Restriction on Deductibility of Technical and Management Fees, and Royalties Paid to Non-Residents: Potential Conflict with Rwanda’s Obligations under Double Taxation Avoidance Treaties

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The Rwandan Income Tax Act (Law nº 016/2018 of 13/04/2018) gazetted on April 16, 2018 overhauled the Rwandan income tax system with various significant changes. One of the changes introduced by the Rwandan Income Tax Act that gave rise to wide discussion among tax practitioners relates to non-deductible expenses—particularly the restriction imposed on the deductibility of management and technical service fees as well as royalties paid to non-resident persons. Article 26 Paragraph 1 (9^{0}) of the Rwandan Income Tax Act provides that fees exceeding 2% of the turnover of the taxpayer cannot be allowed as deductible expenses for the purpose of determining taxable income.[1]
One of the issues raised in relation to this restriction was whether it would apply even in circumstances where relevant fees are paid to independent non-resident persons. Fortunately, this issue was duly resolved by the Tax Administration through its public ruling issued on August 29, 2019 in which it clarified that the restriction would only apply to management and technical fees and royalties paid to non-resident related persons.[2]

Nevertheless, the restrictive construction of the provisions of Article 26 Paragraph 1 (9^{0}) by the Tax Administration did not address all issues associated with the provisions such as it being a disincentive to the operation of multinationals in Rwanda given that intra-group transactions in terms of management and technical services and licensing of intellectual property rights constitute the lifeblood of many multinationals. More importantly, the same provision potentially runs afoul of Rwanda’s obligations under various double taxation avoidance treaties (“**DTAs**”). This blog post thus considers whether the provisions of Article 26 Paragraph 1 (9^{0}) of the Rwandan Income Tax Act conflicts with the non-discrimination provisions under various DTAs to which Rwanda is a party and how such potential conflict may be resolved by Rwandan courts.

Conflict with non-discrimination provisions under DTAs

Rwanda has entered into DTAs with various countries most of which are modelled after the OECD Model Tax Convention and include non-discriminatory provisions. Cases in point are the DTAs with South Africa, Morocco[3], Belgium, Singapore and Barbados. Each of these DTAs contains an expense-related non-discrimination provision similar to Article 24 Paragraph 4 of the OECD Model Convention with Respect to Taxes on Income and on Capital as it read on 21 November 2017. The expense-related non-discrimination provision states as follows:

“Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11 or paragraph 4 of article 12[4] apply, interest, royalties and other disbursements[5] paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, *for the purposes of determining* the taxable profits of *such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first mentioned State*.”[6] [Emphasis added]

It appears from the non-discrimination provisions of the identified DTAs that the restriction imposed in terms of Article 26 Paragraph 1 (9^{0}) may, in all likelihood, be construed as discriminatory and thereby conflicting with the provisions of the DTAs considering that in terms of the same article, technical and management fees plus royalties paid to non-residents are not deductible in the manner that those paid to resident persons (which can be deducted in their entirety) are. On this basis, it is conceivable that the provisions of Article 26 Paragraph 1 (9^{0}) can be successfully challenged by Rwandan taxpayers incurring expenses in terms of technical and management fees and royalties paid to non-resident related parties (residing in countries having DTAs with Rwanda). Other DTAs such as the DTA with Mauritius and the DTA with Jersey do not have expense-related non-discrimination provisions, but a taxpayer can arguably still rely on ownership-related non-discrimination provisions considered below.

The ownership-related non-discrimination provision under various DTAs to which Rwanda is party reads as follows:

“Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any *requirement connected therewith* which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.”[7] [Emphasis added]

A closer look at the above provisions indicates that Rwanda is, under the relevant DTAs, expected not to subject Rwandan enterprises owned and/or controlled by residents of other contracting States to more burdensome taxation and requirements connected therewith than those an enterprises controlled by Rwandan residents is subjected to. In this regard, if a Rwandan enterprise controlled by Rwandan residents is allowed to deduct management and technical fees, and royalties paid to its controlling resident persons without any restriction other than those relating to the arm’s length principle (ALP), denying the same treatment to an enterprise controlled by residents of the other contracting State in its dealings with the latter may arguably be construed as discrimination in terms of the ownership-related non-discrimination provisions of the relevant DTAs.

We consider, below, how this potential conflict between the provisions of Article 26 Paragraph 1 (9^{0}) on the one hand, and non-discrimination provisions under relevant DTAs on the other, can be resolved.

Constitutional way out

Rwanda is a purely monist State in that ratified international treaties become part of municipal law and can be relied on before Rwandan courts. Rwanda’s monism is entrenched in Article 168 of the Constitution of the Republic of Rwanda of 2003 revised in 2015 (the “**Constitution**”) which unequivocally states that “[u]pon publication in the Official Gazette, international treaties and agreements which have been *duly ratified or approved have the force of law as national legislation* in accordance with the hierarchy of laws provided for under the first paragraph of Article 95 of the same Constitution.” [Emphasis added] The hierarchy of laws referred to under Article 168 of the Constitution cited herein puts international treaties above ordinary laws (the category the Income Tax Act belongs to), and therefore, in case of conflict between the non-discrimination provisions under the DTA and the provisions of Article 26 Paragraph 1 (9^{0}) of the Income Tax Act, the provisions of the DTA would prevail in accordance with Paragraph 2 of Article 95 of the Constitution which states that “*a law cannot contradict another law that is higher in hierarchy*”. One would even have no trouble concluding that the same interpretation can be followed by Rwandan courts.

Wrapping up, indeed every economy is expected to put in place tax measures aiming at protecting its tax base and preventing profit-shifting and base-erosion. Nonetheless, in so doing, countries ought to be mindful of their international obligations under DTAs and the fact that some tax measures can negatively affect the flow of investments into a specific economy. In the instant case, one can validly argue that measures like withholding tax on technical and management fees, and royalties paid to non-residents and the transfer pricing ALP were sufficient to protect Rwanda’s tax base and prevent the shifting of profits offshore.

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END NOTES

[1] “The following expenses are not deductible from taxable income:…management, technical services and royalty fees paid to a non-resident person exceeding two percent (2%) of the turnover of the taxpayer.”

[2] This is article 23 paragraph 4 of the DTA with South Africa, article 23 paragraph 3 of the DTA with Mauritius, article 24 paragraph 4 of the DTA with Barbados, article 23 paragraph 5 of the DTA with Belgium, article 23 paragraph 3 of the DTA with Jersey, article 23 paragraph 5 of the DTA with Morocco and article 23 paragraph 4 of the DTA with Singapore.

[3] Public ruling issued by the Commissioner General on Article 26 of Law nº 016/2018 of 13/04/2018 establishing taxes on income.

[4] The Rwanda-Morocco DTA was approved for ratification by the Rwanda’s parliament vide law nº 24/2017 of 31/05/2017 approving the ratification of the agreement signed in Kigali, Rwanda, on 19 October 2016, between the Republic of Rwanda and the Kingdom of Morocco, for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, but it has not yet been ratified by the President of the Republic.

[5] The provisions of article 9 (1), article 11 (6) and 12 (4) relates to the arm’s length principle of transfer pricing to which all related party transactions must adhere.

[6] The word disbursements does in one’s opinion include management and technical fees.

[7] See article 23 (3) for Rwanda-South Africa DTA, article 24 (4) for Rwanda-Morocco DTA, article 24 (3) for Rwanda-Barbados DTA, article 23 (3) for Rwanda-Singapore DTA and article 24 (4) for Rwanda-Belgium DTA.