



Should Kenya repeal its domestic Limitation of Benefits Rule in favour of the Simplified Limitation of Benefits Rule in the MLI?

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Abstract

The Limitation of Benefits (LOB) rule is a recommended measure to fight treaty abuse by the Organization for Economic Cooperation and Development (OECD). It works by preventing residents of third-party states from accessing treaty benefits between states where they do not have sufficient connection in the contracting state based on set criteria. The rule originates from US tax treaty practices and has since been embraced in domestic and treaty practice by other countries worldwide.

Kenya is one of the countries that have a domestic LOB rule, which was enacted in 2014. In addition to the domestic LOB rule, Kenya has also elected to include in its treaty practice a version of the rule known as the simplified LOB (SLOB). This has been done under the auspices of the OECD's multilateral tax treaty (MLI). While the two rules operate in different legal realms, there are similarities and differences in their construction and application. Similarly, there are different challenges and opportunities in applying each rule in its own legal realm. By analysing the current law in Kenya, the study highlights the history of the rule and examines its utility for anti-abuse purposes in Kenya today. The SLOB, which is poised to be applied at the treaty level once Kenya ratifies the MLI, is also discussed in detail in contrast to the domestic law provision.

The study finds that while the two rules can co-exist, there is a convincing case for why the domestic LOB rule should be repealed. This is because of the main challenge it poses in jurisdictions where it is used which is allowing domestic law to override treaty law. Its repeal will also be a step towards bringing the practice in this area on par with best practices, as reflected in the drafting and content of the treaty version of the rule espoused by the SLOB.

The study concludes that for Kenya and other developing countries that have the rule in their domestic law, the MLI presents an opportunity to align with international best practices.

Abbreviations

BEPS - Base Erosion and Profit Shifting

CBDT - Central Board of Direct Taxes

CTAs - Covered Tax Agreements

DTAs - Double Tax Agreements

EAC - East African Community

GAARs - General Anti-Avoidance Rules

IMF - International Monetary Fund

ITA - Income Tax Act

KRA - Kenya Revenue Authority

LOB - Limitation of Benefits Rule

MTC - Model Tax Convention

MLI - Multilateral Instrument

MNCs - Multinational Corporations

OECD - Organization for Economic Cooperation and Development

PPT - Principle Purpose Test

SAARs - Specific Anti-Avoidance Rules

SLOB - Simplified Limitation of Benefits Rule

USD - United States Dollar

USA - United States of America

UN - United Nations

VCLT - Vienna Convention on the Law of Treaties

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Chapter 1

Introduction

Tax Treaties make up part of the internationally coherent system of tax rules aimed at countering double taxation¹. These international rules have naturally over time cascaded into the realm of national tax laws as states seek to align their domestic tax practices after rules set by pioneering and authoritative organizations in the international tax field, such as the Organization for Economic Cooperation and Development (OECD) and the United Nations (UN)².

Despite the intentions of these bodies in their work pertaining tax treaties, the abuse of tax treaties became an emerging concern in the mid to the late 20th Century. This was after the explosion of multinational corporations (MNCs) in the era of globalized business which exposed the cracks in the international tax rules that could easily be circumvented by such powerful players³.

To contextualize this, it has been reported that Africa loses about USD 240 Billion in tax revenue annually due to various forms of tax avoidance⁴ and tax evasion⁵ involving large multinational corporations⁶. This situation poses a problem because tax revenue is key in advancing the economic and development agenda of any nation and this tax revenue loss defeats these goals and aims of developing countries in Africa that rely on tax revenue to fund their governments.

It is amidst such concerns that the field witnessed the emergence of concerted efforts towards the elimination of abusive tax practices using artificial means culminating into the

¹ David Chamberlain and Mario Petriccione Conrad Turley 'Tax Treaties' in Khoonming Ho & Yuesheng Jiang (ed) *A New Dawn for the International Tax System: Evolution from past to future and what role will China play?* Online ed (2017)

² *Ibid.*

³ *Ibid.*

⁴ Black's Law Dictionary 2 ed (online) <https://thelawdictionary.org/?s=tax+evasion> (accessed 17 June 2025) defines tax avoidance as the "lawful tax liability minimization that occurs from a sound financial plan."

⁵ HM Revenue & Customs "Tackling Tax Evasion: HMRC Issue Briefing" (n.d.) https://assets.publishing.service.gov.uk/media/5a7b9b6ded915d131106058a/HMRC_issue_briefing_-_tackling_tax_evasion.pdf (accessed 17 June 2025) defines tax evasion as "a deliberate attempt not to pay tax liabilities that are due."

⁶ Tax Justice Network *Curbing Illicit Financial Flows and Tax Injustice in Africa (A toolkit for members of parliament)* (2023)

Base Erosion and Profit Shifting project (BEPS) led by the OECD⁷. BEPS refers to instances where artificial arrangements by entities result in low or no taxes by shifting profits from places where the activities that generate the profits are based⁸. It is contended that while most BEPS schemes are not illegal, they leave undesirable consequences such as inspiring tax non-compliance as they undermining the integrity and fairness of tax systems from the perspective of a domestic taxpayer⁹. The OECD BEPS Action Plan of 2013 identified treaty abuse and specifically treaty shopping as one of the most crucial sources of BEPS concerns¹⁰.

1.1 Countering Treaty Abuse Using Domestic Measures

The OECD's view in the 2003 Commentary to the Model Tax Convention (MTC) was that countries could adopt any domestic measures they deemed necessary to counter treaty shopping and abuse as such measures would not conflict with their tax treaty obligations¹¹. This position in turn supported the emergence of different and varied domestic measures. The focus of OECD's BEPS Action 6 was therefore on realigning countries efforts towards countering treaty abuse and the harmonization of different measures adopted by different countries to counter treaty abuse¹².

One of the ways the BEPS project proposed to deal with tax treaty shopping and abuse was through the formulation of MTC treaty provisions and assisting countries with recommendations on how to design domestic rules to counter these practices¹³. The eventual goal was for these proposed solutions under BEPS Action 6 to be implemented and included in BEPS Action 15 on the Multilateral Instrument (MLI) where solutions would be reflected and coordinated¹⁴. This came to pass when the Multilateral Instrument came into force in 2018.

⁷ David Chamberlain and Mario Petriccione Conrad Turley *op cit* note 1

⁸ OECD *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (2015) OECD Publishing, Paris available at <http://dx.doi.org/10.1787/9789264241343-en> (accessed 26 June 2025) at 82

⁹ Organisation for Economic Co-operation and Development (OECD) "Base Erosion and Profit Shifting (BEPS)" (n.d.) <https://www.oecd.org/en/topics/base-erosion-and-profit-shifting-beps.html> (accessed 17 June 2025)

¹⁰ OECD *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 2015 Final Report* (2015) para 1

¹¹ OECD *Commentaries on the Articles of the Model Tax Convention on Income and on Capital* (2003) para 9.2

¹² David Chamberlain and Mario Petriccione Conrad Turley *op cit* note 1

¹³ Bruno da Silva 'BEPS Action 6 and the LOB Provision: Restoring the Debate on the Compatibility with EU Law ' in *The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* (P. Pistone & D. (Dennis) Weber eds. (2018)

¹⁴ David Chamberlain and Mario Petriccione Conrad Turley *op cit* note 1

The MTC provisions recommended by the OECD to comprise the minimum standards on anti-treaty abuse included three options:

- a) A Principal Purpose Test (PPT) Rule
- b) Using a combination of PPT rule and a Simplified Limitation of benefits (SLOB) provision
- c) Using a detailed Limitation of Benefits (LOB) provision in conjunction with an additional treaty based or domestic anti-conduit company rule¹⁵.

Of the three recommendations, the study focuses on the nature and workings of the LOB provision within the context of a domestic jurisdiction. The study also considers how the LOB provision works within tax treaties.

1.2 LOB Rule under BEPS

An LOB clause as prescribed under BEPS Action 6 was meant to restrict and limit access to treaty benefits for persons who do not have sufficient nexus with the treaty states such as to be entitled to treaty benefits¹⁶.

At the international law level taxation is based on the nexus rule. This rule stipulates that for a country to claim jurisdiction to tax income, the tax principles of nationality, domicile and source are evaluated before such claim is established¹⁷. Once all these are established, a person's tax presence within a given country is recognized and a corresponding subjectivity to tax is possible.

The BEPS Action 6 report describes the LOB rule by referencing its existence and use within certain country treaties such as those used by the United States of America (USA) and India¹⁸. These countries and specifically the USA pioneered the use of the LOB rules in their treaty networks long before the OECD adopted these clauses, and it was therefore only right that their settled practices be a point of reference.

It has been argued that LOB rules are complex because they impose additional criteria for qualification for treaty benefits other than the standard nexus requirements. These

¹⁵ Bruno da Silva *op cit* note 13 section 8.2.1

¹⁶ *Ibid* section 8.2.2

¹⁷ M.F. de Wilde 'Introduction: "Sharing the Pie"' in *Sharing the Pie: Taxing Multinationals in a Global Market* (2017) section 1.1.2.2

¹⁸ OECD *op cit* note 10 para 19

additional tests are typically objective tests which depend on the discretion of the competent authority's assessments¹⁹. In addition to residence, persons are required and expected to meet at least one other additional test or criteria to be able to access treaty benefits²⁰.

1.3 The OECD's detailed and Simplified LOB Rule

The OECD's Multilateral Instrument (MLI) has the unique ability of being able to introduce measures to counter BEPS practices that have been identified as weak areas that the international tax rules have struggled to tame²¹. One such opportunity is the inclusion of minimum standards²² on anti-treaty abuse measures against treaty shopping and abuse as per BEPS Action 6 recommendation.

The SLOB option is provided for under Article 7 of the MLI as an optional obligation that countries can use alongside the PPT to meet the minimum standard on treaty shopping and abuse. The PPT is a standalone substantive rule that seeks to deny treaty benefits to a party in a transaction where it can be proved that one of the principal purposes of entering the arrangement or transaction was to obtain a tax benefit²³. The detailed LOB is also a substantive and standalone anti abuse rule even though it is widely criticized for its complexity by scholars. The SLOB has therefore been offered as a complementary option to PPT or a non-automatic measure that is otherwise easy to apply on a matching symmetry basis²⁴.

1.4 Kenya's LOB Clause

In the case of Kenya, approximately USD 43 Billion is lost through tax evasion and illicit financial flows²⁵. Illicit financial flows refer to the movement of funds "generated by methods, crimes and practices aimed at moving money from a jurisdiction in contravention of national

¹⁹ Qunfang Jiang 'Treaty Shopping and Limitation of Benefits Articles in the Context of the OECD Base Erosion and Profit Shifting Project' (2015) 69 *Bulletin for International Taxation* section 3.2

²⁰ Bruno da Silva *op cit* note 13 sec 8.2.2

²¹ Nathalie Bravo *A Multilateral Instrument for Updating the Tax Treaty Network* (2020) section 1.6-1.7

²² Organisation for Economic Co-operation and Development *Inclusive Framework on BEPS: Background Brief* (17 January 2017) <https://web-archiv.oe.cd.org/2017-01-17/425229-background-brief-inclusive-framework-on-beps.pdf>, accessed 25 June 2025. Refers to measures that have been agreed upon by the OECD inclusive framework membership to tackle issues in instances where a lack of action by some countries or jurisdictions would create negative effects (including adverse impacts of competitiveness) on others. The agreed four minimum standards are Action 5 (Countering harmful tax practices), Action 6 (Preventing treaty abuse), Action 13 (Re-examining Transfer pricing documentation) and Action 15 (Improving dispute resolution mechanisms).

²³ Elliffe Craig 'The Meaning of the Principal Purpose Test: One Ring to Bind Them All?' (2019) 11 *World Tax Journal*

²⁴ Sebastien Leduc and Geerten Michielse 'Are Tax Treaties Worth It for Developing Economies?' in *Corporate Income Taxes under Pressure: Why Reform Is Needed and How It Could Be Designed* (Ruud A. de Mooij, Mr. Alexander D Klemm, and Ms. Victoria J Perry) (2021)

²⁵ Tax Justice Network *op cit* note 6

and international laws”²⁶. The statistics therefore points to the fact that BEPS is a valid concern for Kenya. In attempts to deal with this concern, Kenya adopted among other measures the LOB Rule in domestic tax legislation in 2014²⁷. This rule is codified in section 41(2) of Kenya’s Income Tax Act and was aimed at fighting cross border tax treaty abuse and tax avoidance.

Kenya became a member of the OECD Inclusive framework in 2016 and therefore participated in the discussions that brought about the MLI²⁸. Subsequently, Kenya signed the MLI in November of 2019²⁹. Under the minimum standard relating to the prevention of treaty abuse, Kenya elected to use the SLOB to meet the minimum standard. It is worth noting that the MLI is not yet in force as it must undergo the ratification process by parliament as required in law³⁰.

Although Kenya has elected the SLOB as the preferred way to meet the minimum standard against treaty abuse, its application to treaties will not be automatic. Other jurisdictions with which it has tax treaties have to match this choice. The table below highlights the results of the MLI matching exercise for Kenya and its treaty partners. It depicts whether the SLOB option will apply to the existing treaties.

MLI Article 7 Matching	
DTA Partner	Outcome
Canada	No match
France	No match
Germany	Not under CTA
India	Match
Iran	No match
South Africa	No match
Seychelles	No match
Qatar	No match
Norway	Not under CTA
Korea	Not under CTA

²⁶ OECD *Illicit Financial Flows from Developing Countries: Measuring OECD Responses* (2014) at 20

²⁷ Introduced in the Finance Bill (Kenya) 2014

²⁸ Clement Okello Migai ‘Kenya’ in *Implementing Key BEPS Actions: Where Do We Stand?* (M. Lang et al. eds.) (2019) section 20.1

²⁹ Organisation for Economic Co-operation and Development (OECD) “*Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (BEPS MLI)*” (online) <https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm> (accessed 17 June 2025) provides OECD’s mapping of MLI uptake.

³⁰ Organisation for Economic Co-operation and Development (OECD) “*BEPS MLI Position: Kenya*” (online) <https://www.oecd.org/tax/treaties/beps-mli-position-kenya> (accessed 17 June 2025).

Zambia	Not signed MLI
United Kingdom	No match
United Arab Emirates	No match
Sweden	No match

Only one of Kenya's treaty partners has matched Kenya's selection of the SLOB and the rest of the countries in Kenya's treaty network have not matched this selection under the MLI. This means that the SLOB option for Kenya will still not apply to most of the existing treaties and therefore the domestic LOB provision remains relevant for countering tax treaty abuse. This is especially crucial considering that most of Kenya's treaties do not incorporate a treaty LOB rule except for the renegotiated Kenya-India treaty of 2015.

However, as it has been highlighted, discussion on anti-treaty abuse and avoidance laws have culminated into an advanced version of the rule either in its detailed form i.e. detailed LOB or simplified form known as the SLOB rule. These rules have been proposed for inclusion in existing tax treaties and the MLI provides an opportunity for these rules to be incorporated into existing treaties.

1.5 Research questions.

By analysing Kenya's LOB rule as against the SLOB rule proposed in the MLI, the research seeks to determine:

- 1) What additional tax avoidance schemes and scenarios does the new rule cover that the Kenyan rule is rendered inadequate in comparison?
- 2) If such schemes and scenarios are omitted in application of Kenya's LOB, is it time for its repeal in favour of the SLOB?

The main objective of the study is to evaluate the workings of the Kenyan domestic LOB provision and the selected optional measure to meet the minimum standard SLOB option under Article 7 of the MLI and identify any overlaps, similarities and distinctions that exist.

The study achieves this through a critical study that considers the following,

- i. The history and nature of Kenya's domestic limitation of benefits clause,
- ii. An overview of the OECD's SLOB clause and its usage,
- iii. An analysis of how select countries that have elected this option in the MLI navigate its interaction with their domestic anti treaty abuse and shopping mechanisms.

It is anticipated that the findings from the study shed light on how the SLOB option under the MLI works in treaties where it is incorporated and how it also interacts with existing domestic anti treaty abuse and shopping provisions.

Both primary and secondary sources were consulted to help in answering these research questions and meet the objectives of the study including sources such as the MLI, OECD MTC and Commentaries, Explanatory Memorandums, legal texts and academic journals articles.

1.6 Research Methodology

The research adopted a doctrinal research methodology³¹ and was desktop based. This type of methodology falls under qualitative research (as contrasted with quantitative research) which simply refers to research that does not incorporate numerical analysis³². This involved analysing legal concepts, principles, statutes, legal texts and rules and case law with the aim of establishing how legal doctrines have developed and are applied or simply what the law is³³.

In later chapters the research also incorporated comparative legal research to highlight and compare the legal practices and positions in different jurisdictions as relates to the operation and implementation of LOB and SLOB articles. This helped to appreciate the varied approaches in different jurisdictions that have had opportunity to interrogate this interaction and assess the relevance of this option in fighting treaty shopping and abuse.

The research was designed systematically starting with a broader discussion of principles of a good tax policy and how the ideals are reflected by the LOB rule as designed. The study looked at both the LOB rule in a domestic law context of Kenya and the SLOB option as recommended by the OECD in the MLI. Subsequently, the study sought to consider how these two rules interact and operate within select domestic settings and whether there were any conclusions that could be made based on the observations made. The conclusions and findings of the paper were presented with the aim of contributing to the body of research in this area.

1.7 Limitations of the study

The scope of the study is restricted to the SLOB option recommended under article 7 of the MLI. It does not include a detailed discussion of the workings of the other measures proposed

³¹ Also known as pure theoretical research

³² Various *Research Methods for Law* (2007) at 16-22

³³ Terry Hutchinson 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17 *Deakin Law Review* 83 at 84-85

that facilitate the achievement of the minimum standard on treaty abuse such as the PPT or the detailed LOB set out under article 7 of the MLI.

Similarly, while interrogating the workings of the SLOB option in jurisdictions that have elected this option, detailed discussion of their domestic anti abuse measures other than the LOB was not be conducted.

1.8 Chapter Breakdown

Chapter one forms the basis of the research. It introduces the research question that the author sought to study and lays out the research methodology as well as the limitations and general outline of the research.

Chapter two highlights the principles of a good tax policy as an evaluation criterion for effective tax rules.

Chapter three explores the history of LOB, the established essential aspects of limitation of benefits provisions as evaluated against principles of a good tax policy.

Chapter four discusses Kenya's domestic Limitation of benefits Rule as contained in The Income Tax Act.

Chapter five discusses in detail the SLOB under the MLI and what the option entails. A comparison was done to highlight the nature of interaction and similarities or differences in modalities between the domestic LOB clause and the SLOB under the MLI.

Chapter six highlights other jurisdictions that have the LOB in their domestic law, seeks to understand the MLI positions, if any, that these countries have adopted and draws conclusions on the workings and future of the rule in these jurisdictions.

Chapter seven concludes the study and makes recommendations where necessary, as well as identifies aspects of the rule that require further research.

Chapter 2

Principles of a good tax policy

This chapter briefly highlights some of the key tax policies that guide policy makers in designing tax policies and laws at different levels. It aims to lay out one of the basis upon which the limitation of benefits rule will be evaluated in later sections whether encountered at international level as found in tax treaties and at domestic level. Some of the key principles are discussed below:

2.1 Equity

The concept of equity in taxation is tied with the goal of achieving fairness within the tax system³⁴. Under this principle, policy makers seek to ensure that they balance out or reconcile the ability of taxpayers to pay taxes with the utility gained by taxpayers from services provided by the state³⁵ such as security, sanitation, education and health care. The result of these aims are reflected in progressive tax rates, taxes on capital and support for certain social welfare goals such as disability and unemployment allowances³⁶.

Equity can be viewed at from three angles: horizontal, vertical and inter-nation equity. Horizontal equity tries to ensure that taxpayers who earn the same income of capital are taxed in the same way³⁷. It has been argued that a failure to ensure horizontal equity leads to high tax non-compliance levels³⁸. Vertical equity as a contrast to horizontal equity seeks to ensure that taxpayers at different levels of income are treated differently or subjected to different tax burdens³⁹. The resulting effect of trying to achieve vertical equity leads to the determination of taxes to be either regressive, proportional or progressive. Inter-national equity is the determination of how taxing rights are to be shared out among different nations based on nexus. Ultimately, inter-national equity seeks to eliminate harmful tax competition practices⁴⁰.

³⁴ Jennifer Roeleveld Pasquale Pistone, Johann Hattingh, João Félix Pinto Nogueira and Craig West ‘ Chapter 2: Principles of Taxation in Fundamentals of Taxation’ in *An Introduction to Tax Policy, Tax Law and Tax Administration* (2019) section 2.1.2.1

³⁵ *Ibid*

³⁶ *Ibid*

³⁷ *Ibid* section 2.1.2.2

³⁸ *Ibid*

³⁹ *Ibid* section 2.1.2.3

⁴⁰ *Ibid* section 2.1.2.5

2.2 Administrability

This concerns the ease with which tax laws can be enforced by the tax administration agencies. This is best measured as a function of the cost it takes to collect taxes. A higher cost of collection means that the government and therefore the citizenry stands to lose as the taxes are not collected or enforced as set out in law which renders the tax collection efforts inefficient⁴¹.

There are various factors which would raise the cost of tax collection. One of them is where there is a lack of certainty and simplicity in the tax rules. The tax rules need to be clear, simple and certain so that a taxpayer knows exactly what taxes they owe, how they are calculated and when and where to pay the taxes. The interpretation of what the tax laws require from taxpayers by the tax agencies also needs to be available to taxpayers. This motivates taxpayers to comply with tax laws. It has been stated that complex tax rules lead to aggressive tax planning⁴².

2.3 Coherence

A tax system needs to be relatively stable to ensure that taxpayers can rely on it. This means that the way the tax rules are passed, and the way the tax law reform process is undertaken is essential to maintaining coherence of the entire tax ecosystem⁴³. This is because in such a system there would be predictability on how tax reforms are carried out and the taxpayers can depend on rules being passed through coordinated efforts and in a structured way. It has been argued that while coherence in the domestic system is desirable, there is also a need to ensure that the domestic system maintains some level of coherence with the international tax system because the international level facilitates a smooth interaction between different domestic tax systems⁴⁴. International cooperation should therefore inform part of the strife towards coherence in a domestic tax system.

2.4 Neutrality

This principle aims to prevent and do away with any distortions that taxes may introduce in the economy because of tax measures applied across businesses or sectors within the economy. A neutral tax promotes optimal allocation of resources in the country in terms of investments and

⁴¹ *Ibid* section 2.1.4.1

⁴² *Ibid* section 2.1.4.2

⁴³ OECD OECD/G20 Base Erosion and Profit Shifting Project *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report* (2015) section 2.1

⁴⁴ Jennifer Roeleveld Pasquale Pistone, Johann Hattingh, João Félix Pinto Nogueira and Craig West *op cit* note 35 section 2.1.5.6

transactions. It has been argued that to promote this, tax measures targeting capital imported and capital exported need to be aligned so that one side of the capital equation does not suffer as compared to the other.

2.5 Effectiveness and fairness

This has to do with the perception created because of how tax is collected from different avenues and taxpayers. Where the tax collection agency does not collect taxes from certain class of taxpayers who are required to pay tax, it may lead to the perception that the tax systems is unfair and ineffective. This means that the practical enforceability of tax rules is an important part in the design of tax rules⁴⁵.

2.6 Conclusion

Ultimately, scholars have argued that tax systems of different countries adhere to different tax principles based on the objectives they seek to achieve. Despite this, it has been opined that a good tax system is one that is designed upon set principles that have been laid down over time. While there is no consensus as to which of these principles discussed above are most important, they are deemed as a mandatory combination of principles when evaluating the characteristics of a good tax policy or measure⁴⁶.

⁴⁵ OECD *op cit* note 44 section 2.1

⁴⁶ Attiya Waris 'Taxation without Principles: A Historical Analysis of the Kenyan Taxation System' (2007) 1 *Kenya Law Review* section 2.1

Chapter 3

The Evolution to LOB as one of the solutions against treaty shopping

This chapter highlights briefly the evolution of the practical guidance on how to tackle treaty abuse using domestic laws or measures at an international level as evidenced by the work of the OECD and how it led to adoption of LOB Clauses in tax treaty practice. The discussion seeks to understand how this clause might offer utility for policy makers and tax administration in developing nations despite its origins as a developed country practice, and what criteria developing nation tax authorities and legislators ought to be guided by in designing an effective LOB clause.

3.1 International efforts against treaty abuse

The abuse of tax treaties became an emerging concern in the mid to the late 20th Century. This was especially with the explosion of multinational enterprises (MNEs) in the era of globalized business which exposed the cracks in the international tax rules that could easily be circumvented⁴⁷. It is this concern that led to the emergence of coordinated efforts towards the elimination of abusive tax practices using artificial entities and later culminating into the BEPS project led by the OECD⁴⁸. The OECD BEPS Action plan of 2013 identified treaty abuse and specifically treaty shopping as one of the most crucial sources of BEPS concerns⁴⁹.

The OECD first officially addressed treaty anti abuse in the 1977 OECD Commentary to the MTC. The initial position was that states that adopted domestic anti-abuse measures or laws ought to specifically include such laws in their tax treaties as well for the said anti abuse laws to be applicable bilaterally⁵⁰. Failure to do so would mean that such laws only applied domestically and did not apply to the treaty partner state⁵¹. It has been argued that this could have been taken to mean that tax treaties did not include implied domestic general anti avoidance rules (GAARs)⁵².

⁴⁷ David Chamberlain and Mario Petriccione Conrad Turley *op cit* note 1

⁴⁸ *Ibid.*

⁴⁹ OECD *op cit* note 10 para 1

⁵⁰ Luc De Broe ' Application of Domestic Anti-avoidance Rules to Tax Treaties: Position of the OECD and Analysis of Case Law' in *International Tax Planning and Prevention of Abuse* (2008) section 4.1.1

⁵¹ *Ibid* para 143

⁵² *Ibid.*

In 1987, the OECD Conduit Companies Report and the Base Companies report suggested two different possible approaches on domestic anti abuse laws⁵³. The report's suggested approach was a notable deviation from the 1977 position. The suggestion was first that domestic principles could be applied in tax treaties without explicit mention or inclusion in the tax treaty and secondly that in other cases domestic anti abuse laws could be applied pursuant to the principle of good faith (*pacta sunt servanda*)⁵⁴.

In 1992 both controversial approaches were introduced into the revised OECD Commentary on article 1 of the OECD MTC in paragraph 7. The Model Commentary adopted both the wording of 1977 Model Commentary and the 1987 reports reference to the principle of *pacta sunt servanda*⁵⁵. Commentators lamented the confusing nature of the 1992 revised Model Commentary for a lack of clarity in how domestic law provisions on anti-avoidance and abuse were to interact with tax treaties⁵⁶.

In 2003, the OECD revised its 1977 position requiring for explicit inclusion of domestic tax rules on the grounds that the rule was prone to taxpayer abuse as taxpayers sought to take advantage of different country's tax law provisions on anti-abuse⁵⁷. The OECD recognized and affirmed that domestic laws and jurisprudence could exist together with tax treaties without conflict and applied to every perceived form of treaty abuse⁵⁸. It was also clarified that the fact that domestic anti abuse rules applied to treaties did not preclude specific anti abuse measures from being included in a tax treaty⁵⁹.

This clarification of stance by the OECD was accompanied by its first ever recommendation of the use of a limitation of benefits clause. In the 2003 Commentary to the MTC, the OECD proposed several different ways to combat treaty shopping⁶⁰ and recommended that the most comprehensive way to deal with treaty shopping was using a detailed LOB provision and suggested a model LOB provision⁶¹. However, the OECD still

⁵³ *Ibid* para 144

⁵⁴ *Ibid*.

⁵⁵ *Ibid* para 145

⁵⁶ *Ibid*.

⁵⁷ *Ibid* section 4.1.2

⁵⁸ *Ibid* para 149

⁵⁹ *Ibid* para 152

⁶⁰ Under the Title "Improper Use of the Convention" approaches such as the use of subject to tax provision, exclusion approach and the look-through approach.

⁶¹ OECD *op cit* note 11 Commentary to Article 1 at para 20

encouraged countries to adapt any of the different suggested approaches to their own circumstances as they deemed fit.

Naturally, these changing positions on the interaction of domestic law and tax treaties witnessed at an international level up to the firm 2003 stance by the OECD meant that over time different countries were free to adopt different domestic laws and measures to counter treaty abuse⁶². Subsequently treaty shopping practices continued to be witnessed as large MNCs continued to find favourable tax arrangements in low tax jurisdictions as countries attempted to maintain some level of tax competitiveness to attract these large businesses⁶³.

3.2 The rise of the LOB clause in USA Model Tax Convention Practice

Before the OECD ever suggested the LOB clause in 2003, the use of the LOB clause was only prevalent in USA tax treaties. The USA is credited as the pioneer of using LOB articles in tax treaties as an anti-treaty shopping mechanism⁶⁴. The practice has spread to other non-US tax treaties which largely model their version of the article after the US version⁶⁵.

The USA practice gained notoriety post 1962. This was after its inclusion in the treaty with Luxemburg in 1962. Due to some special tax incentives in Luxemburg's domestic law, the USA legislators thought that such regime would be taken advantage of by investors from third countries to invest in the USA at a low tax cost. Most of USA's tax treaties thereafter in the 1960s and 1970s featured this provision until the USA officially drafted its own Model Tax Treaty in 1977 and 1981 that included a more refined versions of the LOB rule⁶⁶.

Even though LOB rules were not adopted in any of the MTCs by the OECD or the UN early on when Treaty Shopping concerns arose, it does not mean that these bodies were not actively taking steps to address treaty shopping through other approaches. Some of the approaches were articulated when the OECD and the UN issued reports after the works of the OECD's Fiscal Affairs Committee on International Tax Avoidance and Evasion and the UN Ad Hoc Experts Group report of 1988. The reports highlighted other potential practices that could therefore be useful to combat treaty shopping.

⁶² Andreas Thier 'Some Observations on the Transition from Tax Statehood to International Taxation' in *The History of Double Taxation Conventions in the Pre-BEPS Era* Online ed (2021) section 1.2.2

⁶³ *Ibid.*

⁶⁴ Qunfang Jiang op cit note 19 section 3.1

⁶⁵ *Ibid.*

⁶⁶ Mimi E. Gild 'Tax Treaty Shopping: Changes in the U.S. Approach to Limitation of Benefits Provisions in Developing Country Treaties' (1990) 30 *Virginia Journal of International Law* at 579-590

It is worth mentioning that since the USA is a developed nation, like the OECD MTC, its tax treaties favour residence-based taxation. However, the USA was not oblivious to some of the concerns raised by the UN pertaining developing nations which favour source-based taxation as relates to anti treaty abuse measures. Its tax treaty with India, a developing nation, has been touted as providing the USA's reference position on how it would handle anti-avoidance matters using the limitation of benefits clause with a developing country⁶⁷.

3.3 Basic elements of the LOB clause

The American Law Institute in its recommendations on the LOB rule⁶⁸ suggested that the technical form of the rule ought to be drafted in a manner and style that would take into account the circumstances of the parties to a tax treaty as follows:

- 1) A comprehensive clause where the treaty was with a tax haven jurisdiction
- 2) A less comprehensive rule where the treaty was with a developing nation and
- 3) A more liberalized/detailed rule where it was with a highly developed nation.

Scholars who have written in this area point out the fact that there are indeed many alternatives to be used in the development of a limitations of benefits policy⁶⁹. While the USA-India Tax Treaty reflects the circumstances highlighted above between the two nations, whatever form a limitation of benefits provision takes must include at the very least the following elements:

- 1) An ownership/base erosion test
- 2) A publicly traded safe harbour and
- 3) A business connection safe harbour⁷⁰.

Under the ownership and base erosion test, it is expected that the required degree of ownership and the foreign corporation's economic income resides and is exposed to tax in the that treaty country. The safe harbour provisions provide exemptions for genuine transactions

⁶⁷ *Ibid* at 586-590

⁶⁸ The American Law Institute, Federal Income Tax Project, International Aspects of United States Taxation II : Proposals on United States Income Tax Treaties, At V (1992)

⁶⁹ William P. Streng 'Treaty Shopping: Tax Treaty Limitation of Benefits Issues' (1992) 15 *Houston Journal of International Law* at 30

⁷⁰ *Ibid*.

occurring within a treaty country as a measure of certainty⁷¹. For developing nations there is a further element that relates to relief which is highlighted in the next section.

3.4 Treaty Shopping Approaches that may be incorporated in an LOB provision

While the developed nations devised an approach to deal with treaty shopping in one way, the UN having the interests of developing countries has weighed in on approaches that could be used to fight against treaty shopping for consideration by developed nations⁷². These four approaches are additional to the established method i.e. the limitation of residence test and the beneficial ownership test. The tests are discussed below:

a) The direct/Look-through method

Under this method, the contracting states stipulate that treaty benefits would only be available to companies in the other contracting state where its ownership is held by residents of the other contracting state. It seeks to limit the creation of conduit companies for the purposes of accessing treaty benefits⁷³.

b) The Exclusion approach

This approach is popular with countries that have special tax regimes as these are typically used by foreign investors seeking to invest abroad. Companies that participate in special tax regimes at times are subject to reduced tax rates or no taxation at all. This approach allows the country in which such regime exists to preclude participating companies from tax benefits under tax treaties as they can potentially become conduits in tax avoidance schemes⁷⁴.

c) The subject to tax approach

This approach seeks to limit the relief available under a treaty with another country to persons from the other country where it is determined that they are not subject to tax on that income in the other country⁷⁵.

⁷¹ *Ibid.* at 30-40

⁷² United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters* (1988) UN Doc E/C.18/1988/11.

⁷³ OECD *op cit* note 11 Commentary on Article 1 para 13-14

⁷⁴ *Ibid* para 21

⁷⁵ Mimi E. Gild *op cit* note 67 at 575

d) The Channel or Use of Income Approach

This method seeks to ensure that a company that has high revenue but low net taxable income because it expends costs that are related to non-resident owner activities through payments such as interest and royalties (which in across border sense are at reduce tax treaty rates) are precluded from accessing treaty benefits in the form of tax relief⁷⁶.

While these approaches are by no means exhaustive⁷⁷, they represent a consensus of both developed and nations and are therefore championed by both the UN and the OECD as measures to counter treaty shopping⁷⁸. However, the OECD contends that all these methods are inherently inadequate due to the ways in which they are still susceptible to abuse on their own without being supplemented⁷⁹. Moreover, they do not suit all treaty shopping situations. Incorporating all these approaches in drafting an LOB clause will result in a comprehensive rule that even though not fool proof would cover the most obvious cases of treaty abuse.

3.5 The USA-India Treaty 1989

The USA-India Treaty was the first representation of a prototypical LOB clause⁸⁰ between the two nations which represent a developed nation-developing nation dynamic. It is therefore worth noting what the essential features of the clause originally entailed. The LOB clause was contained in article 24 of the treaty, and revealed three key essential features of an LOB clause:

- a) Objective test
- b) Subjective test and
- c) A decision of the competent authority⁸¹.

For an entity to be allowed to receive treaty benefits, these tests were employed to determine if the claim would succeed or not. The first two tests tested primarily for sufficient nexus with the residence country to be eligible for treaty benefits. However, the third test allowed the competent authority of the source country to be able to make a determination on

⁷⁶ *Ibid* at 576-577

⁷⁷ José Calejo Guerra 'Limitation on Benefits Clauses and EU Law' (2011) 51 *Bulletin for International Taxation* section 4.4 and 4.5 include contemporary tests namely the headquarter test and the derivatives benefits test

⁷⁸ OECD *op cit* note 11 Commentary on Article 1 para 7-21

⁷⁹ *Ibid.* para 17

⁸⁰ Mimi E. Gild *op cit* note 67 at 588

⁸¹ *Ibid.*

what benefits the aggrieved entities would be entitled to. This marks the key deviation from the drafting of the clause between the USA and a fellow developed nation.

These tests essentially incorporate aspects of the UN suggested approaches discussed above⁸² as the circumstances call for, because the treaty states are unequal from an economic developmental perspective. The objective test, for instance, incorporates the following aspects:

- 1) The classes of persons that are eligible to receive treaty benefits. These include individuals, public companies, governments and entities which meet the two-part ownership and base erosion test.
- 2) A beneficial ownership test which requires at least 50% of the beneficial interest be owned by residents of the contracting state. This test is a feature of the Ad Hoc Group's direct method of identifying conduit companies
- 3) The base erosion test which checks against the defraying of costs or liabilities of non-residents using the income of a resident. This is akin to the use of income approach.
- 4) The stock exchange safe harbour rule. This incorporates the stock exchange test to secure exemption for entities listed on a stock exchange from the use of income test.
- 5) Provisions to secure relief for *bonafide* claimants.

The subjective test incorporates the active business connection test which is subjective in nature. This guarantee benefits an entity that is legitimately involved in business activities although there is a lack of definition of what constitutes an active business connection. All in all, this test was intended to be the catch all opportunity for investment activities that did not meet the other criteria of the clause. The test provides certainty to investors about relief options⁸³.

As is evident from the drafting of the USA-India Treaty, the rule incorporates the basic elements of an LOB clause at a minimum. Other additional features of the provision, specifically the provision to secure relief, is an added measure that evidently is geared towards the interests of the developing nation. This ensures that the clause is easy to administer and that the interests of investors are upheld, as they would benefit from the certainty of being assured that an alternative relief would be granted if the clause was invoked by India's tax authority.

⁸² *Ibid* section 3.6

⁸³ Mimi E. Gild *op cit* note 67 at 594

3.6 Contemporary International Tax Practice on Limitation of Benefits Provisions

Up to this point, the discussion has focused on the early days of the LOB clauses. The scholars of the early times had indeed expressed optimism that the concept would evolve beyond its rudimentary form. This natural expectation arises out of the necessity as the problem at the core, treaty shopping, continues to evolve and grow and there is no shortage of ways that individuals and companies invent to take advantage of treaty networks all over the world. After the USA MTC, the next MTC to adopt a model LOB clause was the OECD.

3.6.1 LOB in the OECD and UN MTCs

The OECD first recommended a detailed version of the LOB clause in its MTC in 2003. At that time, the inclusion was a mere proposal or suggestion in the Model Commentary to Article 1 and therefore the member states were not obliged to adopt it. However, the OECD did consider it the most comprehensive way to deal with treaty shopping⁸⁴. The provision incorporates different approaches that have been mentioned in this chapter previously that are a product of the work of the UN (whose stance is geared towards the interests of developing nations).

The provision has in subsequent Model Commentaries to the OECD MTC largely remained the same from 2003 all the way to 2014 and the most significant update happened in the 2017 OECD MTC when the LOB provision was officially included in the MTC⁸⁵ as opposed to only being a recommendation in the Model Commentary to the Convention. This was a result of the recommendation of the work of the BEPS project under Action 6 which was tasked with addressing treaty shopping. The drafting of the article allows for a detailed as well as a SLOB provision. The same update has also been incorporated into the UN MTC of 2017.

Similarly, the SLOB has also been incorporated in the MLI as part of the way to meet minimum standards against treaty abuse. This is an option for countries who might consider updating their tax treaties through the use of the MLI.

⁸⁴ OECD *op cit* note 11 Commentary on Article 1 para 20

⁸⁵ OECD *Model Tax Convention on Income and on Capital 2017 (Full Version)* (2017) and the accompanying OECD *Commentaries on the Articles of the Model Tax Convention on Income and on Capital* (2017) Article 29

3.7 Conclusion

Where the ideal LOB rule has the three essential features highlighted under section 3.3 and incorporates the different approaches highlighted in section 3.4, it meets the criteria for a good tax measure as established under chapter 2. This is because the LOB rule is easy to administer because it sets forth a criterion for when it applies, and taxpayers and tax administrators can easily determine this. The rule can also be perceived to be fair as it seeks to ensure taxes are collected from taxpayers without letting some taxpayers get away with abusing the tax treaty network. It is also practical to administer and achieves equity. Generally, there has also been coherence in the way the rule has developed over time at the international level.

While the LOB rule started out as a treaty rule, over time some developing nations have adopted this rule in their domestic laws. This has been attributed to the perception that large MNCs take advantage of the treaty network and developing nations miss out on tax revenues as pointed out in chapter 1 and so adopting a domestic LOB is a measure of protection of the local tax base against the activities of these MNCs.

Chapter 4

The Limitation Of Benefits Rule in Kenya

This chapter discusses and highlights the legislative background of Kenya's Limitation of Benefits Rule to understand its origins, nature, intent and purpose as well as its practical application in curbing treaty shopping.

4.1 Legislative History of Kenya's Limitation of Benefits Clause

Kenya's domestic LOB rule was introduced by the Finance Bill of 2014⁸⁶ and later became law when the bill was passed as the Finance Act 2014. The provision came into effect on 1st January 2015.

Section 12 of the Finance Act proposed to amend the Income Tax Act by inserting a new sub section 5 and 6 which reads as below:

“ (5) Subject to subsection (6), where an arrangement made under this section provides that income derived from Kenya is exempt or excluded from tax, or the application of the arrangement results in a reduction in the rate of Kenyan tax, the benefit of that exemption, exclusion, or reduction shall not be available to a person who, for the purposes of the arrangement, is a resident of the other contracting state if fifty per cent or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other contracting state for the purposes of the agreement.

(6) Subsection (5) shall not apply if the resident of the other contracting state is a company listed in a stock exchange in that other contracting state... ”⁸⁷

Prior to this introduction, there were no public policy discussions by the relevant departments, law reform or state agencies such as the KRA that allude to the reason for the adoption of this rule into Kenya's Income Tax laws.

Additionally, since the provision was not a substantive or anchor law/rule on its own, the Budget Statement or Memorandum of Explanation that accompanied the Bill does not

⁸⁶ National Assembly, *Kenya Finance Bill, 2014* (Bill No 25 of 2014, introduced 12 June 2014) <https://new.kenyalaw.org/akn/ke/bill/na/2014/25/eng@2014-06-12> (accessed 23 June 2025).

⁸⁷ Republic of Kenya *Finance Act, 2014* (Act No 16 of 2014, assented 14 September 2014, commenced in phases from 1 October 2014 to 1 January 2015) https://www.kenyalaw.org/ki/fileadmin/pdfdownloads/Acts/2014/FinanceAct_2014.pdf (accessed 23 June 2025) section 41

reveal the specific aims of the legislative arm in introducing this specific provision. Similarly, as the Finance Bill of that year is aimed at meeting the government budgetary goals, the budget statement did not also discuss the specific details of the new tax provisions individually.

In the budget statement of the year, the government broadly committed to reviewing all tax legislation with a view to modernizing and simplifying them⁸⁸. Special focus was called for to the KRA to work towards eliminating tax leakages by streamlining its tax administration operations and activities. This would tie in with the government's undertaking to align the tax code to with modern best practices⁸⁹. It is arguable that at the time, specifically on international scale, the use of the LOB rule was being considered and encouraged through the work of the OECD's BEPS project under Action 6⁹⁰.

4.2 International Influences in Kenya's adoption of LOB Rule

4.2.1 The USA

Since the USA was the first country to delve into the use of limitation of benefits clauses in its treaty practice, it is worth considering whether the drafting style was influential when Kenya was drafting its own provision albeit at a domestic level.

In the first USA MTC where the clause was incorporated, the following was the wording of the LOB clause;

1. A person (other than an individual) which is a resident of a contracting state shall not be entitled under this convention to relief from taxation in the other contracting state unless:

(a) more than seventy-five percent of the beneficial interest in such person is owned, directly or indirectly, by one or more individual residents of the first-mentioned contracting state; and (b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are residents of a state other than a contracting state and who are not citizens of the United States.

For purposes of subparagraph (a), a company that has substantial trading in its stock on a recognized exchange in a contracting state is presumed to be owned by individual residents of that contracting state.

⁸⁸ Kenya National Treasury *Budget Review and Outlook Paper 2014* (2014) para 86.

⁸⁹ *Ibid* para 87

⁹⁰ Bruno da Silva op cit note 13 section 8.2.1

2. *Paragraph 1 shall not apply if it is determined that the acquisition or maintenance of such person and the conduct of its operations did not have as its principal purpose obtaining benefits under the convention.*
3. *Any relief from tax provided by a contracting state to a resident of the other contracting state under the convention shall be inapplicable to the extent that, under the law in force in that other state, the income to which the relief relates bears significantly lower tax than similar income arising within that other state derived by residents of that other state.*⁹¹

The USA provision as drafted is more detailed such that Kenya's provision in comparison is a simpler version. However, there are areas of similarity such as the presence of an ownership threshold and the exemption granted for companies traded on the stock exchange. The USA provision adopts approaches such as the use of income approach, subject to tax approach, which is enshrined in subsection 3, look through approach in subsection 1(a) and the channel approach in subsection 1(b)⁹². All these make it capable of wider application.

4.2.2 The OECD and the UN Model Clauses

Scholars have expressed doubt as to whether the introduction of the provision in Kenyan law was inspired by the OECD's BEPS project discussions around BEPS Action 6. This is because the rule gives room for treaty override which goes against OECD recommendations on the interaction of domestic and treaty law.⁹³ Others opine that the provision came about following the advice of the International Monetary Fund (IMF) which suggested the opportunity for the country to be able to implement anti treaty abuse measures in its existing DTAs through provisions such as LOB⁹⁴.

In a discussion of Kenya's International Taxation Issues by the IMF, it was noted that although Kenya's tax policy is manifest in its tax law provisions, there is a need for a tax treaty policy that reconciles Kenya's double tax agreements with Kenya's international tax policy⁹⁵. The report further emphasized the importance for Kenya to have an LOB clause especially in

⁹¹ United States Model Tax Convention (1981) Article 22 (Limitation on Benefits)

⁹² Discussed in chapter 3

⁹³ Clement Okello Migai *op cit* note 28 section 20.8

⁹⁴ Joy W. Ndubai 'Implementing the Multilateral Instrument in Kenya' in Georg Kofler, Michael Lang, Jeffrey Owens, Pasquale Pistone, Alexander Rust, Josef Schuch, Karoline Spies & Claus Staringer (ed) *The Implementation and Lasting Effects of the Multilateral Instrument* vol 21 (2021) section 23.1.1

⁹⁵ African Department International Monetary Fund 2018 *IMF Staff Country Report 2018 : International Taxation Issues in Kenya* (2018) para 36-40

its DTAs with countries that do not have material income tax in Kenya's treaty network such as Kuwait, Mauritius, Qatar and Seychelles.

The IMF called for an adoption of an LOB rule that would be used in Kenya's DTAs with its treaty partners and further encouraged the use of an MLI LOB provision in the MLI process. This coupled with Kenya's election of the SLOB under the MLI is more indicative of the influence alluded to by scholars.

Whether the influence was by one of these bodies or not, scholars have always criticized these bodies for the solutions geared towards developing nations such as Kenya as they are deemed to not be compatible with the state of development of these countries. Scholars have urged that these legislative recommendations have to be aligned to local circumstances and developing nations require technical assistance and capacity building in implementing these rules⁹⁶.

4.2.3 Regional Treaties and MTCs

While the influence of international tax bodies remains plausible, it is also worth noting that the 2014 ITA amendment was not Kenya's first encounter with an LOB provision. Kenya is a signatory to the East Africa Community (EAC) regional trading and custom union block. The EAC has an MTC known as the *EAC Model Tax Convention for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income*⁹⁷. Since Kenya is a signatory of the EAC, the MTC is presumed to hold some influence in its tax practice not just at domestic level but also at treaty practice level.

Kenya is also a party to the *Agreement between the Governments of the Republic of Kenya, the United Republic of Tanzania and the Republic of Uganda for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (28 Apr. 1997)*. This Agreement never became operational and was subsequently replaced with a 2014 version which has had more traction and support from the parties. While the 2014 version

⁹⁶ Evanson Njaramba Gichuki *Tax Administration Reforms in Kenya Identifying Lessons to Model a Strategy for Sustainable Administration of County Taxes* Doctor of Philosophy University of Nairobi, 2015) at 3

⁹⁷ Conclusion Date: 30 November 2010 and Ratification Date: 7 June 2012 (Rwanda); 10 October 2014 (Kenya).

of the MTC does not contain a LOB rule, the 1997 MTC contained an LOB clause⁹⁸. This together with the EAC MTC had an LOB clause.

The EAC MTC contained the following provision:

1. *“...A person (other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if:*
 - *more than 50 per cent of the beneficial interest in such person (or in the case of a company, more than 50 per cent of the number of shares of each class of the company’s shares) is owned, directly or indirectly, by one or more individual residents of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or other individuals subject to tax in either Contracting State on their worldwide incomes, or citizens of the partner states; and*
 - *the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not resident of one of the Contracting States, one of the Contracting States or its political sub-divisions or local authorities, or citizen of one of the partner states.*
2. *The provisions of paragraph 1 shall not apply if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company).*
3. *The provisions of paragraph 1 shall not apply if the person deriving the income is a company which is a resident of a Contracting State in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. For purposes of the preceding sentence, the term recognized stock exchange means:*
 - *in the case of (State A) ...*
 - *in the case of (State B) ...*

⁹⁸ Johann Hattingh ‘East African Community/European Union - The East African Community Multilateral Tax Treaty – Fit for Purpose?’ (2016) 70 *Bulletin for International Taxation* section 2.4 and section 3.2.3

- *any other stock exchange agreed upon by the competent authorities of the Contracting States.*
4. *A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs of this Article may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines... ”⁹⁹*

It is evident from the craftsmanship of the clause that it follows the OECD recommended clause under the Commentary to Article 1 of the 2003 MTC. It is therefore a more comprehensive Treaty LOB provision and has potential for wide application as compared to the Kenyan domestic law LOB rule. As can be seen, it includes all the essential features of an LOB rule and adopts most of the recommended approaches for fighting treaty abuse.

4.3 From GAAR to a domestic anti avoidance rule

While there has been international influence in Kenya’s adoption of the LOB Rule in its domestic law, Kenya has had a GAAR under section 23 of the ITA since 2006. Subsequent anti avoidance rules such as the LOB have been passed to help further the anti-avoidance efforts by the government. One could therefore view the evolution and intent of the LOB Rule through the lenses of anti-treaty abuse and avoidance rules specifically by companies or artificial entities in cross border transactions and tie its working with the general anti avoidance rule under the Income Tax Act which was introduced earlier.

The general anti avoidance rule states that:

“...(1) Where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to tax for any year of income, or that the main benefit which might have been expected to accrue from the transaction in the three years immediately following the completion thereof was the avoidance or reduction of liability to tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be effected by the transaction... ”¹⁰⁰

⁹⁹ East African Community Model Tax Convention (EAC MTC) (1997), s 24.

¹⁰⁰ Income Tax Act (Cap 470) (Kenya), s 23.

Kenya's GAAR has been criticized for its shortcomings majorly being that it confers on the Commissioner wide discretion for anti-avoidance matters and the provision has been singled out for its lack of objective guidance and criteria to the revenue authority while executing the powers conferred. These limitations have in turn rendered the provision dormant as no cases have so far been instituted under it¹⁰¹.

However, Kenya's LOB Rule like most other anti-avoidance provisions under Kenya's ITA is a considerable drafting improvement as it comes years after this criticism of the GAAR was noted. The LOB rule has set out objective criteria for the guidance of the Commissioner while adjudicating cases that would fall under it¹⁰². It has been noted that the SAARs in the ITA are more widely used than the GAAR and this could be attributed to the nature of the specified objectivity of the drafting of the rules¹⁰³.

The enactment of Kenya's LOB rule into law can therefore be viewed through the lenses of its intent which is anti-treaty abuse and avoidance and therefore read together with section 23 of the Income Tax, one could discern the general thread running through the two provisions, albeit section 41(2) appearing to be more specific in nature. The provision can therefore be seen as an attempt by the government to curb treaty abuse by artificial means in cross border situations. The High Court of Kenya has stated that the interpretation of statute ought to follow a purposive interpretation where the literal interpretation would produce ambiguity¹⁰⁴.

4.4 Analysis of Kenya's LOB Provision

There is scant analysis on the detailed aspects of the Kenyan LOB provision. The reason for it is that the provision has not been litigated through the court system to test how its salient features hold up in an actual dispute where it has been invoked by the KRA. However, based on the established feature of an LOB provision as discussed in the previous chapter, it is evident that the provision fulfils some of the features of an ideal LOB rule as established by USA's treaty practice and the OECD works under the Model Commentaries. This is highlighted in the analysis below.

¹⁰¹ Afton Titus 'Designing a General Anti-Avoidance Rule for the East African Community – A Comparative Analysis' (2019) 11 *World Tax Journal* section 5

¹⁰² Objectivity is inferred from the criteria that is laid out by section 41(5) and is discussed in a later part of this chapter

¹⁰³ Afton Titus *op cit* note 102

¹⁰⁴ KE: HC, 14 March 2017 in *Law Society of Kenya v. Kenya Revenue Authority* (2017) eKLR

4.4.1 Objective Tests

Under this test the key criteria would be an incorporation of the various tests that can be applied easily without further context in the drafting of the provision which can be discerned on the plain reading of the provision. These tests should incorporate the suggested UN approaches that deal with treaty shopping discussed in chapter 2. They include for instance the ownership test, base erosion test, UN approaches (look through approach, the exclusion approach, the subject to tax approach and the channel approach) and the safe harbour tests.

The LOB provision states that “...*the benefit of that exemption, exclusion, or reduction shall not be available to a person who, for the purposes of the arrangement, is a resident of the other contracting state if fifty per cent or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other contracting state...*”¹⁰⁵

This reveals the use of **the look-through approach** where persons who do not fulfil the residence criteria in the other contracting state are excluded from deriving any benefits under the provision. In this case the persons denied the benefits are persons of the other contracting state whose ownership comprises more than 50% of individual not resident in that state. This ensures that only persons from the other contracting state are accorded treaty benefits and seeks to prevent persons who do not have sufficient connection in the other contracting state,

Additionally, the provision employs the use of **an ownership test** where a limit of on the qualifying criteria is set such that the persons from the other contracting state who can benefit need to demonstrate that at least 50% or more of their underlying ownership is comprised of people who are residents of the other contracting state. This is also a feature of the **look-through approach** where focus is whether the beneficiaries are in the other contracting state or not which can be easily deciphered. The choice of the words underlying ownership rather than beneficial ownership by the drafters is rather telling especially because the concept of beneficial ownership was already prevalent in dealing with treaty abuse. Perhaps it is worth speculating that the intention was to bypass the complexity of the concept of beneficial ownership and focus on the more direct approach where the analysis of ownership

¹⁰⁵ Income Tax Act (Cap 470) (Kenya), s 41(2).

is more mechanical in nature than nuanced and detailed approach required under beneficial ownership.

The provision also contains a **stock exchange safe harbour test**. It reads “...shall not apply if the resident of the other contracting state is a company listed in a stock exchange in that other contracting state...”¹⁰⁶. This provides an exemption for entities listed in the stock exchange with the understanding that the holding of the company traded in the other contracting state will constitute of persons who are residents in the country and therefore taxed in that country. It is implied that in this case the chances that the corporation is being used to channel funds out of the other country are low. This can also be looked at from the lenses of the **channel approach**.

Finally, there is a consideration for the **person(s) who fall under the scope** of the provision or qualifying persons. As drafted, the provision only applies to incorporated entities as it is only incorporated entities where there could be reference of ownership in terms of percentage. Furthermore, the drafting of the provision does not make it clear whether it would apply to other forms of incorporated entities other than companies such as partnerships, limited liability partnerships, trusts and collective investment schemes. This is because the nature of ownership in these entities is not defined in clear percentage terms and are not considered companies under the Companies Act in Kenya.

4.4.2 Subjective test

Business activity safe harbour

Under this test the criteria is the level of discretion given to the tax authority in considering the nature of the qualifying activities. The provision refers to the phrase “*an arrangement*” and “... *for the purposes of the arrangement...*”¹⁰⁷

The subjective elements are revealed by two words “purposes” and “arrangement”. The provision and by extension the Act do not define what the terms mean or how they should be interpreted. This phrase could potentially cover a wide range of business and investment activities that are left to the interpretation of the tax authority to determine whether they constitute an arrangement under the section. However, the lack of guidance when making this

¹⁰⁶ Income Tax Act (Cap 470) (Kenya), s 41(3).

¹⁰⁷ *Ibid.*

determination as to limits of permitted activities leaves room for arbitrary action which can be passed off as an exercise of discretion.

4.4.3 Guarantee of relief

The drafting of the provision does not include any assurance as to the availability of relief where tax benefits are denied. This makes it such that there is a level of uncertainty for taxpayers who would be denied benefits under this provision as the tax authority is not obliged to provide any relief while at the same time having some discretion on the subjective parts of the provision.

4.4.4 Conclusion

Kenya's LOB rule adheres to only some of the laid-out essential elements of what an LOB clause ought to constitute. It has both an objective and subjective aspects, which makes it easy to apply and fit for the purpose it was intended for. The simple drafting style of the provision also helps its application as the discretion granted to the Commissioner under the subjective criteria is somewhat guided by the objective criteria and simplicity means that technical capacity is less likely to be a hindrance to its application.

However, the lack of clarification on the qualifying persons to whom the provision applies to leaves it susceptible to abuse by forms of ownership that are not clearly incorporated entities under the Companies Act. Further, while granting discretion, the provision only caters to the interest of the tax authority administration and does not strike the balance for investor interests where there is no guarantee of relief where the provision is applied, and benefits denied. The objective criteria also only incorporates the look through approach to fighting treaty shopping as recommended by the UN which makes the LOB rule rather limited in scope.

4.5 The interplay between domestic and international law in Kenya: Dualism

The other factor that must be considered when discussing Kenya's LOB rule is the dualistic nature of Kenya's legal system as relates to the application of international law and what the Kenyan constitution position is on the matter. As a dualist nation, international law and domestic law in Kenya are viewed as distinct and separate such that international law does not automatically apply in Kenya without domestication¹⁰⁸. This position is anchored in the

¹⁰⁸ Sachin Sachdeva 'Tax Treaty Overrides: A Comparative Study of the Monist and the Dualist Approaches' (2013) 41 *Intertax-Kluwer* section 2.2

Constitution which acknowledges that *international law forms a part of the laws of Kenya*¹⁰⁹. However, under the hierarchy of laws, the constitution still reigns supreme and any laws that are in conflict with it are null and void. Consequently, to domesticate international law, there is the Treaty Making and Ratification Act of 2012 which prescribes the process of ratifying international law that Kenya signs. This includes tax treaties.

Kenya's LOB provision therefore constitutes a treaty override in as far as it limits the application of a tax treaty where tax benefits under a treaty would be denied because of the domestic provision. This is a unique situation where express treaty override is allowed by domestic law i.e. the Income Tax Act¹¹⁰. The protection given to tax treaties under the Act in the opening of section 41 (1)¹¹¹ is taken away by the LOB rule as section 41(5) is designated as an exception to section 41(1). Treaty override of this nature goes against the established rules of international law under the VCLT (detailed discussion below).

It has been argued that treaty override permitted by the domestic law in this case the ITA section 41(5) is a non-starter as the supremacy granted to domestic law in this case in the ITA threatens the supremacy of the constitution as there is always a chance that the provision could affect rights of persons in contracting states when the domestic law changes¹¹².

The OECD position on the matter is also worth mentioning in the case of Kenya's domestic LOB rule which is a treaty override. Post 2003 the OECD posited the view that domestic law anti treaty abuse measures do not necessarily conflict with the application of tax treaties¹¹³ and that where that happens the provisions of tax treaties are to prevail. The OECD seems to hold the view that a conflict would not arise but in the instance of dualist nations like Kenya where the potential for domestic law treaty override is real, this supposition is doubtful.

¹⁰⁹ Constitution of Kenya (2010) Article 2(5).

¹¹⁰ Albertus Marais 'Kenya/Mauritius/Nigeria/South Africa - The Risk for Tax Treaty Override in Africa – A Comparative Legal Analysis' (2014) 68 *Bulletin for International Taxation* section 5

¹¹¹ This provides as follows: "...(1) Every special arrangement for relief from double taxation made with the Government of any country outside of the Republic of Kenya with a view of affording relief from double taxation in relation to income tax and any taxes of similar character imposed by the laws of that country shall, subject to subsection (2) but notwithstanding any other provision to the contrary in this Act or in any other written law, have effect in relation to income tax, and every such agreement shall be subject to the provisions of the Treaty Making and Ratification Act (Cap. 4D)."

¹¹² Sachin Sachdeva *op cit* note 109 at 207

¹¹³ OECD *Commentaries on the Articles of the Model Tax Convention on Income and on Capital* (2014) Commentary to Article 1

4.6 Kenya's LOB Rule and Treaty Override

This by far is the most controversial issue concerning Kenya's LOB Rule as it touches on aspects of international law practice as relates to the law of treaties under the Vienna Convention on the Law of Treaties (VCLT). Kenya is a signatory of the VCLT. However, the VCLT has not been ratified in Kenya and therefore does not have legal effect in Kenya.

VCLT provides generally that treaties will not apply retroactively¹¹⁴ and that a country may not invoke internal law as a reason for non-performance of its treaty obligations¹¹⁵. These two provisions read together illustrate the need for Kenya to have a fresh look at the provision as it offends the international rules on the protection granted to international law. This is because section 41 allows domestic law to override treaty law. Similarly, they provide the reason as to why the LOB as a domestic law measure would need to be brought into specific treaties through negotiations to have any effect on Kenya's existing tax treaty relations. This is indeed the position that is supported by the OECD where it is suggested that countries need to include anti abuse provisions in their tax conventions as that proves more useful¹¹⁶.

4.7 LOB in Kenya's Current domestic law and Future Treaty Practice

Kenya's LOB provision has been criticized for allowing tax treaty override. In 2021 the provision underwent a minor amendment to clarify on aspects regarding tax treaty application in Kenya. The provision calls expressly for treaty override but has only been reworded to clarify the position that tax treaties are required to undergo the domestic ratification process under the relevant domestic law. The provision reads as follows:

*"...Every special arrangement for relief from double taxation made with the Government of any country outside of the Republic of Kenya with a view of affording relief from double taxation in relation to income tax and any taxes of similar character imposed by the laws of that country shall, **subject to subsection (2) but notwithstanding any other provision to the contrary in this Act or in any other written law, have effect in relation to income tax, and every such agreement shall be subject to the provisions of the Treaty Making and Ratification Act (Cap. 4D)...**"¹¹⁷*

¹¹⁴ Vienna Convention on the Law of Treaties (1969) Article 28.

¹¹⁵ *Ibid* art 28.

¹¹⁶ OECD *op cit* note 11 Commentary on Article 1 para 9.6

¹¹⁷ *Ibid*.

Tax treaty override where the LOB is invoked by tax authorities in Kenya is still permitted in Kenya. A cursory look at recently negotiated DTAs does not seem to shed positive light on which direction the Kenyan Legislators are intent on following as regards the application of the problematic domestic LOB rule in bilateral treaties.

The only treaty that has since been passed that would provide an indication of the position the legislators intend to prevail is the revised Kenya-India Double Tax Agreement which came into force on 30 August 2017. This DTA was entered into and signed post the 2014 LOB law on 11 July 2016 and was meant to replace the previous DTA between the two countries which came into force in 1985¹¹⁸. Under the revised treaty, there is a clear stipulation that the treaty does not limit the power of a contracting state from applying domestic anti treat abuse laws whether they are designated as so or not. The article is drafted in the following manner:

“...*ARTICLE 29*

LIMITATION OF BENEFITS

- 1. The provisions of this Agreement shall in no case prevent a Contracting State from the application of the provisions of its domestic law and measures concerning tax avoidance or evasion, whether or not described as such.*
- 2. A resident of a Contracting State shall not be entitled to the benefits of this Agreement if its affairs were arranged in such a manner as if it was the main purpose or one of the main purposes to take the benefits of this Agreement.*
- 3. Any person including legal entities not having bonafide business activities shall not be entitled to the benefits of this Agreement...”*

It is not surprising that Kenya would be amenable to this provision and especially surrounding the potential application of a domestic LOB clause as an override for treaty matters. This is because the clause acknowledges that domestic law in either contracting state could override treaty law under subsection 1. Consequently, this provision acts as a way to

¹¹⁸ Paras Shah, Alex Mathini and Bowmans, “*Revised Kenya-India Double Taxation Agreement Comes into Force*” (20 October 2017) *Bowmans* (online) <https://bowmanslaw.com/insights/tax/revised-kenya-india-double-taxation-agreement-comes-into-force/> accessed 18 June 2025

indicate that Kenya is keen on pursuing the use of limitation of benefits clause not only in domestic law but also in treaty practice.

4.8 Impact of Kenya's LOB Rule

4.8.1 Lack of Clear Legislative Rationale/Approach

From the forgoing discussion, it is evident that it is not clear exactly how Parliament came to adopt this provision into Kenyan law. No justification was made. This situation is amplified by the general lack of tax policy and documented tax law reform process that led to the adoption of this rule. Indeed, the country has been criticized for a lack of tax certainty especially as pertains to new tax administration efforts and laws¹¹⁹. This is evident with the introduction of the LOB rule as highlighted above.

4.8.2 Complexity of fulfilling bureaucratic requests

Another concern expressed upon passage of this rule was the complexity that tax administrators would be subjected to while trying to determine the underlying ownership of an offshore entity before granting or denying relief¹²⁰. This is because a request for the provision of ownership details of a foreign company addressed to the other contracting state is bound by the rules of exchange of information, whether under the treaty concerned or through diplomatic channels. Similarly, the other contracting state is likely to have its own working procedures for fulfilling such requests before sending a response. This back and forth is administrative in nature and therefore follows predetermined administrative channels and procedures. The result is that inevitably, some level of bureaucracy is expected. This is likely to result in lengthy fact finding exercises anytime ownership information is needed.

4.8.3 Lack of transparency on its application

Although the provision has been in force for going on to a decade now, it is not clear how effective it has been. KRA has not published the circumstances or cases in which this discretion has been applied to invoke this rule. The lack of such publication means that taxpayers are not in the know on what to expect if they are faced with a situation where they require the benefit of this rule one way or another. And more so investors from nations with whom the country has tax treaties.

¹¹⁹ Evanson Njaramba Gichuki op cit note 97 at 4-5

¹²⁰ Joan Apuun Atim, *"The Double Taxation Architecture Conceptualised under Section 41(5) of the Income Tax Act; Chapter 470, Laws of Kenya"* (2020) Vol 1 No 2 *Financing for Development* section 4.2

4.8.4 Retroactive application

There are concerns that the provision amounted to a unilateral amendment of the DTAs in place as the time the law was passed¹²¹. This coupled with the lack of transparency surrounding its use by the KRA has added to this speculation on whether the provision indeed has effect on current treaties which were negotiated and in force before this provision came into force. None of the treaties Kenya has have been amended to specifically include this provision as well which adds to the speculation on what the intentions of the legislature was.

4.8.5 Conclusion

We have seen that while there is not much clarity on how Kenya came to adopt the LOB rule in its domestic law, there is definite influence from the international and regional levels as to the drafting of the clause and its salient features. The provision incorporates some of the established features of a prototypical LOB clause and would still be effective as is. However, as compared to model LOB clauses, the provision is narrow in scope, and its application would naturally be very limited as compared to the ideal comprehensive LOB rule. The OECD has indeed recognized that the clause ought to be regarded as comprehensive, but Kenya's version of the clause cannot be said to be comprehensive. Domestic analysis of the rule is lacking particularly from the courts, or the KRA, it is imperative that its continued existence as is be questioned given the problem of treaty override it poses.

As a tax measure, Kenya's LOB rule does not meet the requirements of a good tax measure discussed in chapter 2. The rule lacks a clarity in the way it was introduced without revealing its legislative purpose. Various aspects of how it works are not clear and the lack of guidance on how it is applied reveals a lack of coherence, certainty, stability or practical effectiveness.

¹²¹ KPMG Advisory Services Ltd, 'Tax Alert – Professional fees paid to a South African entity is not subject to withholding tax under Kenya–South Africa DTA' (KPMG Tax Alert, 2021) <https://assets.kpmg.com/content/dam/kpmg/ke/pdf/tax/Tax%20Alert%20Professional%20fees%20paid%20to%20a%20South%20African%20entity%20is%20not%20subject%20to%20withholding%20tax%20under%20Kenya-South%20Africa%20DTA.pdf> accessed 22 June 2025.

Chapter 5

The SLOB Rule under the OECD 2017 MTC and MLI

This chapter discusses the SLOB rule recommended by the OECD under the MLI and the 2017 OECD MTC. Kenya is one of the signatories of the MLI that has elected this method to deal with treaty abuse. The focus is to understand the rule's nature, intended use, and application as an option against treaty abuse.

5.1 Introduction

The public concern over tax planning by MNCs was the breaking point for the commencement of BEPs discussions in 2013. Some key areas were identified where MNCs' activities could get away with low or no tax obligations. At the end of the BEPS discussions, new international tax standards covering different areas of tax were suggested, which were presented as sufficient to capture the new business and technological models¹²². Specifically, two minimum standards were proposed for adoption through the MLI. The minimum standards were captured under Articles 6 and 7 of the MLI. The provisions call for a new preamble and the adoption of a General Anti-Abuse Rule (GAAR) or a LOB rule.

When it comes to treaty abuse, two main ways have been identified on how it happens:

- a) Attempting to circumvent nexus rules
- b) Once nexus is successfully secured, putting in place an abusive transaction¹²³.

The OECD has opined that treaty abuses of the first kind are not likely to be addressed by specific anti-abuse rules in domestic law since a person seeking to achieve that aim deals with rules found in tax treaties and are therefore out of the purview of domestic law. Similarly, abuse of the second type involves abuse of domestic laws and would not be effectively addressed through treaty provisions. Either way, anti-abuse concerns would always need to consider the interaction between domestic and treaty rules.¹²⁴ LOBs come into focus in this regard as they are considered specific anti-abuse rules (SAARs).

¹²² Jonathan Schwarz 'Treaty Shopping and Other Avoidance' in *Tax Treaties* Sixth ed

¹²³ OECD *op cit* note 10 para 15

¹²⁴ *Ibid* para 16

While LOBs can exist at both domestic law or treaty level, scholars point out that LOB rules only address the first way treaty abuse happens and are not concerned with abusive transactions. It is argued that for LOBs to be effective, they require additional domestic rules to cover and tackle abusive transactions undertaken by entities having sufficient nexus¹²⁵. This can be seen to inform the OECD's recommendations, which point to the fact that a combined approach to fighting treaty abuse is the most ideal. This is because although the PPT is enough, it would be desirable if the PPT is combined with LOB.

5.2 OECD on the Detailed versus Simplified LOB Rule

The OECD does not define a LOB rule but instead explains that the rule is intended to fight treaty shopping by preventing the granting of treaty benefits to entities that lack a genuine connection to the treaty related country. Over time, the OECD has since set out two alternatives of the rule for its member's: a simplified and detailed version. The SLOB rule is a version of the rule that can only be used together with the PPT against treaty shopping and abuse while the detailed LOB rule is a comprehensive and stand-alone version of the rule that states can adopt through bilateral negotiations to meet the minimum standards against treaty shopping.

The OECD Model Commentaries in 2003 first recommended the use of the LOB as a rule; the suggestion was to tailor the rule to the circumstances of the treaty state by adopting the 2003 version of the LOB rule outlined in the Model Commentaries¹²⁶. The final BEPS report on Action 6 recommended a detailed and simplified version of the LOB rule as alternatives for their member's consideration. Before this recommendation, there was no simplified version of the rule¹²⁷. The first recommended version of the LOB rule was rather complex and lengthy¹²⁸. OECD members did not react positively to the rule and some authors have attributed that to the OECD's adoption of the SLOB in OECD works.

The LOB provision in its original form in US treaties was simple in its drafting style, and its complexity has only deepened with subsequent amendments¹²⁹. It is also evident that US treaty practice has shown a variance in how the clause is drafted where the treaty partner is

¹²⁵ Ameya Mithe 'Critical Analysis of the Principal Purpose Test and the Limitation on Benefits Rule: A World Divided but It Takes Two to Tango' (2020) 12 *World Tax Journal*

¹²⁶ OECD *op cit* note 10 para 20

¹²⁷ OECD *op cit* note 11 para 25

¹²⁸ G.S. (Graeme) Cooper 'Chapter 15: Some Thoughts on the BEPS Proposals to Control Treaty Abuse in Asian Voices' in S.T.Y. Sim & M-J. Soo (ed) *BEPS and Beyond* (2017) Section 15.3.4

¹²⁹ Can be gleaned from a plain comparison of Article 16 of the USA MTC of 1981 and Article 22 of the 2016 USA MTC.

a developing nation versus a developed nation¹³⁰. This observation explains why the OECD can be seen to have recommended two versions of the clause. It has been noted that while there are two versions of the clause in OECD works, both versions are equally long and complex¹³¹. It is worth noting that while the SLOB is a new clause emanating from the work of the OECD BEPs project, the detailed version of LOB borrows heavily from the long-standing USA treaty practice and is drafted in a complex and comprehensive style.

Under the MLI, Article 7 recommends that countries use either a PPT rule on its own to counter treaty abuse or supplement the PPT with a SLOB rule. Under the MLI, therefore, there was no room made for the detailed LOB provision as the OECD deems the detailed LOB rather complex in nature such that it requires substantial bilateral negotiations. It is therefore not befitting for inclusion under the MLI given the goal of the MLI which is to be able to amend existing treaties quickly and easily. However, the MLI makes provision for countries that would like to negotiate a detailed LOB to opt out of the minimum standards and aim for a solution that meets the aims of the minimum standards¹³².

While the detailed version is not set out in the MLI as a minimum standard, countries are free to negotiate for a detailed LOB bilaterally which would be sufficient to meet the minimum standard. Consequently, under the OECD MTC Article 29, the OECD sets out two alternatives, a detailed and a simplified version of the LOB clause so that the detailed alternative can inform bilateral negotiations. The OECD explains that the combined approach using SLOB and PPT provides a flexible option to use a general rule (PPT) and the certainty of an automatic rule (LOB) hence making it easy to administer¹³³. However, it is also encouraged that to meet the minimum standard against treaty abuse; countries could use the detailed LOB and aim to have in place robust provisions that would cover most forms of treaty abuse.

¹³⁰ See current US treaties such as USA-Netherlands (Article 26) as compared to USA-India Treaty (Article 24)

¹³¹ Błażej Kuźniacki 'Implementation and Application of the LOB Clause in BEPS Action 6/MLI: Legal and Pragmatic Challenges' in Ana Paula Dourado (ed) *International and EU Tax Multilateralism: Challenges Raised by the MLI* (2020)

¹³² OECD, *Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (2017) para 90, available at <https://www.oecd.org/tax/treaties/explanatory-statement-multilateral-convention-beeps.pdf> accessed 19 June 2025.

¹³³ OECD *op cit* note 86 Commentary on Article 29 para 1 and 2

The MTC therefore only distinguishes between the simplified and detailed LOB by explaining that the detailed version can operate independently and is applicable where a country has strong anti-abuse laws. The SLOB on the other hand cannot stand on its own and can only be used to supplement that PPT rule¹³⁴.

Some authors have pointed out that the compromise of the SLOB is that while it is easy for tax administration purposes and lends itself to certainty of use from a taxpayer's perspective, it is only helpful in the most obvious treaty abuse scenarios and has too many loopholes¹³⁵.

5.3 An overview, scope and key features of SLOB

5.3.1 Overview

The OECD recommended the adoption and use of SLOB to its members, after the successful use of the rule by select countries in their treaty practices. It was, therefore, not a unique solution tailored to address treaty abuse comprehensively. The BEPS Final Report termed it 'a specific anti-abuse rule'¹³⁶.

As mentioned above, the use of the term simplified does not have a bearing on the nature of the rule as recommended i.e. it should not be taken *prima facie* to mean the rule is necessarily simple in its construction according to the OECD. Rather, the manner in which a LOB rule is applied whether together with the PPT or alone is the determinant of whether its use is in a 'simplified' or 'detailed' manner.

5.3.2 Scope of SLOB

When it comes to the scope of the SLOB, as a minimum standard, it has to be weighed against the PPT and then compared to the MLI and MTC versions of the SLOB to determine whether there are any differences in scope. The BEPS final report has identified the scope of the PPT as threefold: to guard against treaty shopping, to prevent rule shopping¹³⁷, and to circumvent

¹³⁴ *Ibid* para 2

¹³⁵ Lisa Ramharter and Rita Szudoczky 'Chapter 3: Limitation on Benefits Clauses' in *Limiting the Entitlement to Treaty Benefits in Tax Treaty Entitlement* M. Lang et al. eds. ed (2015)

¹³⁶ OECD *op cit* note 10

¹³⁷ Luc De Broe, *International Tax Planning and Prevention of Abuse* (IBFD Doctoral Series, August 2008) (online), available at

<https://www.ibfd.org/sites/default/files/20212/International%20Tax%20Planning%20and%20Prevention%20of%20Abuse.pdf> accessed 22 June 2025. Some authors opine that rule shopping is a step from treaty shopping in that it aims to take advantage of the distributive rules in a treaty rather than just taking advantage of the treaty itself.

domestic law. In comparison, the LOB's scope has been singularly identified as covering typical forms of treaty shopping.

The BEPs final report outlines the scope of the LOB rules generally as being aimed at combatting treaty shopping situations through manipulation of aspects such as the legal nature of a business entity, ownership and the type of activities an entity is engaged in¹³⁸. It was contended that LOB does not cover other forms of treaty abuses and only captures treaty shopping. Moreover, even though its focus is on treaty shopping, the rule is not capable of dealing with all forms of treaty shopping, such as conduit financing arrangements (entities formed with the aim of raising funds from unrelated entities with the purpose of remitting them to their parent companies¹³⁹)¹⁴⁰.

Additionally, for simplicity and administrative ease, the SLOB scope of application has been said to apply to all treaty benefits as opposed to just treaty benefits applying to passive income provisions in a tax treaty. The earlier view was that only passive income could be easily manipulated through routing them through certain jurisdictions in attempts to abuse treaties. However, the current expansion of scope of the SLOB is to ensure that the rule applies and covers all forms of income dealt with in a treaty and this helps to resolve the potential debate about what income is covered by SLOB and what income is not covered. The previous limited scope where SLOB only applied to treaty benefits relating to passive income made it susceptible to circumvention¹⁴¹. Therefore, this expansion of scope adds substantial weight to the rule instead of being left merely as a black-and-white categorization exercise.

The OECD has suggested that a country that adopts the LOB rule in its tax treaties would have to supplement this rule with domestic rules to deal with tax avoidance transactions that could be out of the scope of the LOB rule. Scholars point out that treaty override is always a threat in such situations. This is because, for such unforeseen abusive arrangements, countries are not restricted in amending their domestic laws through parliament, while naturally, amending a treaty is not as easy because of it involves two different states relying on varied expertise to reach a solution through lengthy diplomatic channels¹⁴². Ultimately, therefore, LOB

¹³⁸ OECD *op cit* note 10 para 20

¹³⁹ Paul Feuvrier Maria Borgia, Fedor Kharlashin, Mirco Lattwein and Francesca Spinelli *Finacial Conduits* (2021) para 1

¹⁴⁰ OECD *op cit* note 10 para 20

¹⁴¹ Lisa Ramharter and Rita Szudoczky *op cit* note 136 section 3.3.3

¹⁴² Ameya Mithe *op cit* note 126

rules requiring supplementation by domestic law to cover avoidance transactions not covered by the rule seem to encourage unilateral action by and within states, which goes against the aims and spirit of the BEPs Action 6 of coherent approach¹⁴³.

Increasingly, scholars have noted that there has also been an emerging practice where states seek to preserve domestic statutory provisions and judicial doctrines aimed at countering treaty abuse from being challenged while applying a treaty in specific anti-abuse situations. This aims to preserve laws and doctrines that serve as supplementary rules for conduit arrangements. This position reflects the OECD's support for treaties incorporating a clause that expresses that domestic rules will apply even where the treaty has been applied¹⁴⁴

This explains why the LOB in its simplified form is considered only supplementary to the other minimum standard, PPT¹⁴⁵. This has been argued to be the main reason why its uptake has been rather dismal, as countries show a preference for the PPT which is sufficient on its own¹⁴⁶.

5.3.3 Key features of SLOB

The SLOB has two key features:

- 1) Objective tests which determine which determines which entities qualify for the benefits provided by the treaty and
- 2) Residual or discretionary relief granted by the tax authority once a company fails to meet the objective tests

5.3.4 Objective tests

This is the feature of the SLOB that is lauded for being straightforward in application. It encompasses the objective and somewhat automatic nature of the rule. It has been said that the main reasons for an LOB rule generally is to impose additional criteria for granting treaty benefits by ensuring that there is sufficient connection with the resident state (qualified person test) and the relevant business activities are actively conducted in the state concerned (active trade or business test)¹⁴⁷. The objective tests, once passed, entitle a resident of a contracting

¹⁴³ OECD *op cit* note 10 saw the elimination of “poorly coordinated domestic measures” as referred to in the foreword to the BEPS Action 6 final report

¹⁴⁴ G.S. (Graeme) Cooper *op cit* note para 15.4

¹⁴⁵ OECD *op cit* note 133 at para 6 of the explanatory statement to Article 7

¹⁴⁶ Błażej Kuźniacki *op cit* note 132 section 10.2

¹⁴⁷ Lisa Ramharter and Rita Szudoczky *op cit* note 136 section 3.3.2

state to treaty benefits even if based on a subjective assessment, one would come to a different conclusion¹⁴⁸.

Qualified person test

Under this test, the SLOB provision lists the different categories of persons covered by the provision. This includes individuals, state entities such as political subdivisions, local authorities, state agencies and other organizations. Pension funds and some non-profit organizations are also covered¹⁴⁹.

Publicly traded company test

The test exempts publicly listed companies from the application of the rule¹⁵⁰ as they are considered less likely to be used as vehicles for treaty abuse because of the stringent listing requirements which act as barriers to such intentions¹⁵¹.

Ownership test

A threshold is set for equity holding in the company by residents of the contracting state, below which a company would not be entitled to treaty benefits. The typical threshold is normally set at 50%,¹⁵² but it could vary depending on the contracting states. The rationale is to ensure that majority or significant ownership of a company be held by shareholders who are residents of the same country as the company¹⁵³. This ensures that residents in third states do not benefit from the treaty between the contracting states to secure lower or no taxation than they would ordinarily otherwise be required to pay.

Base erosion test

The test seeks to prevent companies from enjoying treaty benefits if those companies channel income to recipients who have no equity relationship with the company but still have a connection with the company. Such connection could be through for instance family ties, social

¹⁴⁸ Sebastien Leduc and Geerten Michielse ‘Are Tax Treaties Worth It For Developing Economies?’ in *Corporate Income Taxes Under Pressure Why Reform is Needed and How It Could Be Designed* (2021) at 167

¹⁴⁹ OECD *op cit* note 86 Article 29(2) and OECD *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (2017) Article 7(9)

¹⁵⁰ OECD *op cit* note 150 Article 7 (9) (c)

¹⁵¹ Lisa Ramharter and Rita Szudoczky *op cit* note 136

¹⁵² OECD *op cit* note 150 Article 7(9)(e) although a higher threshold of 75% is set under Article 7(11) for ownership of beneficial interests

¹⁵³ Sebastien Leduc and Geerten Michielse *op cit* note 149 at 167

ties or professional ties. The rule achieves this by scrutinizing the income and expenses trail as opposed to an equity relationship where the equity and capital accounts trail would be more telling¹⁵⁴. This ensures that income or expenses are actually attributed to the business activities instead of being incidental or remotely related to the business activities. Unusual income and expenses incurred on business connections mentioned above would be disallowed under the test and added back or excluded.

Active trade or business test

The test seeks to exclude persons from treaty benefit who conducts business in the residence state that are not substantial in nature. This ensures that the company is not being merely used to “pass through” income but that actual business activities are being undertaken to generate the income¹⁵⁵. Additionally, the level of business activity must be substantial and not just perfunctory. An example would be a company set up to conduct manufacturing but contracts out this activity to another entity in a different state such that it does manufacturing “on paper” within the resident state. This test also enumerates instances where some business activities are not deemed active business¹⁵⁶.

Derivative benefit test

Under this test, a safe harbour provision is made to allow a company owned for a fixed period within the year in the contracting states and to a certain percentage of ownership to receive treaty benefits if the resident owners would be deemed ‘equivalent beneficiaries’¹⁵⁷. The term is defined in broadly similar parameters as would fulfil the ownership and base erosion test but with higher requirements¹⁵⁸. For instance, the percentage of ownership is set at 75% instead of the usual 50%¹⁵⁹. The test allows a company in a third state to benefit from the treaty if they would have the same access without the need for the established intermediate legal entity¹⁶⁰. This for example occurs where tax treaty rates even though reduced are the same as in the third state and therefore no benefit was accrued from claiming treaty rates using an entity established

¹⁵⁴ OECD *op cit* note 150 Article 7 (10) (b)

¹⁵⁵ *Ibid* Article 7(10)(a) and OECD *op cit* note 86 Article 29(3)

¹⁵⁶ OECD *op cit* note 150 Article 7(10)(a)

¹⁵⁷ OECD *op cit* note 156 Article 29(4) and *Ibid* article 7(11)

¹⁵⁸ *Ibid* Article 29(7) and *Ibid* article 7(13)(c)

¹⁵⁹ OECD *op cit* note 150 Article 7(11)

¹⁶⁰ Lisa Ramharter and Rita Szudoczky *op cit* note 136 Section 3.3.2

in the resident contracting state. The test acknowledges that residents of a third party may have legitimate business reasons to conduct business in one of the contracting states.

5.3.5 Residual relief

Even where an entity fails the objective tests highlighted above, it may be up to the competent authorities of the contracting states to decide whether they may still grant access to treaty benefits where it can be demonstrated that there are evident business reasons to set up operations in either of the contracting states. This is a discretionary power of the relevant competent authority¹⁶¹.

5.4 Implementing SLOB under the MTC 2017 as compared to SLOB under the MLI

The overarching aims of Article 29 of the OECD MTC and Article 7 of the MLI are similar: to afford an opportunity to adopt treaties that safeguard the minimum standards for the prevention of treaty abuse. As we have already highlighted, both instruments recommend the SLOB, and the 2017 OECD MTC also presents as an alternative a detailed version of the LOB capable of standing on its own and fulfilling the requirements of a minimum standard against treaty shopping.

The two versions of the SLOB are largely similar in the sense that they are used in combination with the PPT¹⁶². The notable point of departure (which would be evident in practice) is seen in how the different instrument's provisions come into effect. Under the MLI, a party that selects SLOB adopts the clause exactly (*emphasis mine*) as is drafted in Article 7. This means that all covered tax agreements will contain the SLOB as is worded under the MLI. On the other hand, under the MTC, since the MTC guides bilateral negotiations, the states have more flexibility on the actual wording and provisions of the rule and can tailor it to their specific circumstances. It is therefore conceivable that states that adopt SLOB under a bilateral treaty would end up with a customized version of the SLOB which would have different wording and subclauses as the parties deem fit.

5.5 How the SLOB works under the MLI (demonstration of the matching concept)

Under the Explanatory Notes to the MLI, SLOB generally can only apply where both contracting states have chosen to apply it in their Covered Tax Agreements (CTAs). Where

¹⁶¹ OECD *op cit* note 86 Article 29(6) and OECD *op cit* note 150 article 7(12)

¹⁶² OECD *op cit* note 86 Commentary to Article 29 para 1 and 2 clarify that SLOB is supplementary to the PPT

both parties do not choose SLOB, or only one party does, there is no match and by default, only the PPT applies¹⁶³.

5.5.1 Symmetrical matching

This occurs when both parties either agree to apply the SLOB to their CTAs or they agree not to apply SLOB to their CTAs¹⁶⁴The symmetry lies in mirroring the agreed choice on both ends of the contracting states on whether to apply PPT only or SLOB in addition to PPT in determining entitlement to treaty benefits.

5.5.2 Asymmetrical matching

This occurs when both contracting parties agree that one of them will apply the SLOB in addition to the PPT while the other will only apply the PPT and not SLOB in their CTAs¹⁶⁵.

5.5.3 Example of Matching under the MLI

To illustrate the matching concept under the MLI, the tables below show both symmetrical and asymmetrical outcomes.

Symmetrical matching and application of SLOB illustration

Jurisdiction	Reservations on application of Article 7 of the MLI
Kenya	Pursuant to Article 7(17)(c) of the Convention, Kenya hereby chooses to apply the Simplified Limitation on Benefits Provision pursuant to Article 7(6) to all Covered Tax Agreements.
India	Notification of Choice of Optional Provisions Pursuant to Article 7(17) (c) of the Convention, India hereby chooses to apply the Simplified Limitation of Benefits provision pursuant to Article 7(6).

¹⁶³ OECD *op cit* note 133 explanatory statements to Article 7 Para 101

¹⁶⁴ OECD *op cit* note Article 7 (a)

¹⁶⁵ *Ibid* Article 7 (b)

Asymmetrical matching illustration

Jurisdiction	Reservations on application of Article 7 of the MLI
United Kingdom	Pursuant to Article 7(17)(b) of the Convention, the United Kingdom of Great Britain and Northern Ireland hereby chooses to apply Article 7(4).
Kenya	Pursuant to Article 7(17)(c) of the Convention, Kenya hereby chooses to apply the Simplified Limitation of Benefits Provision pursuant to Article 7(6) to all Covered Tax Agreements.

Tabulation of similarities/differences of domestic LOB and SLOB in Kenya

Feature	SLOB	Domestic LOB
Realm of application	Since SLOB is a recommendation of both the OECD MTC and MLI, it applies only in bilateral treaty situations.	This is a law made by the national legislature and only applies domestically.
Scope	Only used in supplemental capacity to other anti-treaty abuse measures	It can be used as a stand-alone anti-treaty abuse law and can be as simple or as complex as the legislature deems appropriate in the circumstance of the country concerned
Amendments	Not easy to amend as it would require the negotiation of the treaty by the treaty partners	Easy to amend through the parliamentary law-making process
Operationalization	For its optimal utility, it might require additional domestic laws to cover areas where its application is lacking.	It can be used as is without the need for further enactments
Nature	It is an international tax concept	Is a domestic rule

Interpretation	It uses the Vienna Rules of Interpretation as it is a treaty concept	It uses domestic rules of interpretation as set by judicial precedence
Residual relief	The discretion is granted to the Tax Authority to provide a befitting relief to the aggrieved party	No provision is made, leaving the matter uncertain.
Objective tests	A comprehensive range of tests included under the SLOB makes its utility broadly effective as it is wide-reaching.	A select few basic tests were included in its drafting, leaving it vulnerable to circumvention
Constitutionality	There is a requirement for the ratification of the MLI in Kenya before it can become operational. Under the hierarchy of laws per Article 2(5) and (6) of the Kenyan constitution, it forms part of Kenyan law under the constitution.	Forms part of the laws of Kenya subject to the constitutional limits.

5.6 Interaction between tax treaty SAAR and domestic law SAAR

From the foregoing discussion, it has emerged that in some countries, there is a situation where a tax treaty entered by the state has a SAAR that is meant to work or operate in the same way as a domestic law SAAR. It has been opined that in this scenario, one of the key questions that arises is whether tax authorities would favour the application of the broader SAAR as opposed to the narrower SAAR¹⁶⁶. It has been suggested that in such a case, where the domestic SAAR has a broader scope, it may only be applied to the transaction if its scope falls within the scope of the tax treaty SAAR. Otherwise, in all circumstances where a transaction or arrangement is not within the scope of the tax treaty, then domestic SAAR only applies¹⁶⁷.

¹⁶⁶ Eivind Furuseth ‘Chapter 19: SAARs in the Tax Treaty’ in *The Interpretation of Tax Treaties in Relation to Domestic GAARs* (2018) section 19.1

¹⁶⁷ *Ibid* section 19.2 and 19.4

The OECD Commentaries, the UN Commentaries, the BEPS Action 6 Final Report and the 2017 OECD Commentaries on Article 29 have been spotlighted for failing to offer explicit regulation in the above scenario. However, the above instruments have nonetheless been credited with offering some useful indications, especially the UN Commentary on Article 1, paragraph 19¹⁶⁸. Following this, one takeaway could be that the domestic SAAR only applies if it falls into the scope of the treaty SAAR. However, the lack of guidance causes confusion for taxpayers or tax authorities.

5.7 Is adopting SLOB feasible for Kenya?

Kenya's election of SLOB presents an interesting situation as the MLI clearly stipulates that SLOB cannot stand on its own. It might then be presumed that the election of SLOB is to supplement PPT, even though there is no clear statement as to this¹⁶⁹. This can be contrasted to how India, for instance, clearly mentions that PPT is an interim measure and proceeds to express intention to negotiate bilaterally and include a detailed LOB while simultaneously also electing SLOB as a measure with jurisdictions that would match it in those lines. On Kenya's part, no such indication has been made as to how SLOB will interact with PPT. Further, only three treaties in Kenya's treaty network could potentially have a match of SLOB: India, France and Qatar.

It is worth noting that SLOB represents the current post-BEPS practice in anti-treaty shopping efforts. This is to be contrasted with the domestic LOB provision in Kenya, which was passed before the conclusion of the BEPS process and the signing and ratification of the MLI. The more up to date rule is always preferred as it reflects the tax principle of coherence. Furthermore, since the domestic LOB was passed after most of the treaties in the network were already operational, it offends treaty law for the provision to be applied to any existing treaties, as it would violate the principle of good faith in treaty negotiations. This is because a domestic law cannot be passed after the treaty was negotiated and be allowed to apply retrospectively in relation to the treaty¹⁷⁰.

It has been opined that where treaty provisions are identical to what domestic law provides on anti-avoidance, no issues are bound to arise. It is only where the two are different that a conflict of application arises, as treaty provisions are expected to prevail generally. When

¹⁶⁸ *Ibid* section 19.2

¹⁶⁹ Signatories were required to give a clear indication of whether PPT applies even if as an interim measure.

¹⁷⁰ VCLT *op cit* note 115 article 28

this situation occurs, it is thought to encourage uncertainty in tax administration, which results in a lack of certainty and predictability in cross-border tax issues, which is the very essence of having tax treaties in place¹⁷¹.

In Kenya, this is the exact situation. The interaction between the domestic LOB and the SLOB will likely bring into focus the inadequacies and inefficiencies of both SAARs for different transactions and arrangements they cover. As has been highlighted, the scope of SLOB, as discussed above, represents a broader scope when compared to the scope of Kenya's domestic LOB. SLOB, therefore, fulfils the broad principles of a good and effective tax measure, while the domestic LOB does not meet the criteria to be considered a good and effective tax measure.

While discussions of interaction between these two rules from the OECD perspective focuses on the question of the domestic rule being broader, in the case of Kenya, the reverse is true as the domestic LOB features fewer objective tests and does not empower the tax authority to give alternative relief where treaty benefits are denied. Therefore, the SLOB will facilitate better and broader utility in the tax treaties where it will be used as it is comprehensive and grants the tax authorities the power to give discretionary relief.

¹⁷¹ Jonathan Schwarz *op cit* note 123

Chapter 6

Other Jurisdictions Experiences and Approaches

This chapter highlights how other jurisdictions have developed their limitation of benefits rules and examine the extent to which these rules have influenced their tax treaty practices. The jurisdictions' selection for India, Nigeria, and Uganda is influenced by their similar categorization as developing nations as Kenya and their respective MLI positions. These are aimed at presenting a developing nation's perspective.

The key aspects that are to be examined include:

- Domestic law LOB or anti-abuse laws and its features
- Treaty practice
- MLI selection

6.1 INDIA

Judicial pronouncements in India have largely been credited with shaping the discussion around treaty anti-abuse laws, specifically limitation of benefits rule provisions. As discussed in chapter two, India was among the first developing nations to have a limitation of benefits clause in their treaty with the USA, which was entered into in 1989. For a long time, this was India's only treaty to have such a provision, and the implications of having the clause were seen through the subsequent judgment that referred to the clause.

6.1.1 *Union of India v. Azadi Bachao Andolan, (2004) 10 SCC 1b*¹⁷²

The case (hereinafter referred to as the *Azadi Bachao case*) concerned the validity of certain government circulars issued by the Government of India clarifying the taxation of capital gains made in 1994 by certain foreign institutional investors (FIIs). The circular stated that the alienation of shares of an Indian company by residents of Mauritius was taxable only in Mauritius.

Once the circular was issued, several FIIs set up in India and invested capital in shares of Indian companies assuming they would not be taxed in India. However, sometime after this, the tax authorities issued notices to show cause, demanding the FIIs pay tax for profits and

¹⁷² Case 2003-(263)-ITR-0706-SC

dividends accrued in India. The tax authorities were concerned that most companies receiving the notices were ‘shell’ companies being run by persons not in India or Mauritius.

This led to another circular to be issued by the Central Board of Direct Taxes (CBDT) stating, among others, that FIIs were to be considered tax residents in Mauritius as they were incorporated therein. The certificates of residence from Mauritius were to be considered sufficient proof of residence, and pursuant to that, the companies were not to be taxed on gains and sale of shares in India under Article 13(4) of the India – Mauritius Treaty.

The CBDT circular was challenged in the High Court, where it was held to be ultra vires and quashed. The High Court ruling was appealed to the Supreme Court, which ultimately held that the CBDT circular was valid and proper. The court stated that if the Indian government intended that third-state nationals were not entitled to benefits under the India-Mauritius Treaty, they would have included a limitation of benefits clause in the Treaty, as was included in the India-USA Treaty of 1989.

The case has since been credited for laying down the view that the lack of a specific SAAR, such as LOB, in a tax treaty was an indication that treaty shopping was allowed and tolerated under the laws in the country¹⁷³. In contrast to this case where the shares concerned were in India and the matter involved the Indo-Mauritius tax treaty, another key case had been decided involving capital gains from sale of shares outside India. In contrast to the *Azadi Bachao case* above, this case was not a treaty case and involved domestic law¹⁷⁴.

6.1.2 Relationship between domestic and international law in India

India is a dualist state, which means that under their legal regime, international law does not override domestic law but forms part of the country's laws after ratification. The position of international law in India has been the subject of much debate in recent years, with a perceived notion that the country is functionally monist but formally dualist¹⁷⁵. This position is reflected in the tax cases highlighted above, where the decisions mostly uphold treaty law over domestic law. This also played out in the *Azadi Bachao case*, where it was reiterated that domestic anti-

¹⁷³ A.P. Kotha & P.K. Peshori ‘Chapter 19: Implementing the Multilateral Instrument in India’ in *The Implementation and Lasting Effects of the Multilateral Instrument* G.W. Kofler et al. eds. ed (2021) section 19.3.3

¹⁷⁴ D.J. Sanghavi ‘Chapter 18: India’ in *Taxation of Companies on Capital Gains on Shares under Domestic Law, EU Law and Tax Treaties* G. Maisto ed. ed (2013) section 18.5.3.1.1

¹⁷⁵ Ranjan, Prabhash, *The Supreme Court of India and International Law: A topsy-turvy Journey from Dualism to Monism* (May 6, 2022). 43(3) *Liverpool Law Review*, 2022, 571-595, Available at SSRN: <https://ssrn.com/abstract=4210902> discusses in detail.

avoidance provisions cannot be used to deny treaty benefits unless permitted by a limitation of benefits clause in the treaty.

6.1.3 Treaty Override

For most dualist states, treaty override is not a high risk. However, since there is no clear stance in India on whether domestic law can override treaty law and vice versa, there remains a risk for treaty override in India. In tax-related matters, this is fuelled by provisions of the India Income Tax Act. The provision reads that

*“...Where a specified association in India has entered into an agreement with a specified association of any specified territory outside India under sub-section (1) and such agreement has been notified under that sub-section, for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee...”*¹⁷⁶

In effect, the provision states that the Act will apply to a taxpayer if it is more beneficial than the tax treaty in question. This means that any GAAR or SAAR in the Act apply to their circumstances even though the treaty may provide a more favourable tax outcome¹⁷⁷. Other scholars have opined that this can be extrapolated to mean that if there is a conflict between a DTA and domestic law, the domestic law shall override the treaty provisions¹⁷⁸.

It should also be further noted that the uncertainty as regards treaty override in India is also because India is not a signatory to the VCLT. While this is the case, scholars point out that courts in India use the principles laid down in the convention as they are universal in nature¹⁷⁹.

6.1.4 Current practice-domestic and treaty law

India's struggle with the difference between its domestic and tax treaty law regarding anti-abuse measures demonstrates the need to mirror efforts between international tax obligations and domestic law provisions. One realm cannot be so progressive while the other realm remains unchanged, as the perception of disparity only intensifies, and the opportunity for tax treaty abuse remains possible.

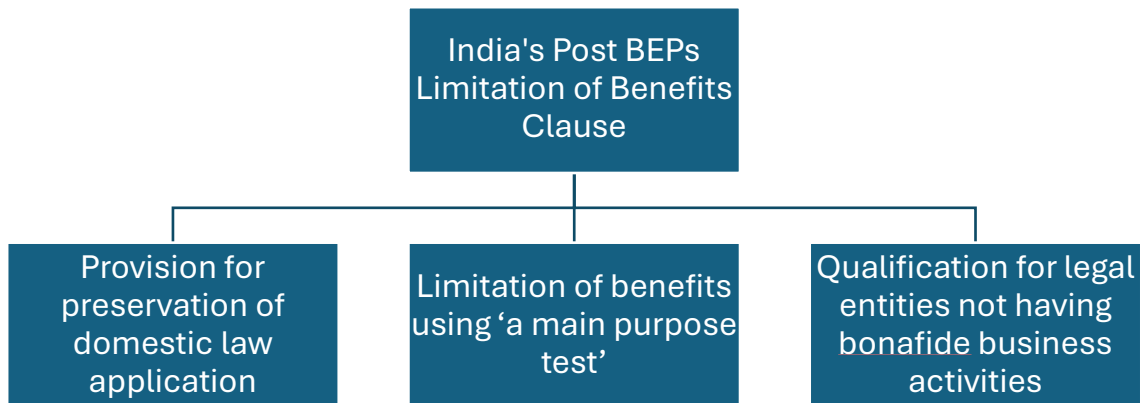
¹⁷⁶ Income Tax Act, 1961 (India), s 90A(2).

¹⁷⁷ Dhruva Gandhi & Gaurav Bhawnani 'GAAR to Override DTAs: Can the Constitution or Limitation of Benefits Clauses Prevent This Menace?' (2017) 10 *NUJS Law Review* section IV.

¹⁷⁸ *Ibid.*

¹⁷⁹ Ganesh Rajgopalan and Rakhi Mod *Reconstructing the Treaty Network* (2020) section 2.2.1

In the post-BEP era, India has renegotiated some of its old tax treaties with its treaty partners to include a LOB clause¹⁸⁰. These include treaties with the United Kingdom, United Arab Emirates (UAE), Kenya, Mauritius and Poland. Similarly, an example of new treaties with a LOB clause includes treaties with Bhutan, Malta and Colombia, all effective in 2015¹⁸¹. It is worth noting that the LOB clause adopted by India post BEPs has three subparagraphs that are broken down as follows:



It has been noted that the new treaties' format of a LOB clause differs from the previous formats used by India, for instance, in the India-Singapore Treaty. The LOB clause takes the form of a 'Principle Purpose Test' and has been criticized for being subjective in nature when it comes to application¹⁸². The lack of safeguards for arbitrary application of the clause has also been pointed out, with only the UK-India Treaty having such safeguard in place, which reads as follows:

*" ...Where by reason of this Article a resident of a Contracting State is denied the benefits of this Convention in the other Contracting State, the competent authority of that other Contracting State shall notify the competent authority of the first-mentioned Contracting State."*¹⁸³

¹⁸⁰ K. R. Girish *India Experience* at 19-21.

¹⁸¹ *Ibid* at 23-26.

¹⁸² *Ibid* at 22.

¹⁸³ Convention between the Government of the Republic of India and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains (1993), Article 28C.

6.1.5 India's MLI Selection

Under the MLI, India has opted to use the PPT as an interim measure to meet the minimum standard and expressed intent to negotiate bilaterally for a detailed LOB with its treaty partners. Additionally, India has also elected to use the optional measure SLOB in addition to the PPT in the time before detailed LOBs are negotiated to beef up its anti-abuse efforts. Scholars point out that this reflects India's firm stance against treaty abuse¹⁸⁴.

6.1.6 Conclusion

India can be said to have achieved some level of success when it comes to negotiating and including limitation of benefits rules in their tax treaties. Perhaps due to, in part, its early exposure to this kind of clause in the India-USA tax treaty and to the pronouncement of the court in the Azadi Bachao case. What is clear is that the risk of treaty override is ever-present due to section 90A of the India Income Tax Act. Nonetheless, there has been a growing preference to include LOB clauses in India's tax treaties. These efforts have also been reflected in India's MLI position.

6.2 UGANDA

6.2.1 Domestic LOB

Similar to Kenya, Uganda has a domestic limitation of benefits rule. The provision reads as follows:

*"...Where an international agreement provides that income derived from sources in Uganda is exempt from Ugandan tax or is subject to a reduction in the rate of Ugandan tax, the benefit of that exemption or reduction is not available to any person who, for the purposes of the agreement, is a resident of the other contracting State where 50 per cent or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other contracting State for the purposes of the agreement..."*¹⁸⁵

The rule is simple in its construction as it provides only one objective test: an ownership test. It lacks other key features of a LOB provision, such as some detailed exceptions and safe harbour rules, and does not provide a means for discretionary relief to the tax authorities. This means that the tax authority in Uganda is left with wide discretionary powers to implement the

¹⁸⁴ A.P. Kotha & P.K. Peshori *op cit* note 174 section 19.3.2

¹⁸⁵ Income Tax Act (Cap 340) of Uganda, s 88.

rule, and no relief is guaranteed for a party aggrieved by the tax authority's action under this provision.

6.2.2 International law and treaty override In Uganda

The Ugandan Income Tax Act is clear on how international instruments relating to matters of taxation are required to interact with the Income Tax Act¹⁸⁶. It is envisaged that international agreements dealing with tax rank on the same level as the Income Tax Act and none is placed above the other¹⁸⁷. This is in alignment with Uganda's dualist status. Therefore, as discussed in previous sections, international instruments do not automatically become part of the law as they have to be ratified through an Act of Parliament.

However, the Act clearly points out that in the case of conflict of provisions between the two, the Treaty provisions prevail with two key exceptions to this:

1. Where the limitation of provision rule applies or is invoked
2. Where the domestic GAAR is invoked under the Act¹⁸⁸

Therefore, the Ugandan Income Tax Act clearly states that section 81(5), which lays down the limitation of benefits rule, applies as a treaty override. Scholars have heavily criticized this position, and the situation is inconsistent with Uganda being a signatory to the VCLT, which does not support the override of treaties. This is because it has no constitutional safeguards for the place of international law and has a relatively small treaty network. These factors combined make the environment susceptible to treaty overrides¹⁸⁹.

6.2.3 Treaty Practice and Challenges

Uganda has a small tax treaty network consisting of about 9 DTAs. Although the treaty network is small, it has been argued that Uganda has negotiated well in the past and its treaties might offer the best protections in the sub-Saharan region on provisions relating to withholding taxes on management fees¹⁹⁰. However, a few of its tax treaties have attracted heavy criticism, such as the tax treaty with Mauritius and Netherlands, for being susceptible to abuse through the

¹⁸⁶ *Ibid* section is dedicated to international agreements

¹⁸⁷ *Ibid* s88(1).

¹⁸⁸ *Ibid* s88(2).

¹⁸⁹ Albertus Marais op cit note 111.

¹⁹⁰ Martin Hearson & Jalia Kangave 50 *A Review of Uganda's Tax Treaties and Recommendations for Action* (2016)

dividends and the technical fees Article, which makes it possible for a taxpayer to reduce their tax obligation to 0%¹⁹¹.

A key treaty case in Uganda that illustrates the frustrations with the Uganda-Netherlands treaty was *Commissioner General, URA vs Zain International BV*¹⁹² (hereafter referred to as the Zain case). This is a case similar to the Vodafone case in India discussed above. The facts of the case are that Zain International BV sold shares in Zain Africa BV to Bharti Airtel. Both the seller and buyer were incorporated and resident in the Netherlands. Zain Africa BV, among others, owned 99.99% of shares in Celtel Uganda. The Uganda Tax Authority issued assessment notices to Zain International BV on the grounds that it held shares in Celtel Uganda indirectly and had disposed of the same to Bharti Airtel even though the shareholding of Celtel Uganda remained the same.

In its case, the Ugandan tax authority argued, among other things, that sections 81(1) and 81(5) conferred jurisdiction to make the assessments. At the same time, the respondent maintained that it was not subject to Uganda's tax jurisdiction. The court dismissed the appeal in favour of the respondent on the strength of their argument on procedural impropriety. However, it did not preclude the tax authority from issuing fresh assessments that adhered to rules of fairness. The court supported the arguments that the tax authority had jurisdiction to issue the assessments under several provisions relied on, including those in section 81.

It would have been of great jurisprudential value for the court to have been properly seized of the matter so that the substantive legal matters raised, especially on sections 81(1) and (5), would be tested. Without that, it remains speculative whether the court would have upheld the treaty override. It has been argued that Uganda would be best served in this respect if the anti-abuse provisions, such as those contained in the domestic law would be included in the treaty itself¹⁹³.

Notably, Uganda's tax authority started the process of re-issuing the assessments, during which the Zain International BV applied for Mutual Agreement Procedures (MAP) under

¹⁹¹ *Ibid* at 12 it was reported that FDI reporting by both countries depicts a heavy mismatch with Netherlands reporting a low figure as compared to what Uganda reports suggesting re-routing of investments by Netherland entities through other countries. See section 3.2 of report for detailed discussion.

¹⁹² Civil Appeal Number 0011 of 2012 in the Court of Appeal Uganda

¹⁹³ Martin Hearson & Jalia Kangave *op cit* note 191 at 19

Article 25 of the Uganda-Netherlands treaty. Some scholars opine that the case underscored the relevance of anti-avoidance rules in model treaties for developing nations¹⁹⁴.

6.2.4 Conclusion

Uganda's experience shows what treaty override can look like where it is entrenched in the law. While the Zain case was a lost opportunity to test judicial rigour in this respect, subsequent cases have had success when the general GAAR was invoked¹⁹⁵. Ultimately, even though Uganda is not a signatory to the MLI, it is imperative to see what gaps in treaty practice there are between countries that are part of the international efforts on anti-abuse against a country that is faced with the task of rethinking its entire treaty-making process after serious gaps in treaty practice are revealed. To date, the renegotiation process is still in talks a decade after the decision; we can only speculate whether being part of the MLI would have fast-tracked the process with the benefit of being able to adopt inbuilt anti-treaty abuse provisions.

6.3 GHANA

The limitation of benefits rule was contained Section 111(4) of the Income Tax Act Ghana 2000 and provided that:

“...Where an international arrangement provides that income accruing in or derived from Ghana or some other amount is exempt from Ghanaian tax or is subject to a reduction in the rate of Ghanaian tax, the benefit of that exemption or reduction is not available to a person who, for the purposes of the arrangement, is a resident of the other contracting state where fifty per cent or more of the underlying ownership of that person is held by an individual or individuals who are not residents of that other contracting state for the purposes of the arrangement...”

Further, section 111(1) provided that where there was a conflict between the Act and a tax treaty that had been ratified, the Treaty would prevail save for among others the Limitation of Benefit rule under subsection (4).

¹⁹⁴ Mahawuya Kabuye Kasujja ‘Why the introduction of a General Anti Avoidance Rule (GAAR) in Uganda's Income Tax Act Proved a Good Measure After All’ (2023) SSRN <https://ssrn.com/abstract=4389638>.

¹⁹⁵ *Ibid* at 2-3 Read more on Tullow Oil case where a transaction recharacterization pursuant to section 91 of the Uganda Income Tax Act by the URA was upheld leading eventually to a tax net of US \$250 million.

The provision was criticized first and foremost for allowing domestic law provisions to be used to override treaty provisions¹⁹⁶. This criticism was relevant because Ghana is a signatory to the VCLT although it has not yet ratified the Convention¹⁹⁷. Under the VCLT, members commit to prevent this situation of domestic law overriding treaty law¹⁹⁸. Scholars also criticized this provision for failing to articulate its purpose and being too wide in interpretation and application such that its proper limits could not be made out. This left a lot of uncertainty especially where genuine situations where a treaty had not been misused were involved¹⁹⁹.

This situation in Ghana (among other African countries in a similar situation) attracted heavy criticisms as scholars also pointed out the lack of constitutional safeguards for the place of international law versus domestic law²⁰⁰. This meant that the lax laws would present a situation where treaty override was allowed.

Eventually, the government of Ghana passed a new Income Tax Act in 2015 that removed the domestic limitation of benefit rule. Further, the Act does away with the clause that called for treaty override and hence restores respect for tax treaty obligations. The Ghanaian Revenue Authority has since issued a practice note on obtaining double taxation relief under the new Income Tax Act, 2015. Section 6.1 of the practice note states that before being able to access treaty benefits, a taxpayer has to meet some conditions, among them being:

(e) Meet and Limitation of Benefits (LOB) or entitlement to Benefits provisions contained in the treaty where applicable.

This shift in guidance by the Ghana revenue Authority is indicative of the shift in approach and focus from the repealed domestic LOB rule to focus on implementing LOB rules included in tax treaties. While Ghana has not signed the MLI, the MLI would provide an opportunity to apply the SLOB rule to its existing tax treaties if it so chooses.

¹⁹⁶ Leon Steenkamp & Stephen Hales ‘Do Tax Treaties Override Domestic Law in Africa?’ (2013) 24 *International Tax Review* at 14

¹⁹⁷ United Nations Treaty Collection, ‘Vienna Convention on the Law of Treaties (1969) — Status of Treaties’ <https://treaties.un.org/pages/showdetails.aspx?objid=080000028003902f> accessed 23 June 2025.

¹⁹⁸ VCLT *op cit* note 115 Article 28

¹⁹⁹ Leon Steenkamp & Stephen Hales *op cit* note 197 at 13-14

²⁰⁰ A.W. Oguttu ‘Preventing Treaty Abuse – Action 6’ in *Base Erosion and Profit Shifting: A Blueprint for Africa’s Response* (2021) section 4.4.2.2

6.4 TANZANIA

Under the Tanzania Income Tax Act, the limitation of benefits rule is contained in section 128 and provides as follows:

5) Where subsection (4) applies, the exemption or reduction shall not be available to any entity that meets the following conditions-

(a) the entity is, for the purposes of the agreement, a resident of the other contracting state; and

(b) fifty percent or more of the underlying ownership of the entity is held by persons, being individuals or entities in which no individual holds part of the underlying ownership, that are not, for the purposes of the agreement, residents of the other contracting state or the United Republic.

The section then goes on to provide that in case of any conflict between the Act and a tax treaty, the treaty will prevail save for provisions of sub section 5. Once again, like Ghana, the provision expressly calls for treaty override when it comes to the domestic limitation of benefit rule.

Tanzania's case unlike the other countries discussed in this chapter is quite unique because it has fully acceded to the VCLT. The domestic LOB is therefore in clear violation of the treaty obligations that it signed up for²⁰¹.

Tanzania's domestic LOB also suffers the same heavy criticism for being among the countries that allow domestic law treaty override.

²⁰¹ UN Treaty Collection *op cit* note 198.

Chapter 7

Conclusions and Recommendations

7.1 Conclusions

The focus of this study was to understand the workings of domestic limitation of benefits rules. Its main question has been whether Kenya should consider repealing its domestic LOB rule for the MLI's SLOB. While the legislative efforts to combat treaty shopping in Kenya are laudable, the lack of clear tax policy rationale impedes the wide adoption, acceptance and use of the LOB rule that was put in place for this purpose. This can be seen from the domestic LOB provision that has been in the tax law for several years without much direct and practical influence being attributable to it. While it is unlikely that the domestic law LOB provision is utterly useless, the most likely scenario is that the discretion conferred under the domestic LOB makes it such that disputes arising from it are dealt with at the KRA department levels. In that case, the tax authority likely has distinct positions and interpretations on the rule that are only divulged in specific taxpayer assessments, audit findings or disputes.

The study determined that the lack of any specific positive outcomes in the tax arena in Kenya, attributed to the problematic domestic LOB, coupled with the growing relevance of the OECD's work relating to curbing treaty abuse through GAAR and SAARs such as recent model LOB provision in the MTC and the MLI, makes a convincing case for Kenya to reconsider its decade-old domestic LOB and embrace the SLOB in its existing and future tax treaties.

The study highlighted the history of the LOB rule and found that the clause was developed and adopted in attempts to find a solution to treaty abuse and treaty shopping problems faced by the USA in the early 1980s. Later, jurisdictions where it proved useful and effective adopted the rule as part of their treaty-making policy. Indeed, the use of the rule later spread both among developed and developing nations treaty and domestic law practices.

While it was determined that there is no hard and fast rule about what an ideal LOB clause should be drafted, different countries adopt their own drafting styles and include some of its objective tests or all or have just the bare minimum conditions. Ultimately, the relevance and importance of a LOB clause depends on how well the country's overall anti-abuse laws provide coverage for tax abuse and whether LOB is the only mechanism being relied on for this purpose.

The practice of developing countries has been highlighted using different jurisdictions. The emerging trend is that, save the early USA treaty partner states who have had experience with this rule, the other developing nations have caught into the wave around the time the BEPS project discussions were going on. In such cases, rather than adopting the rule primarily in their tax treaties, some developing nations have adopted it primarily in their domestic laws. While the OECD and the UN approve using such SAARs and other domestic measures to fight treaty abuse, a few concerns on how the domestic and treaty LOB interact have emerged in some jurisdictions. For instance, where the domestic law has a LOB but the treaty has no LOB clause, there is no clear direction on whether the domestic LOB can be disregarded for the purposes of such a treaty where such clarification has not been made in law or by the relevant tax authority.

One of the early concerns for the domestic law adopting a LOB rule is the potential for retroactive application in conflict with existing treaty obligations these countries have with their treaty partners. In Kenya, for instance, the domestic LOB rule was introduced without proper guidance on whether it could apply to existing treaties. The unresolved question has always lingered and attracted scepticism. Without any emerging clarification from the revenue authority, this remains a grey area and could potentially offend the principle of good faith with the existing treaty partners if it was applied to deny treaty benefits negotiated before the rule was introduced.

Additionally, in countries where the rule has been incorporated into domestic law, there has not been a successful application or testing of the rule through courts such that the rule's existence in law appears unnecessary. This was seen in Uganda's Zain Case, where although the tax authority attempted to invoke the rule, the court did not pronounce itself on the substantive aspects of the case. However, since the tax authority based its argument for jurisdiction on, among others, the LOB rule, the court appeared to endorse such jurisdictional claim by agreeing with the tax authority that they had jurisdiction to issue tax assessments in the case which involved treaty abuse.

The unsuccessful attempts or lost opportunities to use LOB in Uganda (Zain case) and India (Vodafone case) have led to a myriad of subsequent laws that have attempted to be applied retroactively, whether expressly like in India or threatened, such as in Kenya and Uganda for their already existing tax treaties. While this has clearly been challenged for going against principles laid down by the VCLT, it has become evident that the clause's application suits well

where it is included in a treaty. The Indian Supreme Court in the Azadi Bachao case hinted at this.

Another key concern with the domestic LOB rule is the risk of treaty override by domestic law. While treaty override is not permitted under the VCLT, jurisdictions, where a domestic LOB has been legislated, have attempted to confer the rule of a treaty override. This was seen in Kenya, Tanzania and Uganda, where the Income Tax Acts specifically invoked treaty override for the relevant sections of the law that contained the LOB rule. These have not been without criticisms. In nations with no constitutional safeguards for the place of international law, and the country adopts a dualist approach, the risk for treaty override is significant where domestic LOB clauses are adopted.

All the defects and criticisms that have been established to have basis for the domestic LOB rule have led the study to conclude that domestic LOBs do not meet the criteria for being good tax policy or measures for fighting treaty abuse. The domestic LOBs lack clarity in the way they apply, they do not promote coherence between domestic and international law practice in the area. While they are easy to administer by tax authorities, they are not predictable and reliable rules to guide taxpayers as they offend established principles of international law when they threaten to apply retroactively and to override international law. The rules have also not proved their effectiveness in countries where they are used.

The OECD's MLI provides an opportunity for nations that want to benefit from the use of a LOB the chance to adopt this rule in its treaty network without having to renegotiate this bilaterally. We have seen that in Uganda, the renegotiations of the treaty with the Netherlands have taken over a decade, and there is still no end in sight. Such countries will benefit from signing up for the MLI and using its SLOB. The SLOB is a comprehensive rule that can supplement the PPT to ensure that a country adheres to the OECD minimum standard. Its application would prove easy as it has more comprehensive objective tests than most domestic LOBs, and it would be directly incorporated into existing or future treaties. The study to this end has concluded that SLOB under the OECD fulfils the criteria for a good and effective tax measure.

India has benefited from the development of LOB rules by the OECD by developing their own version of the LOB clause to use in its tax treaties, which incorporates the main purpose test together with the main features of a LOB rule. Whether more countries will follow suit and tailor their own LOB rule to meet their anti-treaty abuse objectives remains to be seen.

Like India, a few countries intend to develop their own detailed LOB rule to meet the minimum standard under the MLI on treaty abuse. Therefore, there is potential for the rule to gain prominence in the future in the international tax arena.

7.2 Recommendations

While the future of domestic LOBs seems bleak, with only a few jurisdictions currently using them to fight treaty abuse amidst criticisms, there is a need for more scholarly and research focus in this area as the MLI promises to keep LOB rules alive in the international tax realm by making provision for them in Article 7.

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