy options including agreement on convergence or standardisation and whether to adopt a CCTB or CCCTB have been considered. Other policy issues include the agreement on measures to curb double taxation, harmful tax competition and the enhancement of efficiency in tax administration. Law reforms would include the enactment of a Protocol on CIT harmonisation, an EAC framework on CCCTB, ratification of the EAC DTA and the alignment of national legislation to the EAC framework. The administration and compliance challenges call for institutional reforms and as suggested herein, a common institution (EACITA) should be established to implement the reforms. In addition, a working group should be created to review the progress of implementation of harmonisation and advise the member states.

Fourthly, the EU and NFTA initiatives were found to be informative on the EAC drive towards CIT harmonisation. However, while the EU CCCTB initiative is proposed to be implemented through a council directive, the EAC, borrowing from the customs harmonisation, have an opportunity to enact a Protocol on CCCTB since the EAC Treaty provides for tax harmonisation. The NAFTA experience was found useful, especially, on the need for the EAC to adopt gradual convergence and hopefully standardisation of its CIT laws and policies. Generally, all hypotheses set out in part 1.7.4 herein have been proved. Future research is however needed to

consider the implementation of CIT rate harmonisation and the harmonisation of the other outstanding taxes such as VAT, excise and personal income taxes.

In a nutshell, the EAC Member States should re-examine and re-evaluate their traditional ways and approaches of developing a purely domestic income tax policy and redirect its focus on the current drive towards regional economic and political federation. It is hoped that if the recommendations herein are effected, then the second, third and fourth integrative steps as envisaged in the Treaty may be achieved with ease and expeditiously.

6.2. RECOMMENDATIONS

The recommendations are categorised into legislative, institutional, policy and general reforms.

6.2.1 LEGISLATIVE REFORMS

In order to achieve harmonisation of the CTB, legislative reforms on the various existing legal instruments should be effected. In addition, new legal instruments should be put in place to supplement and operationalise the amended provisions. Apart from amendment of the Treaty, it is strongly advocated that a Protocol on EAC corporate income tax harmonisation should be formulated and concluded. In addition, the EALA could also be tasked with the enactment of the law to operationalise the Treaty and Protocol as is the case with customs. It will also be necessary to repeal all the domestic laws on income taxes once regional law is operationalised.

6.2.1.1 Amendment of the EAC Treaty

This study has established that the challenges caused by the differences in corporate income taxes is attributable to insufficient provisions of EAC Treaty and its attendant Protocol.[591]The suggestions for reforms therefore call for the amendment of these provisions to specifically provide for income tax harmonisation and by extension, harmonisation of CITs. The amendments on the Treaty should target Article 83 (e) thereof which provides for tax harmonisation in general terms. It is recommended that this provision be amended to isolate the different taxes that should be harmonised including corporate income taxes. Further, it should provide for conclusion of Protocol on harmonisation of corporate income taxes. The amendment of the Treaty to provide for an EAC Protocol on income taxes will be made pursuant to the provisions of Article 150 of the Treaty.

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[591] Article 83(2)e)) of the EAC Treaty and Article 32 of the EAC Common Market Protocol.

6.2.1.2 EAC Protocol on harmonisation of corporate income taxes (CITs)

The other major recommendation would be the conclusion of the Protocol on harmonisation of income taxes. The protocol should define the scope of income taxes to be harmonised. This study strongly advocates for harmonisation of corporate incomes as it is a major trade-distorting tax because of its cross boundary nature. The Protocol on harmonisation of corporate income taxes can be made pursuant to Article 151 of the Treaty. The protocol shall provide for mechanisms to deal with problematic areas highlighted in Chapter Five of the study which include, the incentive schemes in the CIT system especially EPZs and SEZs, initial capital allowances and capital gains from asset sales, treatment of losses (carry forward), including foreign losses and withholding taxes on dividends, interest payments, royalties and service fees. Two possible routes could be taken to achieve a harmonised corporate income tax regime. These are:

a. Harmonisation of tax bases

One possible route for further coordination in the EAC would be through tax bases. This would involve standardisation of the definition of taxable income/profit within the EAC but keeping the five (5) different corporate income tax systems in place with each country levying its own tax rate. There are several steps that would have to be taken to arrive at a harmonised definition of taxable profits including moving to a harmonised system of tax treatment of deductible items such as depreciation, interest, goodwill, intangibles and other deductions; agreement on the range of tax incentives measures allowable; agreeing on how tax rules should be applied *vis-a-vis* countries outside the EAC framework; agreement on the treatment of income earned in other jurisdictions and on the treatment of dividends, interests and other payments between the EAC countries. A full consideration of the proposed EAC CCCTB has been given in Chapter five.

Unless all these steps could be achieved, there is bound to be limited gains in terms of reducing the distortions outlined in Chapter Four herein. Countries could still compete over their overall tax rates. Harmonising the tax base would still leave room for the exploitation of different tax rates, such as the manipulation of transfer prices.

This leads to a further suggestion that the EAC Member States should develop guidelines on transfer pricing. They could adopt the OECD rules *mutatis mutandis*. There is need to find an appropriate arm's length methodology to cover the increasingly integrated cross-border or regional and global business. Although a harmonised tax base would lead to fewer mismatches between the EAC countries, the existing problems would still arise for transactions between the EAC and the rest of the world. The location of production would remain affected by the differences in corporate income tax rates and organisational structures would still be influenced by the requirements of dealing with five different tax systems. Administrative and compliance costs might fall slightly, however, even if all the corporate income tax reforms worked upon the same definition of taxable profits, there would still be five different ways to administer taxes in the EAC. It should, however, be noted that gradual changes towards a more consistent tax base is likely to occur over time, for instance, through the coordination or approximation of accounting rules within the EAC.

b. Harmonisation of tax rates

If customs tax is considered a suitable model to guide corporate income tax harmonisation, then it is worth considering the harmonisation of the EAC corporate income tax rates to a single rate

or agreeing on a range of tax rates as outlined in chapter one of the study.[592] Each country would levy the same or similar rate of tax on the tax bases. It would remove the competitive pressure between the EAC countries over their statutory tax rates. This would also reduce the amount of distortions arising from differences in tax rates such as income shifting through the manipulation of transfer prices. Assuming that there is harmonisation of tax bases, revenue would still be lost through companies taking advantage of the differences in tax rates and governments would still compete in the tax base, for instance, through incentives or exemptions for certain activities. Decisions over where to locate would also continue to be affected by the differences in tax rates. The equalisation of the tax rate would therefore produce positive results as trade distortion, revenue loss, administrative challenges and compliance cost would be reduced or alleviated by the EAC Member States.

6.2.1.3 *The EAC Income Tax and Coordination Act*

In addition and taking cue from the harmonisation of customs, the Partner States should enact an EAC statute providing for corporate income tax harmonisation (EACITA). This can be made pursuant to Article 63 of the Treaty. This shall be a consolidated legislative framework for the EAC income taxes.

Other than measures to harmonise the tax base and the rate individually, one step beyond such would be to harmonise both. In effect, each country would impose an identical corporate income tax. The challenge with the implementation of this measure would be achieving an agreement on the imposition of the EAC corporate income tax in a particular form. This would operate as a replacement of individual corporate income taxes charged by the respective Member States. This

[592] See part 1.6.1 in chapter one.

means that the income would be levied on agreed bases at a single rate and could be administered centrally, with revenue allocated among the Member States according to the agreed formula. Agreements will also be made on the treatment of income flows between the EAC and non-EAC Member States. The adoption of an EAC wide income tax in the place of national or domestic income taxes would eliminate the opportunities for income-shifting activity within the EAC and, therefore, also eliminate harmful tax competition within the region. This will require a high level co-ordination whereas new system of administration will also be created as per suitable arrangement by the Member States. The significance of this approach is that the non EAC member states desirous of joining the EAC will be sufficiently informed of the law and policy on corporate income taxes within the EAC prior to their entry. The EAC can borrow a leaf from the historical Income Tax Management and Coordination Act, 1952 of EAC 1. It should however be noted that the 1952 legislative process was for administrative rather than 'real' harmonisation within the framework of regional integration.

Since the equalisation and differentiation theories discussed in Chapter One[593] teach us that for there to be income tax harmonisation within the EAC, there is need for consolidated income tax legislation for the region. The harmonisation design formulated by Velayos *et al* as discussed in Chapter Five, based on the scales of standardisation, compatibility, coordination, cooperation and convergence should be adopted with necessary modifications. It is recommended that the proposed consolidated and harmonised law be based upon the tenets of both the recommended Income Tax Policy for the EAC and the conceptual pillars of the Velayos *et al* analysis. This law should be enacted by the EALA alongside the catalogue of laws that the institution has enacted in its short span of existence.

[593] See part 1.5.2, in Chapter One.

6.2.1.4 Implementation of the *Code against harmful tax competition*

In the interim basis before the enactment of a harmonised EAC legislative framework, it is recommended that in order to prevent further harmful tax competition, common tax rules be introduced in areas that are sensitive to cross-border migration. The non-binding EAC Code of Conduct on Harmful Taxes offers a useful guide on what constitutes harmful tax incentives.

In addition, the EAC Member States should develop guidelines on the criteria for the determination of what harmful competition entails so as to assist governments of the Member States to distinguish between acceptable and harmful preferential tax regimes. Member States should then review their existing legislative and administrative measures for purposes of identifying harmful income tax practices. In addition, they should refrain from adopting new measures, or extending the scope of or strengthening existing measures in the form of legislative provisions or administrative practices that constitute harmful tax practices. Further, they should establish a framework where the concerns of individual Member States on harmful tax practices can be discussed. Finally, a timeframe should be set within which the harmful features of their preferential tax regimes should be amended and/or repealed to pave way for the harmonised code.

6.2.1.5 Implementation of the Code against double taxation

In the interim and in order to solve the challenge of double taxation, it is recommended that the EAC Member States adopt the *EAC Model Double Taxation Agreement* which has been developed. In addition, an agreement on exchange of information with third party countries should be developed and adopted to curb this tax challenge. This study suggests that all the

Revenue Authorities of the Member States should be involved in the negotiation of these EAC Agreements. Further, all revenue staff should be sensitised on the existence of the DTAs concluded and their date of application since they are charged with its enforcement. If the recommendation for the establishment of an authority on tax matters is adopted, the body shall be mandated to undertake Treaty negotiations on behalf of the EAC.

6.2.1.6 Repeal of existing laws

From an EAC corporate tax harmonisation perspective, it is imperative for the new law to repeal the existing singular laws of the EAC Member States. The combined effect of Chapters Three and Four of this thesis disclosed the marked heterogeneity in the income tax laws and practices of Kenya, Uganda, Tanzania, Rwanda and Burundi. This differentiation does not augur well for the Common Market, Monetary Union and Political Federation of the EAC. As such, it is recommended that the national laws be repealed and replaced by the common unifying regional code and other support laws on scheduled matters.

6.2.2 INSTITUTIONAL REFORMS

For purposes of implementation of the legislative reforms, it is also recommended that structural changes be effected on the current institutional framework.

6.2.2.1 Creation of the EAC income tax Authority

It is recommended that an institutional body whose proposed name is the EAC INCOME TAX AUTHORITY (EACITA) should be set up to oversee the implementation of the new harmonised law in order to ensure continuous compliance, sustained taxpayer education, tax administration

management of the income revenues of the EAC region, the phase in/ phase out of and coordination of various aspects. It is suggested that the officers of the current national tax authorities be co-opted or seconded on a *pro rata* basis into the new body in order to ensure a smooth transition and preservation of the institutional memories of the existing national tax authorities.

6.2.2.2 The EAC working group on income tax

Income tax harmonisation initiatives are bound to create intractable tensions which can slow down the integration process. This calls for the sensitisation of the citizens of the Member States on the benefits of a harmonised system in order to overcome the lack of legitimacy as a hindrance to the implementation and achieve transnational representation. The first step though is for the Member States to appreciate the greater understanding of the integration of their tax systems and direct efforts at improving the coordination of these systems. Currently, there is an *ad hoc* technical working group reviewing the roadmap on the harmonisation of domestic taxes. It is recommended that the group be established as a permanent working group on direct tax harmonisation. As a group of experts the role of the Working Group is to provide technical assistance and advice to the Community. This group should consist of the officials from the Member State governmental departments that traditionally negotiated tax treaties i.e. the treasury departments of the Member States, their respective revenue authority officials, experts on economic integration and other relevant stakeholders including the academia. The first initiative should be directed at reviewing the coordination of domestic corporate income tax systems of the Member States, especially with respect to Multinational Enterprises (MNEs) with operations in more than one member state. Appendix 5 herein has outlined the legislative provisions of the

various member states that need to be realigned in tandem with the draft code on harmful competition and other regional initiatives. Resources ought to be placed towards ascertaining the economic cost of the current system of tax competition. The group shall represent a forum for a fuller understanding of the impact of tax on trade and capital flows among the EAC Member States. Additionally, the group should investigate the common tax grounds as well as contentious areas which will serve to ferment the sovereign political concerns in cases where obstacles are difficult to overcome. The group should try to reach consensus and mediate on tax policies that distort trade and those ones that are essential to the pursuit of goals based on the preferences of citizenry in order to reduce harmful tax competition. The group will be useful in providing a sustainable framework for future negotiations that will permit new entrants to the EAC such as South Sudan (if allowed) to be integrated more smoothly.[594] Further, a sub working group on CCCTB could be established with specific task of examining from a technical perspective the definition of a common consolidated tax base for companies operating in the EAC, determination of the basic tax principles, determining the fundamental structural elements of a common consolidated tax base and devising mechanisms for 'sharing' a consolidated tax base between Member States.

6.2.3 POLICY REFORMS

6.2.3.1 Harmonised corporate income tax policy

The member states should agree on corporate income tax harmonisation policy document that should underpin the proposed reforms. This policy will specify the tenets of income tax harmonisation in terms of the definition of taxable persons and bases, the definition and scope of taxable income, computation of taxable income for legal persons (individual and corporate),

[594] A number of countries in Eastern Africa have expressed interest in joining the EAC. They include Ethiopia, Republic of South Sudan, Sudan, DRC and Somalia.

diversity of tax incidences and burdens in order to maximise revenue collection, regional income tax base, exemptions, applicable tax rates, the range of tax incentives, procedural issues such as the mode of registration of taxpayers, how to treat non-resident taxpayers and dispute-settlement procedures.[595] The regional policy should be in tandem with the EAC treaty objectives and conform to the general corporate income tax principles.

6.2.3.2 A Harmonised Treaty policy

The lack of a coordinated approach in agreements on Tax Treaties among the EAC Member States could lead to trade distortions which may resultantly be injurious to the integration efforts at the EAC level. In the EU, the Rudding Committee suggested that significant tax distortions hindered the competitiveness of the EU. The committee proposed that at least a Common Treaty Policy among the Member States was necessary to help reduce the distortions. Consequently, the provisions on fundamental freedoms of the EC law as construed by the ECJ already compel Member States of the EU to extend such Treaty benefits to all Member States on MFN standards.[596] It is recommended that the EAC Member States should learn from the EU experience and consider undertaking Multilateral Tax Treaty negotiations in contrast to the conventional Bilateral Treaty Negotiations which have been driven by the desire to extend tax benefits on a reciprocal basis without granting these benefits to all trade partners of the Member States. However, it would be more beneficial to the collective welfare to offer the same tax benefits to all Member States in a non-discriminatory or free trade and investment area in order to enhance integration and avoid fragmentation of the single market.

[595] See a concrete discussion of these issues as far the EAC is concerned in Chapter 4 of this thesis.
[596] See Josef Schuch, *Will EC Law Transform Tax Treaties into MFN clauses?* Tax treaties and EC Law: Kluwer Law Internat., ISBN 9041106804. - 1997, p. 87-123.

6.2.3.3 Dispute-resolution procedures

As economic integration increases, business activities also increase among the Member States. The Member States should agree on centralised dispute resolution procedures that will assist in resolving concerns such as those between taxpayers, inter-country and third parties on transfer pricing. For instance, though the treatment of transfers at arm's length has received recognition on the international sphere, it is yet to be accepted at the EAC level, considering that similar commodities may not be available for pricing regionally. Transfer pricing is likely to attract more attention in the future just like the attendant disputes. The adoption of centralised transfer pricing rules among the Member States would no doubt assist in cross-border activities. In the alternative, binding regional arbitration procedures under proper institutional frameworks would perhaps be useful in resolution of any outstanding differences.

The EACJ legal jurisdiction could also be extended to deal with tax matters such as double taxation relief, transfer pricing and interpretation issues on the adopted rules and procedures. The alternative would be the establishment of an EAC tax court or tribunal to deal specifically with EAC tax and tax related disputes. This would also permit a Member State whose interests are not necessarily involved in the dispute in question to seek a joinder and have input on a decision that would potentially affect its interest in the future. For instance, if a Tanzanian taxpayer is arguing that his portfolio investments in Kenya are being double taxed, a Rwandan official could also sit in the dispute resolution panel. Currently, all Member States have procedures which allow multinationals and relevant authorities to come to an agreement on the methodology to be used in the calculation of transfer prices. Further, each country permits negotiations of a bilateral or multinational nature on transfer pricing agreements. It may be necessary to administer the

transfer pricing rules at a centralised level where the Member States have to adopt similar rules in order to avoid the pitfalls of heterogeneity.

6.2.3.4 Enhanced cooperation on information exchange

The EAC Member States' tax authorities should improve their inter-relationships in order to make it easier for companies to comply with region wide or cross - border tax requirements and best practices. The Member States should improve the formal channels for the exchange of information. This could be done through joint and multilateral audit procedures. Consequently, an agreement for automatic exchange of information should be signed by the member states. The agreement which shall be the legal basis for the exchange of information should provide for modalities of the exchange to ensure free flow of information, confidentiality and other safeguards, the financial institutions covered and the scope of information to be reported. Other features would include obligations to report by relevant financial institutions, record keeping and sanctions to ensure compliance.

6.2.4 GENERAL REFORMS

In addition to legislative, policy and institutional reforms, it is recommended that reforms of general nature be implemented so as to achieve a harmonised and consolidated EAC framework on income taxes generally and corporate income taxes in particular.

6.2.4.1 Recording history

It is equally important to genealogically trace and formally document the development of corporate income tax (or generally taxation) legislation and practice of each of the EAC Member

States. An attempt to give a miniature historical perspective to the study was made in Chapters One and Two in order to discern valuable lessons for the policy proposed herein and to avoid the pitfalls of failure evident in EAC 1. This history can be chronicled and recorded in a background document to guide the policy formulation process and assemblage of archive and archival recording.

6.2.4.2 Complementarity

It is recommended that the proposed EAC corporate income tax harmonisation to be anchored upon the successful integration initiatives concerning customs, competition, the provision of higher education, standardisation, quality assurance, metrology and testing and the tourism sectors. The cooperation of the EAC Member States in these areas formed part of the discussion in Chapter Five which concluded on the hypothesis that if harmonisation has been achieved in these critical areas then why not in the corporate income tax (or fiscal) arena.

6.2.4.3 Overcoming notable challenges

The challenges of harmonisation such as the issues of differentiation, complementarity, revenue loss, equity and compensation, political issues of the loss of state sovereignty or lack of political commitment, overlapping and multiple membership, poor private sector participation and implementational problems can be brainstormed at suitable multipartite workshops/seminars with relevant stakeholders in order to craft solutions to overcome them. Such has been the case with the harmonised areas highlighted above and the same positive experiences can be extrapolated onto the field of corporate income tax harmonisation.

6.2.4.4 Tapping lessons from the EU and NAFTA comparative studies

Chapter five of this thesis is a poignant lesson to the effect that it is possible to overcome the challenges of income tax harmonisation and the EU and NAFTA are perfect examples of such experiences. As an illustration, the EU CCCTB based on enhanced cooperation, a unified tax policy and the subsidiarity principle provides valuable lessons for the EAC. It is thus incumbent upon the region's policy and lawmakers to borrow from the EU and NAFTA experiences as far as the comparables are concerned.

6.4.4.5 Mainstreaming the canons of optimal taxation into the harmonised law and policy

It is important for the proposed law and policy to reflect the classical Adam Smith's canons of optimal taxation, these are, equity or equality (i.e. economic justice), certainty, convenience and economy. The additional canons of productivity or fiscal adequacy, buoyancy, flexibility, simplicity and diversity should also underpin the new law and policy. As such, cases of discrimination in taxation or inequality of the tax burden, inconvenient tax procedures, and uneconomical income taxes should not be tolerated by the new regime. In sum, progressive taxation should inform the harmonised tax regime in the interests of ability to pay tax, social justice, savings and capital formation and economic stability while ingraining administrative simplicity in the tax system.[597] Of fundamental importance is the need to legally underpin the new law and policy in the respective national Constitutions of the EAC Member States.

[597] For a candid analysis of progressive taxation, see Simiyu N.T.T., *Taxation in Kenya: Principles and Practice,* Foundation Institute of Professionals, 5th ed.2003. p. 12-15.

6.2.4.6 Tax education and awareness creation

There is need to convey the spirit of tax harmonisation into the consciousness of administrations and citizens of the EAC in order to create a more optimistic perception of integration and harmonisation. In addition, there is an overall need for massive tax education and awareness-creation on the harmonised tax law and policy among the EAC taxpayers, tax administrators, governments and the civil society.[598] This will provide feedback which will go a long way towards overcoming taxpayer resistance to change and related challenges and also harnessing expert opinion on the draft policy and law. In so doing, the process will also aid in cultivating the necessary goodwill for the successful implementation of the uniform law.

6.2.4.7. Digitization of the EAC corporate income tax systems

Upon the harmonisation of the various aspects of the CIT within the EAC, it is suggested that an e-platform is created so as to enable the citizens and the revenue authorities of the EAC to access relevant information for instance the tax return forms, the filing of tax returns, review mechanisms and appeals.

In the overall, the member states of the EAC are advised to study these recommendations carefully and explore the most appropriate mechanisms towards CIT harmonisation.

[598] Dr. Richard Sezibera, the Secretary General of the EAC in his new-year (2014) message urged the Member States to redouble their effort in reaching out to university students, faith-based communities, women groups and diaspora as, "they give confidence to all our partners that we are committed to a robust and transparent management systems." See Yvonne Kawira, *What is in store for EAC trade bloc this watershed year?* Smart Company, *Daily Nation*, 7th January 2014, p. 6.

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APPENDIX 1: QUESTIONNAIRE

PhD THESIS TITLE: **"INCOME TAX IN THE EAST AFRICAN COMMUNITY: A CASE FOR HARMONISATION AND CONSOLIDATION OF POLICY AND LAW"**

QUESTIONNAIRE

Dear Respondent: *The following research questions are directed to you to enable the researcher (Mr. Jackson Bett, Ph.D Candidate, UoN) evaluate the justifications for a harmonised income tax law and policy within the East African Community (EAC)*:

1. What is the national/domestic income tax profile of your country? Briefly describe.

2. How do you rate the level of administration of the taxes which you have specified in (a) above?

3. Are there any loopholes or disadvantages occasioned by the differential tax profiles of the EAC Member States of Kenya, Uganda, Tanzania, Rwanda and Burundi? In other words, what are the effects of tax heterogeneity on the functioning of the EAC Common Market?

4. What is your opinion on harmful tax competition as an effect of income tax heterogeneity generally and within the context of the EAC?

5. What is your opinion on double taxation as an effect of income tax heterogeneity generally and within the context of the EAC?

6. Would you consider or vouch for tax harmonisation within the EAC in order to overcome the challenges specified in (c) (d) and (e) above?

7. In your opinion, what factors are currently hindering income tax harmonisation efforts within the EAC?

8. Which route should EAC income tax harmonisation take: policy, legal or institutional changes or all of these?

9. Does the current EAC framework provide for income tax harmonisation?

10. How soon should income tax harmonisation, in particular, be effected?

11. What should happen to the individual national/domestic tax laws and policies of the EAC Member States and are there any concerns about the (preservation of) individual sovereignties?

12. Would you advocate for the adoption/transplantation of the EU and NAFTA tax harmonisation models into the EAC? OR what lessons can EAC learn from these developed harmonised tax regimes?

13. Which other relevant institution(s) or persons can you refer us to for relevant and valuable information?

14. What other comment(s) can you make?

THANK YOU!

Respondent's personal information (optional):

Name: .... Official designation...

Qualifications...Experience..

Signature...Date: ....

APPENDIX 2: SUMMARY OF DATA FINDINGS FROM INTERVIEW/ QUESTIONNAIRE RESPONSES

2.1. Introduction

This study set out to interrogate the following questions in order to inform the analytical framework of the study:

1) What are the current national corporate income tax profiles of the heterogeneous and disparate tax systems obtaining in the EAC Member States?
2) What are the negative effects of the current income tax heterogeneity in the EAC?
3) Is a harmonised corporate income tax law and policy the solution to the administrative concerns caused by differences in income tax policies and legislations?
4) Can regional law reform towards a harmonised corporate income tax system in the EAC spearhead and/or enhance regional (economic) integration?
5) Can the EU/NAFTA experience inform the EAC law reforms towards the establishment of a harmonised tax legislation and policy?

Consequently, these questions informed the critical and strategic path of empirical data collection of the study. In order to investigate these questions and supplement the wide range of literature reviewed in this research, empirical research was undertaken using the tool of a questionnaire so as to obtain the relevant information on the subject. The data was collected through both questionnaires and interviews bearing in mind that income tax harmonisation is a novel idea in the EAC since it has not been attained (it is still visualized). Open ended questions were formulated to allow the respondents to express themselves fully considering the novelty of the subject. Interviews were conducted by the researcher between June and September 2013. The

persons interviewed were identified in so far as they dealt with relevant income tax matters. A total of 23 interviewees were interviewed consisting officials from the EAC secretariat, the Kenyan Ministry of EAC, The revenue Authority of Kenya, Uganda, Tanzania and Rwanda. Officials from the major accounting firms such as KPMG, PWC and Deloitte were also interviewed. As stated, the concept of CIT harmonisation in the EAC is not yet in place as it is only envisioned and as such, the intention was investigate the effects of income tax heterogeneity alongside the other research questions so as to make appropriate recommendations. The interviewees chosen therefore represented the critical sample of the main stakeholders in the practice of income taxation in the EAC.

The questionnaire was structure in order to extract information in four main areas, firstly on the diversity of the income tax legislation in the EAC, secondly, on the effects of the heterogeneity in income taxation regimes, thirdly, was the concerns of adoption of an EAC legal framework on income tax harmonisation and lastly, the viability of the EAC CIT harmonisation and the way forward.

2.2. Summary of findings

The following is a summary of the questionnaire responses that have been analysed in the study so as to corroborate the other study findings based on the wide literature reviewed on the subject.

Question 1: What is the national/domestic income tax profile of your country? Briefly describe.

This question was answered by all 23 respondents. They highlighted the various legislative provisions governing income tax in different EAC member states. It emerged that unlike the

EAC customs taxation where common EAC framework has been adopted, the legal regime governing income taxation is disparate as each EAC member state uses its own domestic legislation. Kenya for instance applies the Income Tax Act Chapter 470, while Uganda uses the Income Tax Act Chapter 340 and Tanzania, the Income Tax Act, 2004, Chapter 332. On the other hand, Rwanda uses the Law on Direct Income No. 16 of 2005 while Burundi applies the General Tax Code.

From the foregoing, it is evident that despite the EAC Treaty provisions on tax harmonisation, the EAC member states still apply heterogeneous income tax regimes. The disparities in income tax profiles also offends the provisions of Article 32 of the Common Market Protocol requiring the member states to harmonise their taxes with the aim of reducing tax distortions. A closer look at the EAC constitutive instruments reveal that no elaborate legal framework has been formulated towards the achievement of income tax harmonisation generally and corporate income taxation in particular. The recommendations for reform towards enactment of an EAC Legal framework (EACITA) on corporate income tax harmonisation is intended to seal this lacuna. A further recommendation is aimed at the alignment of the heterogeneous legal regimes on income taxes on the agreed EAC harmonised framework.

Chapter three of this study has evaluated the wholistic spectrum of the disparities in income tax in the EAC where it emerged that the EAC member states have continuously exploited their fiscal sovereignty through legislation and practice to the detriment of the very harmonisation set out in the EAC constitutive instruments. The chapter concludes with a proposal for harmonisation of the heterogeneous income tax regimes.

Question 2: Who/ which institution administers the taxes which you have specified in (a) above?

This question was answered all 23 respondents. They all stated that income tax administration is governed by the revenue authorities of the respective member states.

The findings were useful to this study since the researcher was able to assess the coordinability of corporate income taxes within the EAC region. The disparity in tax administration in the EAC allowed the researcher to assess the viability of an EAC institutional framework on the CIT as was the case with the EAC 1. As recommended in this study, an institution to be referred as the EAC Income Tax Authority should be established to oversee the administration of corporate income taxes.

It therefore emerges from the foregoing that unlike the practice in the EAC 1 where collection of taxes was centralised, the current scheme of administration is that each member state is charged with the responsibility of administration of income taxes. This scenario, to a large exacerbates the challenge of double taxation since each state has a sense of entitlement in the collection of income taxes. With the harmonisation of income taxes, the withheld taxes on income and expenditure will be accepted as tax settlement in the regime of the subsidiary country and therefore avoiding the possibility of double taxation.

Question 3: Are there any loopholes or disadvantages occasioned by the differential tax profiles of the EAC Member States of Kenya, Uganda, Tanzania, Rwanda and Burundi? In

other words, what are the effects of tax heterogeneity on the functioning of the EAC Common Market?

All 23 respondents answered this question. 20 (87%) respondents stated that the major problem was harmful tax competition. 19 (82%) respondents cited the problem of double taxation. 14 respondents cited the problem of revenue losses. 12 (52%) respondents cited the problem of tax planning. 14 ((61%) respondents cited tax evasion. The challenge of tax avoidance was cited by 13 (57%) respondents while 14 (61%) respondents stated that misallocation of resources was closely associated with corporate income tax heterogeneity. 9 (39%) respondents cited the problem of tax discrimination and suggested that a single market should coordinate their taxes and avoid tax preferences.

The foregoing reactions to the challenges of maintaining heterogeneous income tax regimes in the EAC justify the need for legal reforms for harmonisation. Indeed the heterogeneity as seen, is inimical to the general tenets of integration as set out in Article 5 and 83 of the EAC Treaty, and Article 32 of the Common Market Protocol. These findings together with the review of the literature in chapter four of this study formed the basis for the cross cutting recommendations ranging from legal, policy, institutional and general reforms.

Question 4: What is your opinion on harmful tax competition as an effect of income tax heterogeneity generally and within the context of the EAC? In your view, how can this challenge be resolved?

All 23 respondents stated that harmful tax competition was one of the major problems of lack of a coordinated approach on taxation matters. 13 (57%) respondents stated that disparities in

corporate tax incentive regimes of the EAC member states encouraged harmful tax competition. 12 (52%) respondents stated that a Code on harmful tax competition should be agreed upon by the EAC membership in order to resolve the challenge. 10 (43%) respondents stated that income tax harmonisation should be undertaken as a solution to the problem. 10 (43%) respondents stated that both the Code on harmful tax competition and the harmonisation of taxes should be pursued as solution to the problem. One respondent however opposed the notion that huge revenue losses had been incurred as a result of harmful tax competition especially through the incentive regimes. He pointed out that empirical study should be commissioned by the EAC in order to distinguish between revenue foregone and revenue losses and that they should be evaluated vis a vis the economic and social benefits of the FDI.

Harmful tax competition is one of the major challenges of heterogeneity, indeed the EAC member states have negotiated a draft Code on harmful tax competition although it has not been ratified by all the member states. It is on this basis that the study recommended in chapter six the immediate ratification of the Code by all member states. Since the challenge of heterogeneity is not restricted to competition, the member states should not loose sight of the overall goal of comprehensive income tax harmonisation.

Question 5: What is your opinion on double taxation as an effect of income tax heterogeneity generally and within the context of the EAC?

All 23 respondents stated that double taxation was a major problem arising from the lack of coordination of income tax regimes in the EAC. 8 (35%) respondents cited the failure by Uganda to ratify the Tripartite Double Taxation Treaty of 1997 as having impacted heavily on the future

of EAC Double tax Agreement. 9 (39%) respondents cited fiscal sovereignty as the main cause of failure to agree on EAC Double Taxation Agreement while 6 (26%) respondents cited divergent policy goals as the main reason for failure the failure. 13 (56%) respondents expressed optimism that the current membership of the EAC would agree on a DTA.

With the signing a new Double Taxation Agreement, the EAC member states should prioritise its ratification so as to avoid the pitfalls that befell the 1997 proposed treaty. The agreement will resolve the challenge of double taxation and therefore move one step closer towards comprehensive EAC income tax harmonisation.

Question 6: Would you consider or vouch for income tax harmonisation within the EAC in order to overcome the challenges specified in (3), (4) and (5) above?

A total of 20 (87%) respondents agreed that income tax harmonisation was the appropriate tool to overcome the effect of heterogeneity. 3 (13%) respondents expressed scepticism that tax matters were sensitive and that the member states may not wish to relinquish their fiscal sovereignty. 12 (52%) respondents added that the code on harmful tax competition should be prioritised by the member states. 10 (43%) respondents added that the EAC Double Taxation Agreement should be enacted.

It is therefore evident from these findings that income tax harmonisation will be a panacea to the perils of heterogeneity. Indeed the findings from review of the literature presented in chapter five of the study show that similar initiatives are pursued in the EU and the NAFTA. It should be noted however that tax harmonisation has not been explicitly provided in the EU and the

NAFTA constitutive instruments. Since harmonisation is a major competence of the EAC under the Treaty, it should premier the most appropriate model for corporate income tax harmonisation.

Question 7: In your opinion, what factors are currently hindering income tax harmonisation efforts within the EAC?

A total of 20 (87%) respondents cited fiscal sovereignty on tax matters while 15 (65%) respondents felt that competing policy interests hindered harmonisation initiatives. 13 (56%) respondents cited the lack of political drive on the EAC income tax harmonisation. 10 (43%) respondents indicated the lack of elaborate legal provisions for income tax harmonisation while 6 respondents cited the lack of awareness by the general citizenry of the EAC.

These findings sound a warning that any efforts towards harmonisation may not be easily accepted by the member states. Chapter four of this study has considered sovereignty concerns and has examined customs harmonisation where the member states have relinquished their fiscal autonomy and adopted EAC legal and policy framework. Chapter five also recommends the gradual adoption of regional laws and policies so as to avoid the 'big bang' scenario.

Question 8: Which route should EAC income tax harmonisation take: policy, legal or institutional changes or all of these?

All 23 respondents agreed that institutional, policy and legal reforms were required in order to drive the EAC Income tax harmonisation agenda. 8 (35%) respondents felt that policy harmonisation should be pursued first to be followed by legislative and ultimately institutional framework.

The foregoing findings corroborate the literature reviewed in chapters two, three, four, five and the recommendations in chapter six. It is the argument of this thesis that comprehensive reforms should be undertaken in the EAC towards income and specifically corporate income tax harmonisation. To attain this objective, legal, policy and institutional reforms are recommended in chapter six of the study.

Question 9: Can the harmonisation of national income tax laws and policies of the EAC member states take place within the current framework of the EAC?

A total of 16 (70%) respondents stated that there was need for legal reforms in the EAC constitutive instruments to explicitly provide for harmonisation just as was the case with customs. 4 (17%) individuals stated that harmonisation was possible under the current framework since Article 83 of the Treaty as well as Article 32 of the Protocol on Common Market could be utilised to achieve harmonisation. 3 (13%) respondents stated that they were not aware of the legal provisions for income tax harmonisation.

The findings show the need for reforms in the EAC constitutive instruments so as to provide for harmonisation of income taxes. In addition, there ought to be coordination and convergence of income tax policies within the region with the aim of comprehensive corporate income tax harmonisation.

Question 10: How soon should income tax harmonisation, in particular, be effected?

A total of 16 (70%) interviewees responded that it should be gradual just like in the harmonisation of the EAC customs. 4 (17%) respondents stated that it should be an immediate

exercise so as to prevent further tax distortions in the EAC common market while 3 (13%) responded that it was impossible to harmonise since the member states were not keen on relinquishing their fiscal sovereignty.

Question 12: What should happen to the individual national/domestic tax laws and policies of the EAC Member States and are there any concerns about the (preservation of) individual sovereignties?

A total of 15 (65%) respondents hold the view that just like in the case of customs, the EAC framework on income taxation should replace the individual national tax regimes. 8 (35%) respondents stated that the national regimes of the member states should be aligned with the EAC income tax framework. All respondents expressed concerns that fiscal sovereignty would be a major hindrance to speedy adoption of an EAC income tax regime.

These findings support the extensive literature reviewed in chapter five of the study to the extent that the EAC member states could gradually relinquish their fiscal autonomy as it has done in respect to customs, tourism, higher education, standardisation, quality assurance and meteorology and testing.

Question 13: Would you advocate for the adoption/transplantation of the EU and NAFTA tax harmonisation models into the EAC? OR what lessons can EAC learn from these developed harmonised tax regimes?

A total of 16 (70%) responded that there were vital lessons from the EU and NAFTA experiences on CIT harmonisation. 4 (17%) stated that they were not aware of the progress of

harmonisation in those regions. 2 (9%) respondents stated that the EAC should determine its own mechanisms for income tax harmonisation considering its unique circumstances.

These findings support the extensive literature reviewed in chapter five of this study to the extent that despite the lack of competency in the EC Treaty, the EU has embarked on a roadmap for harmonisation of corporate income taxes culminating in the enactment of Council Directives on specific areas of CIT harmonisation and the latest proposal on the EU CCCTB. On the other hand, the NAFTA has sought gradual convergence of fiscal policies with the promise of laying a legal framework for harmonisation.

2.3. Conclusion

This empirical research has shown that currently, the EAC member states maintain heterogeneous income taxation regimes and institutions, a scenario that has caused adverse effects on the economies of the member states contrary to the various provisions in the EAC constitutive instruments. The findings further reveal that the main effects of heterogeneity are harmful tax competition and double taxation. In addition the most appropriate path for harmonisation would be the reforms of the EAC constitutive instruments and the enactment of new EAC provisions spelling out the mechanisms for harmonisation. In spite of the concern over the fate of the individual national income tax legislation, the study revealed the willingness to relinquish fiscal sovereignty as has been the case with customs. These findings have corroborated the extensive literature reviewed hence making a case for income tax harmonisation within the EAC in general and on corporate income in particular.

APPENDIX 3: LIST OF INTERVIEWEES

	NAME	DESIGNATION
1)	Peter N.	Deputy Director, E Affairs, Ministry of EA, Kenya
2)	Mark O.	Senior Assistant Director, Economic Affairs, Ministry of EA, Kenya
3)	Gad A.	Senior Legislative Draftsman and Legal Advisor, Nairobi County Government
4)	Ngugi J. Z.	Assistant Director, Economic Affairs, Treasury, Kenya
5)	James M. O.	Assistant Commissioner, KRA
6)	Jean K.	Rwanda Revenue Authority
7)	Martin G.	Deputy Director, Economic Affairs, Treasury
8)	Jane N.	Finance advisor, Treasury, Kenya
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Appendix 4: Overview on the Income Tax Systems in the EAC

	Burundi	Kenya	Rwanda	Tanzania	Uganda
Law	Law on Income Tax (Code Général des Impôts et Taxes, Livre II) 2005	Income Tax Act 2008	Law on Direct Taxes on Income 2005	The Income Tax Act 2004	The Income Tax Act 1997
A. Taxation of Residents					
Taxpayer	Dependent upon sort of income: - rental income: owner or possessor of real estate - investment income and business income: companies, partnerships and individuals	- companies incorporated under the laws of Kenya - bodies whose management and control of the affairs was exercised in Kenya in the particular year of income under consideration bodies that have been declared by the Minister by Notice in the Gazette to be resident in Kenya for any year of income	- personal income tax: resident individuals in Rwanda - corporate income tax: companies, cooperative societies, public business enterprises, partnerships, entities established by districts and towns to the extent that they conduct business	- companies incorporated under Tanzanian law - management/control in Tanzania - sole proprietor, partnership, trust, cooperative, branch of foreign company	- companies incorporated under Ugandan law - management/control in Uganda - sole proprietor, partnership, trust, cooperative, branch of foreign company - companies undertaking the majority of their operations in Uganda
Scope of Income	Worldwide income	Income in Kenya (residence principle)	Worldwide income	Worldwide income	Worldwide income
Threshold for taxation	- rental income: no threshold; - wages (= business income): 480,000 FBu (390 USD); - other income: no threshold	?	360,000 RWA (630 USD) for individuals	For individuals lower presumptive tax possible if business income does not exceed 20,000,000 TZS (15000 USD)	1,560,000 UGX (750 USD) for individuals
Tax Base	Business profit and gains	Business profit	Business profits and gains	Business profits and gains	Business profit
Accounting standards	Three forms of ascertaining the profit: - the "real profit", deduced from bookkeeping in accordance with the generally accepted accounting principles (no method prescribed) - simplified method with a receipt and expenditure accounting (for medium size businesses) - lump sum system for smaller enterprises consisting of elements of appraisal	IFRS and comprehensive domestic rules	Special rules in the "National Accounting Plan", Transfer Pricing Rules, simplified rules for small businesses	IFRS and comprehensive domestic rules	Generally accepted accounting principles and special statutory rules
Revenue expenditures deductible	In general deductible	In general deductible including interest payments	In general deductible if incurred for the direct purpose of and in the normal course of the business	In general deductible including interest, research and development	In general deductible including interest, research and development
Depreciation on capital expenditures	No special regulations in the law	- Industrial Buildings 2,5% - Rental resid. Buildings 5 % - Hotel buildings 4 % - Roads or similar Infrastructure 100 % - Plant and Machinery Class 1 37,5 % Class 2 30 % Class 3 25 % Class 4 12,5 % - Farm works 33,3 %	- Land, fine arts, antiquities: not subject to depreciation - buildings, equipment, Plants 5 % - purchased good will, cost of reconstruction of intangible assets 10 % - computers, software, communication systems 50 % - other business assets 25 % - investments on special condi-tions (smaller 40 or vehicles excluded) 50 %	- machinery/vehicles/ other 25 to 37,5 % - furniture, fixtures 12,5 % - buildings 5 %	- machinery/equipment 20 % - cars, small buses 35 % - large trucks 30 % - computers 40 %

Non-deductible expenditures	- income tax - profit distribution - fines and penalties - all expenses not necessary to run the business - certain expenses of the supervisory board (costs of meetings)	?	- income tax - fines and penalties - profit distribution - entertainment expenses - donations exceeding one per cent of turnover - restrictions due to thin capitalization rules	- income tax - bribes - fines - profit distribution	- income tax - profit distribution
Capital gains	Taxable at the same rate as other profit	Capital gains tax was suspended in Kenya in 1985	Businesses: taxable at the same rate as other profit; no capital gains tax on the sale of private property	Taxable at the same rate as other profit, no inflation relief, no reinvestment relief	Taxable at the same rate as other profit, no inflation relief, no reinvestment relief
Exempt income: Dividends from controlled companies	No regulation	?	No regulation	Exempt if recipient holds at least 25 %	Exempt if recipient holds at least 25 %
Other exemptions	Income that is designed to be re-invested in vocational information and education; certain profit gained by agricultural enterprises (including cattle breeding)	?	Profit shares with partnerships	Exemptions granted by the minister	Income of - listed institutions or - diplomatic organisations or - local authorities
Losses	Can be carried forward (4 years); losses suffered abroad cannot be offset	Can be carried forward indefinitely (to be changed to: into the next 4 years of income); losses abroad: n/a, due to residence principle	Can be carried forward into next 5 years; losses suffered abroad cannot be offset	Can be carried forward indefinitely; losses suffered abroad can be offset against foreign profits only	Can be carried forward indefinitely; losses suffered abroad can be offset against foreign profits only
Tax rates					
Standard	35 % business income (excluding wages); progressive table for rental income	30 %	30 % (corporate income tax)	30 %	30 %
Reduced	- enterprises exporting non-traditional merchandise (such as coffee and tee) 17,5 % - minimum rate of taxation is 1 % of the turnover figures (in case of losses) - certain enterprises, registered as “exempted” according to the Investment Code of 2008 are exempted for the first ten years of existence. As of the eleventh year the tax rate will be 15 % without time limitation. - within this system further reduction is granted to enterprises employing more than 100 Burundian persons: 10 % - leasing and hire-purchase enterprises are fully exempted for three years, and taxed at 20 % for the next four years (more cases of reduction are stipulated in the law)	EPZs after 10 years: 25 % Newly listed companies approved under the Capital Markets Act: - with 20 % issued shares listed, first 3 years 27 % - with 30 % issued shares Listed, first 5 years 25 % - with 40 % issued shares listed, first 5 years 20 % Non-resident shipping operators: 2,5 % of gross Non-residents telecommunication operators: 5 %	- Tax reductions from 2 to 7 % depending on the number of Rwandan employees - export businesses get a tax discount of 3 or 5 % depending on the turnover; - businesses operating in a Free Trade Zone are taxed with 0 % without time limitation.	- 25 % after 10 years in EPZ - 25 % newly listed company with at least 35% of equity issued to the public (for 3 years) - 0.3 % of turnover in case of losses in 3 consecutive years due to incentives	mining companies 25 -45 %
Withholding Tax on earned income					
Tax credit	No (withholding tax is definitive)	?	Yes	In specific cases	In general
Final tax	If companies derive investment income (e.g. dividends), 50 % of this	?	Withholding tax reduces the payable amount and can lead to a	In most cases if recipient is a resident individual not in business	In case of - interest paid by a financial

	yield is regarded as derived from business and taxed as business income with the regular rate of 35 %; regulation not valid when the yield is re-invested		refund if offset is not possible		institution to a resident individual - dividends paid to a resident individual
Foreign tax credit	?	?	Yes	Yes	Yes
Rates of withholding taxes on distributed income					
Dividends	15 %	> 12,5 % voting power: Exempt < 12,5 % voting power: 5 %	15 %	Standard rate 15 % if paid by listed company to individuals 10 % if paid to company controlling at least 25 % 0 %	Standard rate 15 % if paid by listed company to individuals 10 % if paid to company controlling at least 25 % 0 %
Interest	15 %	bearer instruments 25 % government bearer bonds 15 % other 15 % Qualifying interest: - housing bonds 10 % - bearer instruments 20 % - other 15 %	15 %	10 %	Standard rate 15 % if paid to individuals, associated companies, financial institutions 0 %
Royalties	15 %	5 %	15 %	15 %	0 %
Service fees	15 %	5 %	15 %	0 %	0 %
Rents	15 %	n/a	0 %	10 % if for land and buildings, otherwise 0 %	0 %
Profit shifting					
Transfer pricing rules	No guidelines	Income Tax Rules on Transfer Pricing w. e. f. July 1st 2006	Arm's length principle to be applied; all methods of determination (e.g. resale price method or cost plus method) are acknowledged	Arm's length price to be applied; guidelines being drafted	Arm's length price; no guidelines in force
Thin capitalization rules	No regulation	?	Limited deduction of interest (if loan exceeds four times the amount of equity)	Limited deduction of interest	Limited deduction of interest
Dividend stripping	No regulation	?	No special regulation	General anti-avoidance rule	General anti-avoidance rule
Tax Incentives					
Tax free zones	No tax free zones – as a geographical term – but "Zone franche" according to the Investment Code (tax relief on certain conditions)	Export Processing Zones (EPZ): 10 years tax holidays	Not yet operating, but important tax exemptions or reductions are granted by the law	Export Processing Zones (EPZ): 10 years tax holidays Special Economic Zones (SEZ): 10 years tax holidays	None
Initial capital allowances	see above under "Tax rates, reduced"	(once only at a given percentage) in respect of capital expenditure: - hotel sector: on buildings that are certified as industrial buildings - ordinary manufacturing sector: on both machinery and buildings - manufacture under bond sector: on both machinery and buildings - shipping sector for resident ship owners on ships more than 495 tons	see above under "Tax base, depreciation" and "Tax rates, reduced"	- mining: exploration and development 100 % - agriculture: plant and machinery 100 % - Business buildings, hotels 20 % - manufacturing/tourism: plant and machinery 50 %	- mining 100 % - business buildings 20 % - plant, machinery: urban 50 % rural 75 %
Procedures					
Registration	Yes	Every person with chargeable income is required to obtain PIN	Yes	Yes (IT supported)	Yes (manually)
TIN	Yes	?	Yes	Yes	Yes

Tax period	Tax year	Tax year	Tax year	Tax year	Tax year
Self-assessment	Yes; return no later than 3 months after the end of the year of income	Return of income and accounts no later than June 30 of the following year	Yes; return no later than 6 months after the end of the accounting period	Yes; return no later than 6 months after the end of the accounting period	Yes; return no later than 4 months after the end of the year of income
Payment	Through banks	?	Through banks	Through banks	Through banks
Prepayments	Yes	4 instalments based on previous year's income	4 instalments	4 instalments	2 instalments
Returns of group members	Separate return for each member	?	Separate return for each member	Separate return for each member	Separate return for each member
Audits	Yes	Yes	Yes	Yes	Yes
Adjustments/time limits	Additional assessments possible within 4 years	No	Additional assessments possible within 3 years	Additional assessments possible within 3 years (in case of fraud any time)	Additional assessments possible within 3 years (in case of fraud any time)
Penalties	Yes	Yes	Yes	Yes	Yes
Interest for late payments	Yes	?	Yes	Yes	Yes
Enforcement	Yes	Yes	Yes	Yes	Yes
Appeals	- appeal to a special commission, consisting of representatives of the taxpayers and of the tax administration; decision is not binding - Appeal to the Minister of Finance within three months; decision can be contested with a lawsuit with the administrative courts	?	- within 30 days to the Commissioner General - after decision, within further 30 days to the Appeals Commission - after decision, again within further 30 days to Tribunal	Provided the amount of the undisputed tax or 33 % of the assessed amount (whichever is higher) is paid: - within 30 days to the Board - after decision, within further 30 days to Tax Revenue Appeals Tribunal	- within 45 days to Commissioner General - after decision, within 45 days to High Court or Tax Tribunal - CG may waive the amount or accept a lesser amount to be paid in case where an objection has reasonably been made to an assessment
B. Taxation of Non-Residents					
Scope of income	Source in Burundi (no specification)	Source in Kenya (no specification)	Source in Rwanda (no specification)	Source in Tanzania (no specification)	Source in Uganda (no specification)
Withholding tax rates	Identical to residents	Different to residents	Identical to residents	In general identical to residents	Different to residents
Dividends	15 %	> 12,5 % voting power: Exempt < 12,5 % voting power: 5 %	15 %	- if paid by listed company 5 % - if paid by others 10 %	15 %
Interest	15 %	bearer instruments 25 % government bearer bonds 15 % other 15 % Qualifying interest: - housing bonds n/a - bearer instruments n/a - other n/a	15 %	10 %	15 %
Royalties	15 %	20 %	15 %	15 %	15 %
Service fees	15 %	20 %	15 %	15 %	15 %
Rents	15 %	- immovable property 30 % - other property 15 %	0 %	15 %; for leased aircraft 0 %	15 %
Remittances of branches to head offices	0 %	?	0 %	10 %	15 % of repatriated income (special formula for this income)
Assessment of non-residents	No special regulations	n/a	No special regulations	n/a	n/a

Source: Petersen Report, Tax systems study in EAC, 2009. Supported by respective income tax legislations of the EAC Member States.

Appendix 5: Laws that need to be aligned with the Code against harmful tax competition

SUBJECT	UGANDA	RWANDA		TANZANIA	KENYA	BURUNDI
INCOME TAXES	**Cap 340**	**N° 16/2005 of 18/08/2005 2005 on direct taxes on income**	**Law N°73/2008 Of 31/12/2008 Modifying And Complementing Law N° 16/2005 Of 18/08/2005 On Direct Taxes On Income**	**Cap 332**	**Cap 470 as revised in 2009**	*
Individual rates	S. 6	Article 11		S. 4	S. 34, see also personal reliefs under 3rd schedule and Head B(1) 3rd schedule	
Corporation tax rates	S.7	Article 37, 38, 41, 42		S. 53	Head B(2) 3rd schedule See also EPZ – S.4B and 11th schedule	
Exempt Income	S. 21	Article 14, 39		S. 10, 2nd Schedule	S. 13, 14 and 1st schedule	
Capital deductions	27,28, 29,	Article 24, 25, 26	Article 3	Article 14, 15, 17, 18	S. 15(c & d) , 2nd schedule, part I and II	
Foreign Tax Credit	S. 81	Article 6		S.77	S. 42	
WHT (Non resident) • Public entertainers and sports persons • Professional and contractors • Shipping, Air Transport or Telecom Services	S. 84 S. 85 S. 86	Article 51		S.83	S. 34(2) S. 35 (1)(a, b, c, d, e) Head B(3) 3rd schedule	
WHT on International Payments (Non resident)	S. 83	• Article 33		S.82 S. 83 - Service fees		

Interest, Dividend, Royalty, Rent, Natural resource payment, Management services		• Article 34, 44 • Article 35 • Article 36		and contract payments		
SUBJECT	**UGANDA**	**RWANDA**		**TANZANIA**	**KENYA**	**BURUNDI**
Refunds	S. 113	Article 12 (6)		S. 126	S. 90, 105	
Penalties	S. 151, 152, 153, 154	Articles 59 – 62 of Law N° 25/2005 Of 04/12/2005 On Tax Procedures		S.98, 99, 100, 101, 102	S. 72, 72B, 72C, 72D, 94	
Appeals	S. 100, 101			S. 16 and 17 of Cap 408 - The Tax Revenue Appeals Act	S.86, 87, 88, 89, 91A,	
Foreign employment Income	S.80			S.67	S. 16(2)(c)	
Transfer Pricing Rules	S. 90	Article 30		S. 33	The Income Tax (Transfer Pricing) Rules, 2006	
International Agreements	S. 88			S. 128	S. 41	
Access to Records	S. 129, 131	Article 22, 57 of Law N° 25/2005 Of 04/12/2005 On Tax Procedures		S. 138, 139, 140	S. 69, 125	
Practice Notes and Private rulings	S. 160 and 161			S. 130 and 131		
VAT	**VAT Act Cap 349**	**Ministerial Order N°001 Of 13/01/2003 Providing For Value Added Tax Rules And Taxation**	**Law No 06/2001 of 20/01/2001 on the Code of Value Added Tax**	**VAT Act Cap 148**	**VAT Act Cap 476**	

		Procedure				
Taxable person	S. 6			S. 2	S. 2, S. 6(3)	
Supply of goods	S. 10	Section 2 Article 2 - 8	Article 4	Taxable supplies – S. 5	S. 6	
Supply of services	S. 11		Article 7			
SUBJECT	**UGANDA**	**RWANDA**		**TANZANIA**	**KENYA**	**BURUNDI**
Exempt supplies	2nd schedule	Chapter 11. Articles 70 – 79 See also annex to Ministerial Order Nº 003/Fin Of 17/03/2004 Amending Ministerial Order Nº 001 Of 13/01/2003 Providing For Value Added Taxation Rules And Procedures	Article 15, Article 86 See also article 2 of Law No 25/2010 of 28/05/2010 modifying and complementing Law No 6/2001 of 20/01/2001 on the Code of Value Added Tax	S. 10, 2nd schedule	S. 2, 2nd schedule	
Zero rated supplies	3rd schedule	Article 80	Article 87	S.9, 1st schedule	S. 8 (2), 5th schedule	
Refunds • Refund of over paid tax • Refund of tax for bad debts • Interest on overpayments and late refunds • Refund of tax to diplomats and diplomatic and	• S. 42. • S. 43. • S. 44. • S. 45	Article 6	Article 49	S. 17(3)	S.24	

consular missions and international organizations						
Penal Tax	S. 65	Article 82	Article 47, 68. See also articles 59, 60, 61 and 62 of Law No 25/2005 of 04/12/2005 on Tax Procedures	44, 45, 46, 47	S. 15, 43,	
SUBJECT	**UGANDA**	**RWANDA**		**TANZANIA**	**KENYA**	**BURUNDI**
Access to information			Article 22, 23 and 57of Law No 25/2005 of 04/12/2005 on Tax Procedures	S.38	S.30, 31, 42, 42A	
Practice Notes and Practice rulings	S. 79 and S. 80					
International Agreements	S. 76 and S. 81				S. 26	
Schedules • Listed institutions • Exempt supplies	• 1st Schedule • 2nd			1st and 2nd schedules	• 2nd schedule - exempt goods • 3rd schedule –	

• Zero rated supplies	schedule • 3rd schedule			exempt services • 5th schedule – zero rating	
EXCISE DUTY	**East African Excise Management Act Chapter 28 of 1970**	**Law No 26/2006 of 27/05/2006 determining and establishing consumption tax on some imported and locally manufactured products**	**East African Community Customs Management**	**Customs And Excise Act Cap 472**	
Rates - Advalorem , Specific rates	S. 39, 40 see also 2nd schedule of the Excise Tariff Act	Article 4 See also article 1 of law **No 75/2008 modifying and complementing Law No 26/2006 of 27/05/2006** See also Article 1.of **Law N° 19/2009 OF 30/06/2009 Modifying And Completing The Law N° 26/2006 Of 27/05/2006 Determining And Establishing Consumption Tax On Some Imported And Locally Manufactured Products**	S.110	S.119 (1), 1st, 4th and 5th schedule	
Excisable goods	S. 2, 41, 42, 43		S. 38	S. 12, 14, 31,	
SUBJECT	**UGANDA**	**RWANDA**	**TANZANIA**	**KENYA**	**BURUNDI**
Rebates	S. 61		S. 142	S. 148, 149	
Remission	s.60, 64 ; see also S. 8 of the Excise Tariff Act Cap 338		S. 141	S. 145, 146	
Refunds	S. 62 ; see S.7 of the Excise Tariff Act Cap 338		S. 144	S. 138, 139	
Penalties	S. 91, 92, 93	Article 33 – 37	S. 201, 209 – 213, S. 249	Article 195, 196, 197, 225A	

Taxes on imports	S. 41				S. 155		
Taxes on exports		Article 31		S. 77, 82			
Appeals		Article 21, 22			S. 159		
Disclosure and exchange of information				S. 10	S. 8 of the Customs And Excise (1st Booklet) Code		
INVESTMENT LAWS							
Laws	**The Investment Code Act, Cap 92.**	**Law N° 26/2005 Of 17/12/2005 Relating To Investment And Export Promotion And Facilitation**	**Law No 14/98 of 18/12/1998 Establishing the Rwanda Investment Promotion Agency**	**The Tanzania Investment Act, 1997** **The Export Processing Zones Act as amended by Act 2006** **The Special Economic Zones Act 2005**	**The Investment Promotion Act, 2004 No. 6 Of 2004** **The Export Processing Zones Act Cap 517**	**Law N ° 1 / 24 Of 10 September 2008 On The Code Of Investment s Of Burundi**	**Law N ° 1 / 23 Of 24 September 2009 For Determining The Tax Advantages Provided By Law No. 1 / 24 Of 10 September 2008 On The Code Of Investments Of Burundi**
SUBJECT	**UGANDA**	**RWANDA**		**TANZANIA**	**KENYA**	**BURUNDI**	
Exemptions • Import duties • VAT	S. 21, 24	Annex 1 par. 1 Article 17	Article 33	S. 21(1)(c –e, k),i.e. Corporation tax, WHT, Local Gov't Tax S. 21(l) of The Export Processing Zones Act as amended by Act 2006			
Fiscal incentives	S. 22, 23, 26	Article 18, 19,	Article 30(a), 31	S. 25, S. 21(1)a S. 21(l) of The Export			Article 2

				Processing Zones Act as amended by Act 2006			
Tax Rates		Annex II. C and D		S.21 S. 21(l) of The Export Processing Zones Act as amended by Act 2006		Article 14 & 15	Chapter 1 Section 3, Chapter II S.4
Investment allowances		Annex II. A	Article 30 (b)				
Training and research		Annex II. B	Article 30 (c)				
Infrastructure costs		Article 28, Annex I par. 7	article 30 (d)				
Duty draw back for investors outside the EPZ			article 30 (e)	S. 21(1)b S. 21(l) of The Export Processing Zones Act as amended by Act 2006			
Disclosure of Information					S. 13 of the Export Processing Zones Act Cap 517		
Guarantee against expropriation	S. 27	Article 30	Article 38	S. 22		Article 9	
SUBJECT	**UGANDA**	**RWANDA**		**TANZANIA**	**KENYA**	**BURUNDI**	
Free export economic zones / Export Processing Zone	S.25 – Incentives for certain exporters	Article 22, 23, Annex I par. 6	article 30 (f), 34, 36	The Export Processing Zones Act Cap 517 SEZ Act, 2006 Economic Development Zones Act 2009		Law No. 1 / 015 of 31 July 2001 amending the Decree-Law No. 1 / 3 of 31 August 1992 establishing a free zone regime in	

						Burundi	
Repatriation of Capital and Profits/ externalisation of funds	S.29, 30, 31,		Article 43	S. 21, 26 S. 21 (n) of The Export Processing Zones Act as amended by Act 2006			
Entry and Work permits		Article 20, 21	Article 32	S. 24, S. 21(h &*l*) of The Export Processing Zones Act as amended by Act 2006	S.13. of The Investment Promotion Act, 2004 No. 6 Of 2004	Article 8	

* Burundi has not yet availed its tax laws
Source: EAC Taskforce Report on Harmful Tax Competition, 2011.