KPMG

Tax Alert

Professional fees paid to a South African entity is not subject to Withholding Tax under Kenya-South Africa DTA

Background

This alert brings to your attention the Tax Appeal Tribunal's (TAT) judgment in the case of ***McKinsey & Company Inc. Africa Proprietary Ltd (Appellant) v Commissioner of Legal Services and Board Coordination, Appeal No. 199 of 2020.***

The Appellant, a limited liability company incorporated in South Africa operates a registered branch in Kenya whose principal activity is the provision of consultancy services including strategy, operations, financial and human resource consulting.

The Respondent carried out an audit on the Appellant's affairs for the years 2014 to 2018 and issued an assessment on 31 October 2019 demanding additional withholding tax on professional fees the Appellant paid to a related entity resident in South Africa.

The Appellant objected to the assessment on the basis that professional fees paid to the South African entity were not subject to withholding tax under the provisions of Article 7 (Taxation of business profits) of the Kenya – South Africa Double Taxation Agreement (DTA).

The Respondent rejected the objection and issued its objection decision upholding the demand on the basis that Article 22 of the DTA (Taxation of other income) was applicable in taxation of management fees and not Article 7.

Aggrieved by the Respondent's position, the Appellant filed an appeal at the TAT.

The issue in contention between the parties was whether professional and management fees are taxable under Article 7 (Business income) or Article 22 (Other income) of the DTA.

The Appellant's grounds of appeal at the High Court

The Appellant challenged the KRA's objection decision on the following grounds:

i. Professional income is not subject to withholding tax as it falls under Article 7 of the DTA which provides that:

   "The profits of an enterprise of a Contracting State ***shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein****…*

ii. Since the DTA does not define business profits, the Appellant relied on Section 2 of the Income Tax Act which defines the term "business" as:

   "…any trade, profession or vocation, and every manufacture, adventure and concern in the nature of trade, but does not include employment."

iii. The DTA between Kenya and South Africa should be interpreted in accordance with Article 31(1) of the Vienna Convention which provides that:

   "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."

iv. The DTA is based on model conventions by the Organisation of Economic Cooperation (OECD) and the United Nations (UN).

v. Even though prior to 2000, the OECD model had provided separately for the taxation of management or professional fees under Article 14, this Article, was subsequently deleted on 29th April 2000. The effect of this deletion is that professional services are now taxable under Article 7 of the OECD model.

vi. The UN model commentary indicate alimony and lottery as examples of income covered under "other income" and therefore it would be absurd to subject professional fees in the same category as lottery and alimony and subject it to WHT under Section 35 of the ITA.

vii. According to Article 7, even in the absence of a PE or fixed base, income from business would still be taxable in the contracting state, in this case, South Africa.

The Respondent's submissions

In rebutting the Appellant's arguments, the Respondent made the following submissions to the TAT:

i. Since professional services income is not provided for under a separate Article within the DTA, such income should be taxed as "other income" in Article 22.

ii. Article 7 of the DTA allocates taxing rights with respect to business profits of an enterprise of a contracting state to the extent that these profits are not subject to different rules under other Articles of the convention. Further, the Article, incorporates the basic principle that unless an enterprise of a contracting state has a PE in the other state, the business profits of that enterprise may not be taxed by the other state unless these profits fall into special categories of income for which other Articles of the convention give taxing rights to that other state.

iii. Article 7(7) gives precedence to all other Articles within the DTA which have provided for the income in question. Both UN and OECD Models agree that in situations where Article 7 and Articles on withholding tax are both applicable, then the Article on withholding tax takes precedence.

iv. The Kenya-South Africa DTA is modelled along the UN Model and therefore the Appellant cannot rely on the OECD Model commentary on the effect of the deletion of Article 14 without considering the provisions of the DTA that follows the UN Model.

v. The Kenya-South Africa DTA contains a further Article 22(3) which is absent under the OECD Model. However, this Article is modelled along Article 21(3) of the UN Model and it allocates taxing rights to the Source State on other income not specifically dealt with under the DTA.

vi. In response to the submission by the Appellant on the UN technical paper on Taxation of Income from Services, the Respondent stated that the paper acknowledges that not all situations will call for taxation of technical fees under Article 7.

vii. In response to the Appellant's submission that professional fees are not in the nature of alimony or lottery income which are given as examples at the commentary to Article 21, it was the Respondent's submission that the examples in the commentary were random and not exhaustive. In any case, alimony and lottery income are not related and therefore no general characteristic can be drawn from them.

Issue for determination

From the parties' submissions, the TAT determined that the facts of the case were not in dispute and that the only issue for determination was whether the Respondent had erred in demanding withholding tax from the Appellant in respect of professional fees paid to its related entity in South Africa.

The Tribunal's findings

In allowing the appeal and consequently setting aside the Respondent's Objection Decision, the TAT stated as follows:

a) The Kenya- South Africa DTA is based on both the UN and OECD models and therefore both can be relied upon in interpretation of the DTA.

b) Even though Kenya has not ratified the Vienna Convention on Interpretation of Treaties, the convention may still be used persuasively.

c) Since the definition of the term business as used in Article 7 is not provided within the DTA, the definition under domestic law (ITA) can be used.

d) In view of paragraph (c) above and the definition of a "business" under Section 2 of the ITA, the services offered by the South African entity qualify as business income.

e) Article 22 of the DTA "other income" only applies where the income in question has not been provided for in the preceding Articles. In this case, the income in question is already addressed under Article 7 (business profits).

f) Article 7 of the DTA stipulates that the income is taxable in the country where the enterprise is resident (in this case South Africa) unless it has a permanent establishment in Kenya. The Respondent has not established that the South African enterprise has a permanent establishment in Kenya.

g) In view of the above, the Commissioner erred in demanding for withholding tax in respect of the payments made by the Appellant to its related entity in South Africa.

Our opinion on the judgment

The TAT ruling provides useful guidance on interpretation of DTAs that do not have specific Articles on taxation of management and professional fees. Based on the ruling, such fees are taxable as business profits under Article 7 of the DTA.

This decision does not only clarify the taxation of professional services payments to South African entities but also similar payments to entities resident in the United Arab Emirates, France, Korea and Qatar, whose DTAs with Kenya do not have specific Articles on management or professional fees.

Kenya introduced a limitation of benefits clause in the Income Tax Act (cap 470) through the Finance Act, 2014. The clause provides that the benefits of tax exemption or reduction in DTAs are only available to 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 residents of that other contracting state or to entities that are listed in a securities exchange operating in that country. While this was not canvassed in the current case, it significantly limits the persons who can benefit from the double tax treaties that Kenya has signed.

KPMG is happy to assist with any matters arising from the above decision.

Contacts

Clive Akora
Partner/Director
Tax and Regulatory Services
KPMG Advisory Services Limited
E: cakora@kpmg.co.ke

Stephen Waweru
Senior Manager
Tax and Regulatory Services
KPMG Advisory Services Limited
E: swaweru@kpmg.co.ke

Alex Kanyi
Regulatory Lead
Tax and Regulatory Services
KPMG Advisory Services Limited
E: akanyi@kpmg.co.ke

home.kpmg/ke/en/home