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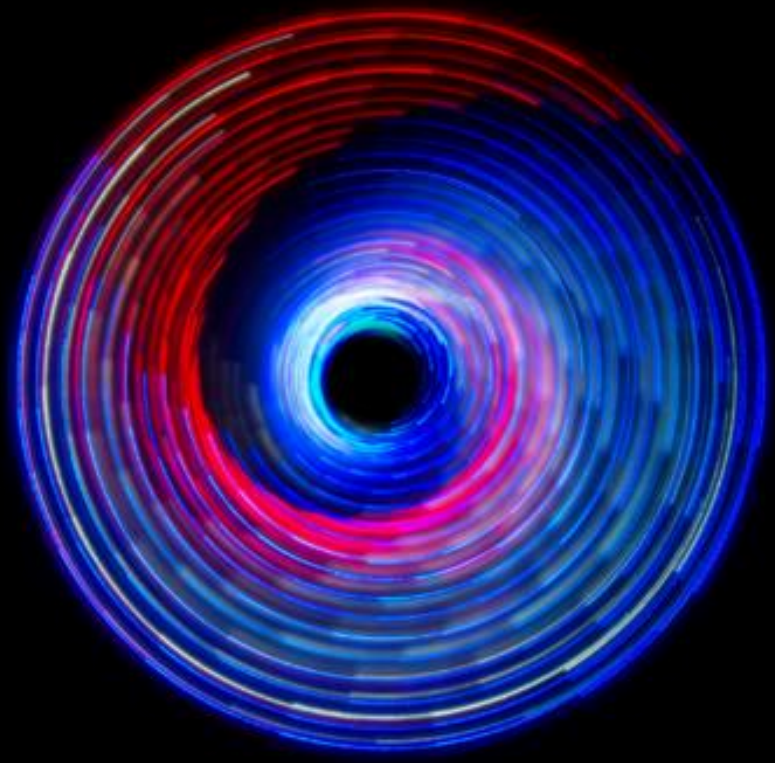

Tax Alert – Tax Appeals Tribunal ruling

Professional fees paid to a South African entity is not subject to withholding tax in Kenya under the Kenya-South Africa Double Taxation Agreement

The Tax Appeals Tribunal ("TAT") has pronounced judgement on the applicability of withholding tax ("WHT") on professional fees under the Kenya-South Africa Double Taxation Agreement ("the DTA"), in a case pitting McKinsey and Company Inc. Africa Proprietary Ltd ("McKinsey" or "the Appellant") against the Kenya Revenue Authority ("KRA" or "the Respondent").

In its judgement, delivered on 1 April 2021, the TAT held that the professional fees paid to the South African entity constitutes business income based on the definition of 'business' under the Income Tax Act ("ITA"), and therefore subject to taxation under Article 7 of the DTA, which deals with business profits.

In consideration of the above, the TAT concluded that, where the recipient does not have a Permanent Establishment ("PE") in Kenya, the right to tax income arising from professional services falls with South Africa, and therefore, WHT would not be applicable on such payments made to the South African entity.

Background

The tax dispute arose from an assessment issued by the Respondent with respect to WHT on professional fees paid by McKinsey to a related party in South Africa.

Aggrieved by the decision of the Commissioner, McKinsey lodged an appeal before the TAT in May 2020.

The main point of contention was the interpretation of the DTA between Kenya and South Africa. In particular, the point of divergence was whether to apply Article 7 (Business Profits) or Article 22 (Other Income) of the DTA in the absence of a specific article on management and professional fees.

Appellant's contentions

In support of its case, the Appellant advanced the following arguments:

- Tax treatment of professional fees paid to the South African related entity should be guided by the provisions of Article 7 of the DTA on business profits.
- Term 'Business Profits' is not defined under the DTA. Therefore, the definition of the term "business" under Section 2 of the ITA would be applicable.
- Vienna Convention on the Law of Treaties forms part of the Laws of Kenya and therefore should guide the interpretation of Kenyan treaties.
- Guidance provided under the OECD Model Tax Convention, and the UN Model Tax Convention form part of the context of the DTA and plays a significant role in interpretation of the DTA. Based on the said guidance, the deletion of Article 14 of the OECD Model Tax Convention in 2000, was based on the rationale that management or professional fees forming part of busines income would fall under Article 7 (Business Profits) of the OECD Model Tax Convention. This position is supported by the commentaries to the OECD Model Tax Convention.
- Based on Article 7, where the recipient does not have a PE in the source country, the said income from business is only taxable in the other contracting state, in this case South Africa.
- Income from professional services cannot be deemed 'other income' under the Article 22 of the DTA, and therefore are not subject to WHT under Section 35 of the ITA.
- UN model commentary provides alimony and lottery income as examples of income covered under "other income". Based on the Ejusdem Generis rule, the incomes are personal in nature and cannot extend to professional fees accruing to a company.

Respondent's contentions

In rebuttal, the Commissioner advanced the following arguments:

- The taxation of professional services is not provided for under a separate Article in the DTA. Therefore, such income is taxed under Article 22 of the DTA on 'other income', which covers income that is not specifically covered under any other Article in the DTA.
- Article 7(7) of the DTA gives precedence to all other Articles within the DTA, which provide for taxation of such income. Therefore, professional services fall under Article 22(3) of the DTA as this Article would take precedence over Article 7.
- The DTA is modelled along the UN Model Tax Convention and the Commissioner's view is that the interpretation should be based on the commentaries to the UN Model Tax Convention.
- Since the OECD Model expressly defines the term "business", the Appellant should have sought guidance on the effect of deletion of Article 14, which is what prompted the addition of the definition of the term business under Article 3. The absence of a definition of the term business is an indication that the DTA follows the UN Model and as such the Appellant cannot rely on the OECD Model.
- The provisions of Article 22(3) of the DTA, mirror Article 21(3) of the UN Model, which allows the source country to tax income where its domestic law so provides. Therefore, Article 22(3) of the DTA gives Kenya the rights to impose WHT according to its local law on such income that has not been subjected to tax under the preceding Articles of the DTA.

The TAT Decision

In its judgement, the TAT noted the following:

- That the Kenya-South Africa DTA follows both the UN and OECD Models. Therefore, the commentaries for both models can be relied upon in interpreting the DTA.
- Though Kenya did not ratify the Vienna Convention on Interpretation of Treaties, the convention may still be used persuasively.
- In the absence of a definition of the term "business" under the DTA, the definition under domestic law (i.e., the ITA) can be used.
- The services provided by the South African entity falls under the definition of business under the ITA, and therefore the professional fees can be termed as business income.
- Article 7 is the appropriate Article that deals with taxation of business profits. The income earned by the South African entity from Kenya constitutes its business profits.
- In the absence of a PE in Kenya, the right to tax the income arising from professional services falls with South Africa.
- Article 22 of the DTA is only relied upon where the income has not been dealt with in the preceding Articles (6 to 21). The income in this case constitutes business profits and therefore falls under the ambit of Article 7 for tax purposes.

Based on the above, the TAT concluded that the Commissioner erred in demanding WHT on payments made to the related entity in South Africa.

Our view

The issue of WHT on management and professional fees in the context of DTAs has been a bone of contention between the KRA and taxpayers, with the KRA insisting that provisions of the domestic tax law apply where a DTA does not have a specific Article for management and professional services, and in effect that Article 7 (Business Profits) does not apply to such payments.

The TAT decision, therefore, brings clarity and gives relief to Kenyan companies making payments to South African based entities (and other jurisdictions With similar DTAs as indicated below), given that in most instances, the local entities are the ones who bear the WHT.

The decision is in line with the position of many tax experts and reinforces one of the key objectives of DTAs, which is eliminating double taxation through delineating taxing rights of contracting states.

Below are some of the key take away points:

- Similar DTAs - taxpayers may now apply the ruling in interpreting similar DTAs such as the DTAs between Kenya and the United Arab Emirates, France, Korea, and Qatar, which do not have a specific Article on management or professional fees.
- Refund to taxpayers – in instances where a taxpayer has been subjecting the income to WHT, there is need to consider whether the taxpayer will be eligible for refund within the confines of Section 47 of the Tax Procedures Act. This may be subject to the outcome of any appeal that the KRA may pursue in respect of the TAT decision.
- Settlement under the Mutual Agreement Procedures (MAP) – in a similar case, the TAT is on record directing parties to pursue settlement under the MAP process. It will therefore be interesting to see the direction pursued by the TAT and Courts in the coming days with respect to the resolution of disputes revolving around interpretation of the DTAs.
- Digital Service Tax (DST) - taxpayers may need to test whether the same interpretation will apply in the case of the recently introduced DST.

Conclusion

The KRA has a right to appeal the decision at the High Court. In the absence of a successful appeal, the current decision by the TAT sets precedence and is binding for both the taxpayers and the KRA.

Should you wish to discuss this further, kindly feel free to contact any of the contacts below or your usual Deloitte contact who will be more than glad to offer you guidance and assistance.

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