Tax policies and developments affecting foreign portfolio investment in sub-Saharan Africa

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Abstract

Despite the increase in nonofficial cross-border capital flows to sub-Saharan Africa following the 2007/2008 global financial crisis, the region is still receiving a limited amount of foreign portfolio investment (FPI) compared to other developing markets. This paper seeks to explore the factors explaining sub-Saharan Africa's lack of FPI and what measures could be implemented to encourage FPI in the region. The key takeaways of this paper are:

- *Tax structures have been identified as one of the key impediments to FPI in Southern Africa. Although various sub-Saharan jurisdictions exempt capital gains on the disposal of listed shares from tax, significant withholding taxes are generally levied on dividend and interest payments to foreign investors.*
- *Mauritius, a popular hub for African investment, has recently been under the spotlight with a number of sub-Saharan African jurisdictions terminating or amending their tax treaties with the country or introducing domestic antiavoidance measures to combat perceived treaty shopping. This is expected to have a negative impact on investment flows through Mauritius. In addition, coronavirus disease-19 relief measures introduced by sub-Saharan authorities focus on safeguarding local businesses and foreign direct investment rather than FPI.*
- *The quality of governance is also a significant factor in attracting net portfolio inflows, and there is a clear need in sub-Saharan Africa for simple, efficient tax systems and appropriate tax incentives to support investor-friendly policies and encourage and stimulate FPI.*

Keywords: COVID-19, domestic antiavoidance, foreign portfolio investment (FPI), governance, investment hub, sub-Saharan Africa, withholding tax

FOREIGN PORTFOLIO INVESTMENT IN SUB-SAHARAN AFRICA

Africa relies heavily on financial inflows to finance its development initiatives and boost economic growth and welfare. Total

external financial inflows into Africa consisting of remittances, official development assistance (ODA), foreign direct investment (FDI) and foreign portfolio investment (FPI) make up 11.6 per cent of Africa's gross domestic product, compared to the global average of 5.4 per cent.[1]

Following the 2007/2008 global financial crisis, there has been a significant increase in nonofficial cross-border capital flows to sub-Saharan Africa. FDI continues to dominate, but the level of FPI, the component of international capital flows consisting of stock (share) and/or bond purchases that do not create a lasting interest in or effective management over an enterprise,[2] has also been increasing. This rise in nonofficial capital flows has taken place against a declining trend in ODA in the form of loans and grants to the region. With the growth in FDI being insufficient to fill the gap, FPI, which has hitherto remained largely untapped, is becoming increasingly important for sub-Saharan countries as an alternative source of the funds required to meet their development needs.[3]

The amount of FPI in the region, however, still lags behind other emerging markets.[4] In 1990, there were merely six stock markets in sub-Saharan Africa: Ghana, Kenya, Mauritius, Nigeria, South Africa and Zimbabwe; and three in North Africa: Egypt, Morocco and Tunisia. There are currently 29 national stock exchanges, including two regional bourses, one of which represents the Francophone countries.[5] Despite this rapid development, these stock markets, with the exception of the Johannesburg Securities Exchange, are still small and lacking depth and liquidity.[6] The question arises as to why Africa receives such limited FPI.

Several empirical studies confirm that the distribution of foreign investment principally depends on the expected rates of return and the estimates of risk of alternative assets globally. A 2003 study, which investigated the obstacles to attracting increased FPI into Southern Africa, identified a number of factors that either reduce the expected rates of return or increase the perceived risk of investments in the region. In addition to the underdevelopment of domestic financial markets, macroeconomic instability, interest rate structures, exchange rate risk, country risk, exchange control, inadequate availability of information, and an underdeveloped telecommunications infrastructure, tax structures have been identified as one of the key impediments to FPI in Southern Africa.[7]

A lower tax rate on the returns from portfolio investment, such as dividends, interest and capital gains, increases the expected after-tax return on an investment and is, therefore, a powerful incentive for attracting foreign investment. Research has proven that this is one of the most effective policy instruments available to developing countries to attract foreign investment.[8] Unfortunately, sub-Saharan African jurisdictions often do not make use of this policy instrument.

TAX ON PORTFOLIO INVESTMENT RETURNS

A 2003 study found that the majority of tax incentives for foreign investment in Southern African countries are directed at attracting FDI rather than FPI.[9] A current review of six jurisdictions in the region: Ghana, Kenya, Nigeria, Mozambique, Uganda and Zambia, shows that not much has changed over the last 17 years. The incentives available in respect of investment returns in these jurisdictions are still mainly focused on substantial investments by local residents and the development of businesses operating in special economic zones.

Various sub-Saharan jurisdictions, including Botswana, Ghana, Kenya, Nigeria, Tanzania and Uganda, exempt capital gains on the disposal of listed shares from tax. Significant withholding taxes, often at rates

Table 1: Withholding tax on interest and dividend payments in selected African jurisdictions

Jurisdiction	*Instrument*	*Withholding tax rate*
Ghana	Dividends paid to residents holding at least 25% of voting rights	Exempt
	Interest paid to members of an approved unit trust or mutual fund and interest paid to non-residents on government bonds	Exempt
Kenya	Dividends received by resident companies holding at least 12.5% of shares and dividends declared by developers or operators in SEZs	Exempt
	Interest on government bearer bonds	15% or 25% (depending on duration)
	Interest paid by SEZ enterprises	5%
Mozambique	Dividends from listed companies	10% (as compared to the standard rate of 20%)
	Interest on treasury bonds and public securities listed on the Mozambique Stock Exchange	10% (as compared to the standard rate of 20%)
Uganda	Dividends paid to residents holding at least 25% of voting rights	Exempt
	Interest on government securities with a maturity period of less than 10 years	20% (as compared to the standard rate of 15%)
Zambia	Dividends from listed companies	20% (the standard rate)
	Interest on government bonds and treasury bills	15% (as compared to the standard rate of 20%)

Note: SEZs, special economic zones.

as high as 20 per cent, are, however, levied on dividend and interest payments to foreign investors. Some countries levy reduced withholding tax rates on dividend payments by listed entities and government bonds or treasury bills, whereas the focus of others remains on incentivising substantial local investments, as illustrated in the Table 1.

There is definite scope for most Southern African countries, especially those with recently established or small stock exchanges, to grant tax incentives to portfolio investors. As the majority of these jurisdictions currently have a limited tax base from FPI, the granting of such incentives should not result in a material loss of fiscal income.[10]

In some recent developments in East Africa, the courts in both Uganda and Kenya have ruled on when the liability for withholding tax on certain payments arises. The Kenya Court of Appeal in the case of *Kenya Revenue Authority v. Republic Ex Parte: Fintel Ltd* (Civil Appeal No. 311 of 2013) in February 2019, overruled a High Court decision that withholding tax was not due on accrued payments. The court held that any amount recognised as an expense in the books of accounts is deemed to be 'paid' as defined by the Income Tax Act and, therefore, subject to withholding tax.

Similarly, the Uganda Tax Appeals Tribunal in the case of *ATC Uganda Limited v. Uganda Revenue Authority* of May 2020, was of the view that 'payment' is no longer restricted to the physical exchange of cash or a transfer of monies. A payment can be made by conversion of a debt into equity, a relief of a debt, or a swap of debt with an obligation, a digital or an electronic

payment or any other means of conferring value or benefit on a person. The converting of interest into a loan obligation by adding accrued interest to the principal loan amount outstanding is deemed to be a payment of the interest at the end of each interest period when it was converted into the loan and the liability for withholding tax on the interest arises at that point.

MAURITIUS AS INVESTMENT HUB FOR SUB-SAHARAN AFRICA

In line with international practice, a significant portion of investment into Africa has been flowing through investment hubs. Among other reasons, this is often done to obtain the benefits of a tax treaty, which may reduce or eliminate withholding taxes on interest, dividends and capital gains tax on the sale of shares on a bilateral basis. Mauritius, with one of the widest tax treaty networks with other African jurisdictions, has been a popular hub for investment by mutual funds and other investors into the African continent.

The Base Erosion and Profit Shifting (BEPS) programme, however, introduced by the Organization for Economic Cooperation and Development (OECD) in the recent past, aims to ensure that profits are taxed where economic activities generating profits are performed and where value is created. The BEPS Action Plan focuses inter alia on the prevention of tax treaty abuse and eradicating 'unfair competition and practices' by low or no tax countries. In order to implement many of the suggestions provided in the BEPS Actions, the OECD introduced a Multilateral Instrument (MLI), which will allow for the swift implementation of these steps without requiring the amendment of bilateral tax treaties on a treaty-by-treaty basis. On the face of it, these measures have a limited impact on African jurisdictions. By the end of 2019, only 13 African countries had signed the MLI and to date, it has entered into force only in respect of Mauritius with effect from 1st February, 2020.[11]

Nevertheless, there has been a recent drive by various African Governments to implement bilateral reform of their tax treaties outside of the MLI, following a 2018 report by the International Monetary Fund on the costs and benefits of concluding double tax treaties with investment hubs. The results of the study, based on a sample of 41 African economies from 1985 to 2015, suggest that signing treaties with investment hubs does not necessarily result in additional investments, but it is often accompanied by significant revenue losses.[12]

Senegal terminated its treaty with Mauritius in June 2019, and Zambia followed suit on 22nd June, 2020. The Zambian Cabinet did approve the negotiation of a new agreement, which will introduce shared taxing rights and antiabuse clauses. An amending protocol to the Botswana–Mauritius treaty entered into force on 27th February, 2020, amending the exchange of information provisions (see Figure 1).

The Kenya–Mauritius treaty became the subject of a High Court case in Kenya in 2019, when the *Tax Justice Network Africa* disputed the constitutionality of the treaty inter alia on the basis that it failed to follow the required ratification process and limited Kenya's taxing rights under various articles. The treaty provided for reducing the withholding tax rate on fees from 20 per cent to zero and relinquishing Kenya's right to tax capital gains on the disposal of shares, thus undermining Kenya's ability to attain sustainable development. In terms of the High Court decision of 15th March, 2019, the treaty did not have legal effect in Kenya and a new treaty was subsequently signed on 10th April, 2019. It was gazetted by Kenya on 30th June, 2020, but is not in force yet (see Figure 1).

In October 2019, the Economic Council of the European Union (EU) declared

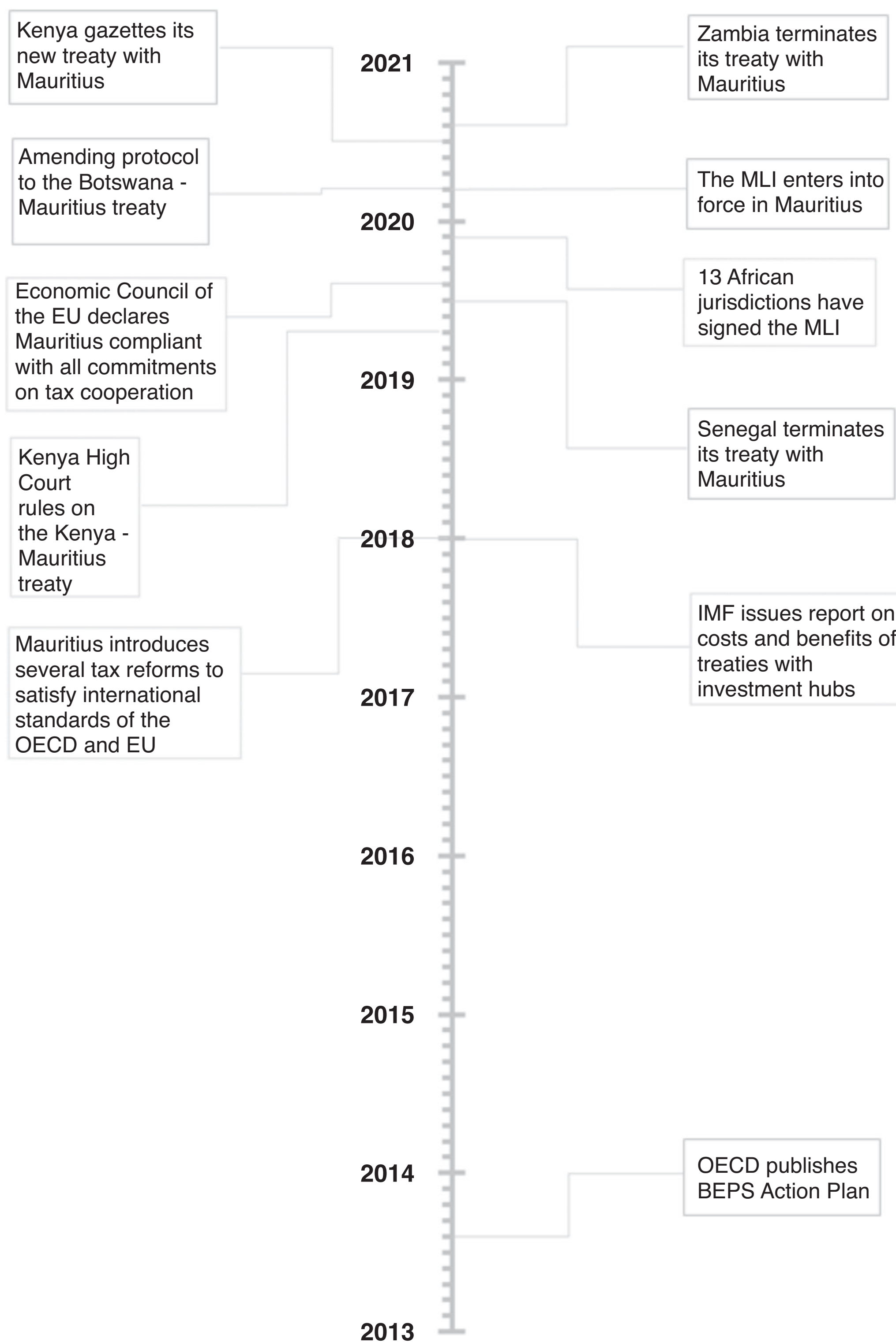

Figure 1 Developments affecting Mauritius as an investment hub for Africa
Note: EU, European Union; IMF, International Monetary Fund; MLI, Multilateral Instrument, Organization for Economic Cooperation and Development (OECD).

Mauritius to be compliant with all commitments on tax cooperation, following its implementation, since 2018, of several tax reforms to satisfy the international tax standards of the OECD and the EU. On 7th May, 2020, the European Commission, however, included Mauritius among a list of 22 countries that 'pose significant threats to the financial system of the Union'. The decision is to be confirmed on 1st October and may further impact on the channelling of investment funds via Mauritius, should the black-listing go ahead (see Figure 1).

DOMESTIC ANTIAVOIDANCE PROVISIONS

Once a tax treaty enters into force, most countries treat it as an applicable law with a superior status to the domestic legislation. An increasing number of sub-Saharan African jurisdictions have, however, been introducing domestic antiavoidance provisions, which override treaty relief in cases of perceived treaty shopping as is illustrated in Table 2.

Until June 2016, Uganda's Income Tax Act provided that treaty benefits are only available if 50 per cent or more of the underlying ownership of an entity in a treaty country is held by individual/(s) who are residents of such treaty country. These provisions were the subject of the High Court case of *White Sapphire Ltd/Crane Bank Ltd vs the Commissioner General of the Uganda Revenue Authority (URA)* in 2017. In the case at hand, a Mauritius-incorporated company, ultimately owned by a Kenyan resident, was the shareholder in a Ugandan entity. The Ugandan entity withheld tax on dividends declared to the Mauritius shareholder at the reduced rate of 10 per cent as per the Uganda–Mauritius tax treaty, but the URA insisted that the standard 15 per cent withholding tax as per the domestic legislation should be withheld. It argued that as not more than 50 per cent of the underlying ownership of the Mauritius entity was held by Mauritian residents, the treaty benefits would not apply.

In its judgment, the court agreed that, on the face of it, the Mauritius shareholder can be taxed at the rate of 10 per cent on the dividends received as it is a resident of Mauritius and a beneficial owner of the dividends. At the same time, however, on the basis that 100 per cent of the shares in the Mauritius shareholder is held by a

Table 2: Domestic anti-avoidance provisions in selected African jurisdictions

Jurisdiction	*Domestic antiavoidance provisions*
Ghana	Treaty benefits are only available if 50% or more of the underlying ownership is held by persons resident in either the treaty country or Ghana.
Kenya	Treaty benefits are only available if 50% or more of the underlying ownership of an entity in a treaty country is held by individual/(s) who are residents of such treaty country, unless the entity is listed on a stock exchange in the treaty country.
Nigeria	In terms of an Information Circular issued by the Federal Inland Revenue Service of Nigeria in December 2019, a taxpayer who qualifies for treaty benefits may be denied such benefits if it is discovered that its residency in a treaty country was principally for the purpose of accessing treaty benefits.
Tanzania	Treaty benefits are only available if 50% or more of the underlying ownership of an entity in a treaty country is held by individual/(s) who are residents of such treaty country.
Uganda	Treaty benefits are only available if the person resident in the treaty country receives the relevant income in its capacity as beneficial owner and it possesses economic substance in its country of residence. Public listed entities are excluded from the restrictions.

non-Mauritius resident, the reduced tax rate as per the treaty will not be allowed. In order to resolve the conundrum, the taxpayer was advised to submit its case to the mutual agreement procedure between the Ugandan and Mauritian revenue authorities. In Africa, such procedures often result in an expensive, drawn-out process for the taxpayer, without any guaranteed results and is, therefore, not a viable solution for resolving the conflict between domestic legislation and tax treaties.

The Ugandan Income Tax Act has subsequently been amended to provide some relief from these restrictions, allowing access to treaty benefits if the person resident in the treaty state receives the relevant income in its capacity as beneficial owner and it possesses economic substance in its country of residence. Public listed entities are excluded from the restrictions.

IMPACT OF CORONAVIRUS DISEASE-19

The coronavirus disease-19 (COVID-19) crisis will cause a dramatic worldwide fall in FDI. Developing economies are expected to be the hardest hit due to their reliance on investment in global value chain-intensive and extractive industries, which have been severely affected, as well as their lack of resources for economic support measures. FDI flows to Africa are forecast to decrease by between 25 and 40 per cent in 2020, with this negative trend being exacerbated by low commodity prices.[13]

The African Tax Administration Forum (ATAF), an international organisation that provides a platform for cooperation among 39 African tax authorities, published a policy paper on 22nd July, 2020, to assist African jurisdictions to limit the impact of the pandemic on their ability to raise tax revenue. Recommendations are provided in respect of tax relief measures, nontax relief measures, business continuity, enterprise risk management, tax fraud and customs revenue, which can be customised to any country's unique set of circumstances.[14]

Yet again, the relevant COVID-19 relief measures implemented by sub-Saharan jurisdictions focus on safeguarding local businesses and FDI investment instead of FPI, with the majority of measures implemented being geared towards employees' tax, corporate income tax and value-added tax. Across more than 20 African countries surveyed, a total of only four measures provide relief from withholding taxes.[15]

Kenya, in April 2020, enacted a reduction in the corporate income tax rate for resident companies from 30 to 25 per cent and the VAT rate from 16 to 14 per cent. At the same time, however, the concessionary income tax rate for companies newly listed on any securities exchange has been repealed and the withholding tax rate on dividends paid to nonresidents has been increased from 10 to 15 per cent. The exemption for dividends received by registered venture capital companies and gains arising from trade in securities listed on any securities exchange operating in Kenya by any dealer licensed under the Capital Markets Act has been also repealed.

THE IMPORTANCE OF IMPROVED GOVERNANCE

FPI in Southern Africa remains hampered by particular impediments such as the lack of well-functioning secondary markets, the limited size and liquidity of financial markets, the absence of sound long-term macroeconomic policies and exchange control restrictions on capital inflows and the repatriation of investment returns imposed by certain jurisdictions.[16]

The quality of governance and financial institutions, however, is also a significant factor in attracting net portfolio inflows.[17] A 2018 study investigated the relationship between the six World Governance Indicators (control of corruption, government effectiveness, political stability and absence

of violence/terrorism, regulatory quality, rule of law and voice and accountability) and FPI in 33 sub-Saharan African countries over the period 1998–2015. The results suggest the ability of governments to implement policies effectively, strengthen the quality of institutions and control corruption is key in attracting portfolio inflows, whereas the region's poor record of the rule of law and political stability is a major deterrent to investment.[18]

Regulation in Africa often lacks transparency and it can be difficult to find reliable, detailed information about the regulatory regimes of some countries. Excessive red tape and slow administrative procedures are also common. A number of countries also appear to apply a high degree of administrative and/or political discretion, resulting in a lack of consistency of implementation. In addition, when governments change key pieces of legislation, they often do so without the required prior engagement with stakeholders.[19] These concerns are also relevant for portfolio investors, and the negative perceptions of poor governance in the region also extend to tax policies. Tax legislation in most sub-Saharan African jurisdictions is notorious for being vague with important terms not clearly defined, giving rise to significant uncertainty regarding potential tax obligations and the time when such obligations arise.

There is a clear need in the region for simple, efficient tax systems in support of investor-friendly policies to encourage and stimulate FPI. Governments should have a clear strategy for their tax system, implement certain and simple tax laws that are unambiguous and allow for adequate and timely consultation with stakeholders.

In June 2018, a Memorandum of Understanding (MoU) entered into between the OECD and the ATAF in 2012, was renewed until June 2023. Under the MOU, the two organisations agree to cooperate to improve tax systems and promote fair and efficient tax systems and administrations in Africa. Since the MOU came into effect, cooperation efforts focused on tax incentives for investment, transfer pricing, exchange of information, taxpayer education and the training of tax officials. Progress has been made, but there is still definite room for improvement in the quality of tax legislation and its application in the region.

The availability of consistent, accurate and current macroeconomic information and details regarding markets, products, investment opportunities and tax implications of investments is a further prerequisite for attracting FPI to Southern Africa. It would be beneficial to market the region as an investment destination on a regional basis, with electronic media providing an excellent opportunity for continued improved communication at a relatively low cost.[20]

Regional markets also have the potential to attract greater investment and contribute to higher levels of liquidity. The African Continental Free Trade Agreement (AfCFTA), which entered into force on 30th May, 2019, is to create one of the world's largest free-trade markets and should facilitate the future development of regional financial markets in sub-Saharan Africa. The commencement of trade through the AfCFTA, which was scheduled to start on 1st July, 2020, has, however, been postponed due to the prevailing circumstances caused by the COVID-19 pandemic, with the realisation of the benefits of regional integration also being delayed.

CONCLUSION

Following the global financial crisis of 2008, sub-Saharan Africa has become an increasingly popular foreign investment destination. The current lack of tax incentives available to portfolio investors and the general poor quality of tax systems

and their enforcement in many countries in the region remain, however, among others, key impediments to material growth in FPI.

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