Developing the Nigerian Model for Avoidance of Double Taxation and Exchange of Information Agreements.

A paper presented by

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Background

All nations have their own tax rules and laws which are designed to raise revenue and support public policy. However some persons (individuals and companies) who have income and capital gains from one country and are resident in another may have to pay tax in both countries under their different tax laws. This is double taxation of the same income and it distorts behaviour and encourages avoidance and evasion activities.

Why we have double taxation agreements

If there is no double taxation agreement between the country where you are resident and the country where you have income or capital gains, then your income or capital gains may be taxed fully in both countries. For many businesses this can be a disincentive to investment in another country and may be punitive to those who both live and work in different countries. There are a number of well researched papers on the interaction of double taxation treaties and Foreign Direct Investment such as that of Prof Eric Neumayer .[i]

To help avoid being taxed twice - 'double taxation', countries negotiate double taxation agreements with other countries. Thus one could say that Double Taxation Treaties are agreements between two states which are designed to:

- protect against the risk of double taxation where the same income is taxable in two states
- provide certainty of treatment for cross-border trade
- prevent tax discrimination against a country's business interests abroad

There is a fuller definition of double taxation from the OECD and that is reproduced in full at the notes at the end of this paper for reference.[ii]

How they work

"Double taxation agreements usually operate in one of three ways:

- you pay tax in your country of residence and get an exemption or relief from tax in the country where you have made your income or gain

•you pay tax in the country where you have made your income or gain and get an exemption or relief from tax in the country where you are resident

•tax is deducted in the country where you make your income or gain and you declare this tax as already paid on your tax return for the country where you are resident - the tax already paid is known as 'withholding tax'

The agreements work in the same way for residents of both countries involved, but which system is in place depends on the individual agreement between those two countries (and can depend on the type of income involved)."[iii]

Double taxation agreements normally allow some tax relief on the following kinds of income:

- pensions and some annuities –
- earnings from employment or professional services – though there are often special rules for entertainers and sportspersons
- royalties
- interest
- income from property
- dividends

Under many agreements Capital Gains Tax is paid in the country where a taxpayer is resident but they will be exempt from Capital Gains Tax in the country where the gain is made. However many double taxation treaties provide for exceptions to this rule such as:

- where the gain comes from an asset that cannot be taken out of the country, for example land or a house
- where the gains come from assets connected with a business or trade which is being run through a permanent establishment in that country

In these circumstances tax is paid in both countries, but the country in which you are resident will give you relief for the tax paid on the gain in the other country.

How can double taxation treaties be abused?

Double Taxation Treaties are also drawn up to protect a Government's taxing rights and protect against attempts to avoid or evade the tax liability due in that country. To help drive transparency and counter avoidance and evasion they also often contain provisions for the exchange of information between the taxation authorities of states.

Nigeria

The current position:

Unlike many countries such as the UK which has over 100 tax treaties, Nigeria has less than 10 agreements in place and very few in the pipeline.

The advantage of not having them is that all those earning income in Nigeria must pay their full taxes once they are resident so Nigeria gets its tax. However, this is often outweighed by the disadvantage of not having them. Where we do not have treaties in place between major trading partners their businesses are unlikely to invest as much as they should and could in Nigeria. In addition the foreign investors have a greater incentive to engage in avoidance activities to try and avoid double taxation. This often means that they use instruments such as transfer pricing and thin capitalisation to extract funds from Nigeria before they have to pay tax on the balance. And the lack of double taxation treaties also usually mean that there are no exchange of information provisions so we cannot even find out if we are being cheated.

The Practicalities of negotiating double taxation (and exchange of information) treaties:

The types of tax treaties:

Double Tax Agreements tend to be based on two models: a dominant OECD model, on the one hand, and a model put forward by the United Nations, on the other.

The OECD Model:

In general, the OECD model gives greater emphasis to residence-based taxation - which is favourable to OECD countries, where many of the multinationals are residence.

The UN Model:

The UN model gives greater taxing rights to source jurisdictions, which are typically developing countries receiving inward investment. [iv]

For a detailed technical comparison of the two, see Michael Lennard's Jan/Feb 2009 paper in the Asia-Pacific Tax Bulletin, ""The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments. And the 2008 paper "The Purpose and Current Status of the United Nations Tax Work" also by Lennard provides a shorter assessment of the differences between the OECD and UN models, along with some history.[v]

Though in Nigeria we have tended to use the OECD model there is a need to fully explore the implications of different models as we need to protect the interests of Nigeria and there are clear advantages to countries like Nigeria for adopting the UN Model Tax Convention.

Regardless of the choice of model it is important that the chosen model includes the essential aspects of DTAs that aid the administration of taxes in Nigeria.

For example because Globalisation not only makes it harder for tax authorities to accurately determine the correct tax liabilities of their taxpayers: it also makes the collection of tax more difficult. Taxpayers may have assets throughout the world but tax authorities generally cannot go beyond their borders to take action to collect taxes. For this reason a new Article 27 on assistance in the collection of taxes was added to the OECD Model Tax Convention in 2003.[vi]

The Convention on Mutual Assistance in Tax Matters also includes provisions on assistance in recovery of tax claims (Articles 11-16).

Tax Information Exchange Agreements (TIEAs).

In addition to DTAs, there is another class of tax treaties that countries sign too. These are called Tax Information Exchange Agreements (TIEAs). TIEAs are far narrower in scope and concern only the provision of information. Generally, countries prefer to sign TIEAs instead of DTAs with tax havens, for fear of fiscal leakage. It is important to fully understand the provisions of these agreements to ensure that there is an even flow of information between the countries and that these do not become a major administrative overhead for Nigeria. There is also greater difficulty in supplying the information because in Nigeria our database of taxpayer information is limited and fragmented as tax is administered at a number of levels. This topic is explored in greater detail in the earlier 2010 paper on this subject by Dr Mark Abani at the CATA Conference in Abuja[vii].

Nigeria is listed among the countries participating in the development of new global transparency here and there is much more information in the March 5 2012 publication of briefing for the OECD 'The Global forum on transparency and exchange of information for tax purposes'.[viii]

The domestication process:

Regardless of the model used because the Double Taxation Agreements apply to and affect the application of domestic tax laws it is important that these are formally adopted by the Government of Nigeria. There is an administrative and legislative process for signing negotiated agreements into law. This means that the executive and legislative arms of Government need to be aware of the importance and necessity for double taxation agreements to protect the Nigerian Tax base while encouraging foreign trade and investment.

Next Steps:

Identification of the important existing Double taxation agreements that need to be addressed:

Nigeria and the UK have had a long standing DTA but this is now old and not in line with most modern agreements which provides for potential to avoid taxes, not just in Nigeria but also in the UK by the unscrupulous. The UK laws on the taxation of UK residents has undergone significant modification in the last five years, for example Nigerians resident for tax purposes in the UK are taxable in the UK on their world-wide income including all the income that they make in Nigeria from their investments. Similarly many of the Nigerian taxes that are paid may not be fully relieved by the existing DTA. Therefore a full review of this and other DTAs may be appropriate.

The identification of new Double Taxation Agreements that we need to consider.

We do not have tax treaties with some of our major trading partners such as, for example, the USA and China. In the case of the USA we may need to be careful that the DTA does not give away Nigreria's ability to tax US companies fully on their income that arises in Nigeria. While with China, the double taxation agreements may need to have fully understood exchange of information provisions to ensure that Nigeria has a grasp of the scale and value of the profits being made in Nigeria by Chinese companies. Other DTAs will be negotiated depending on the identified issues of loss of tax and or impediments to inward investment.

The requirements to build internal capacity to negotiate and domesticate double taxation treaties.

The process of negotiating Double Taxation Agreements is quite specialised but because these DTAs and Exchange of information agreements cover a large range of taxes it is critical to develop a core of staff. These staff will require to not only have a full understanding of the treaty negotiation process, but will also need a broad understanding of the various taxes of Nigeria so that they can call in specialists for specific areas where the implications of the treaties on the local tax base may not be fully understood.

It is also important that in negotiating these treaties anti-avoidance provisions are included such that these cannot be used for the avoidance of Nigerian (or indeed any countries') tax.

The sensitisation requirements for the executive and legislative arms of government is critical to ensuring that where treaties are negotiated they are given effect and become legally operational in Nigeria.

Other Government departments will also need awareness training so that they appreciate the need for effective DTAs and these will include the Foreign Affairs Ministries and the Trade desks of the Federal Ministry of Trade and Investment among others.

Finally there will be the need to sensitise the taxpaying population so that they understand the reliefs that are available to them under the DTAs which will help them to drive their businesses, while preventing or countering avoidance of tax.

Summary

Double taxation is undesirable, because if businesses end up paying tax on the same income in more than one country, they will not want to do business overseas, thus affecting the inward investment into Nigeria. Relieving double taxation is a means of removing barriers to international trade, to the operation of free and open markets and to the free movement of persons and of capital.

Where we do not have double taxation agreements in place companies will try to avoid double taxation by employing avoidance tools such as transfer pricing and thin capitalisation, depriving Nigeria of vital taxes due on income generated in the country.

The open and transparent exchange of information for tax purposes helps counter such avoidance and promotes healthy trade and taxation.

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[i] http://eprints.lse.ac.uk/3054/1/Do_double_taxation_treaties_increase_foreign_direct_investment_to_developing_countries(LSERO).pdf

[ii] International juridical double taxation can be defined as the imposition of income taxes in two (or more) states on the same taxpayer in respect of the same income . Juridical double taxation can arise, for example, where a resident of one country derives income from sources in the other country, and both countries' domestic tax legislation would tax that income. It can also arise where each country considers the taxpayer to be resident in that country under domestic tax laws. Tax conventions reduce juridical double taxation by allocating taxing rights between residence and source states on various categories of income, typically by eliminating or limiting source country taxation or by requiring a residence state to grant relief for source state taxation through a credit or exemption mechanism. For example, tax conventions typically provide that one country may not tax the business profits earned by a resident of the other country unless that resident has a taxable presence in the form of a permanent establishment in the first country and the profits are attributable to that permanent establishment. Tax conventions also reduce juridical double taxation by establishing criteria for determining an exclusive residency status for taxpayers. The most common instances of juridical double taxation disputes are disputes over residency or permanent establishment status, or over the characterisation of particular items of income and their coverage under particular provisions of the convention.

Economic double taxation means the inclusion, by more than one state's tax administration, of the same income in the tax base when the income is in the hands of different taxpayers. Transfer pricing cases are the best example of economic double taxation. For example, a tax administration adjusts a price charged between related parties with a resulting tax charged on the additional income in the hands of one related party, where tax has already been charged in another country on that same income in the hands of the other related party.

Double taxation has a detrimental effect on the movements of capital, technology and persons and on the exchange of goods and services. Thus tax conventions, when properly applied, remove the obstacles of double taxation, thereby promoting the development and flow of international trade and investment.

Source: 1 Background - 1.1. What is a tax convention - 1.1.2. Double taxation - juridical and economic OECD.

[iii] HMRC Website on Double taxation treaties
[iv] Source: http://www.taxjustice.net/cms/front_content.php?idcat=145
[v] Source: http://www.taxjustice.net/cms/upload/pdf/Lennard_0802_Status_of_UN_Tax_Work.pdf
[vi] Source: http://www.oecd.org/document/14/0,3746,en_2649_33767_2499854_1_1_1_1,00.html
[vii] Exchange of information - Domestic and International: The Federal Inland Revenue Service of Nigeria (FIRS) experience, Dr Mark Abani, Board Member FIRS, at the 31st CATA Annual Technical Conference in the city of Abuja Federal Capital Territory of Nigeria from October 10 to 16, 2010 at the Transcorp Hilton Hotel, Abuja, Nigeria
[viii] Source: http://www.oecd.org/dataoecd/32/45/43757434.pdf