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Tax insight

Double Tax Avoidance Agreements: The Emerging Jurisprudence in Kenya

Background

The High Court's recent decision in Commissioner of Legal Services and Board Coordination v McKinsey & Company Inc Africa Proprietary Limited ("McKinsey Kenya") is far more than any routine Withholding Income Tax (WHIT) dispute. It stands as the latest judicial affirmation that THE Kenya Revenue Authority (KRA) cannot claw back taxing rights through administrative re-characterization when the relevant Double Tax Avoidance Agreement (DTAA) does not explicitly grant those taxing rights. The judgement provides an authoritative analysis of treaty interpretation, characterization of management and professional fees and the limits of Kenya's taxing rights under the DTAA framework.

The core of the dispute concerned whether management and professional fees paid by McKinsey Kenya to its related South African entity were subject to WHIT under the Kenya-South Africa DTAA. KRA assessed WHIT on McKinsey Kenya on the basis that these payments were taxable in Kenya, as they fall under Article 22 on "Other Income" in the Kenya–South Africa DTAA, noting that the DTAA lacks a specific article dealing with management and professional fees. Conversely, McKinsey Kenya argued that the payments constituted "business profits" as prescribed under Article 7 of the Kenya-South Africa DTAA. Crucially, because the South Africa service provider had no permanent establishment (PE) in Kenya. Mckinsey Kenya maintained that Kenya lacked the requisite taxing rights over that income under the Kenya-South Africa DTAA framework. The High Court, in the recent ruling has agreed with the taxpayer and upheld the Tax Appeals Tribunal decision in favour of the taxpayer.

The significance of this judgment lies in the Court's uncompromising endorsement of purposive treaty interpretation, strictly adhering to the Vienna Convention on the Law of Treaties alongside the principles provided in the OECD and UN Model Tax Conventions and their commentaries. At the centre of this ruling, the High Court has emphasized that DTAAs are international treaties that must be interpreted purposively and in line with international tax principles, not merely through a domestic revenue mobilization lens.

Critically, the High Court also recognized that Kenya knows how to reserve taxing rights where it intends to do so. The absence of a "management and professional services" clause or service PE provision in the Kenya–South Africa DTAA was deemed deliberate. In essence, the High Court held that KRA cannot recreate taxing rights through interpretation where Kenya did not negotiate for those rights in the treaty itself.

The above decision closely mirrors the judicial reasoning applied in Commissioner of Domestic Taxes v Total Kenya Limited concerning the Kenya–France DTAA. In the Total case, the High Court similarly held that management and professional fees fall naturally within the scope of "business profits" under Article 7 of the Kenya-France DTAA and cannot be taxed in Kenya in the absence of a PE. In both instances the High Court has rejected attempts to push such management and professional fees payments into the residual treaty provisions merely because the DTAA lacks a specific article dealing with management and professional fees.

Taken together, the McKinsey and Total decisions signal a growing judicial trend towards stricter adherence to treaty allocation rules and a rejection of expansive source taxation arguments that are not supported by the treaty allocation rules.

It is equally imperative to note that the High Court recently made a decision in Nairobi Bottlers Limited v Commissioner of Domestic Taxes, limiting persons who can access the network of DTAAs that Kenya has signed with other jurisdictions. In the Nairobi Bottlers case, the High Court clarified that taxpayers cannot invoke DTAAs automatically. One must first strictly satisfy the requirements under Section 41 of the Income Tax Act (ITA), which governs the legal application of DTAAs within Kenya's domestic framework. Under Section 41, commonly referred to as the limitation of benefits (LoB) clause, for a party to access the benefits provided by a DTAA, the non-resident entity must demonstrate that it meets the strict economic substance benchmarks of either being listed in the stock exchange of the contracting state or having more than 50% of its underlying ownership held by persons who are residents of that contracting state.
The Nairobi Bottlers case is therefore a stark reminder that treaty protection itself is not automatic. A taxpayer must first demonstrate entitlement to the DTAA under section 41 of the ITA.

The emerging jurisprudence on DTAAs has effectively established a strict two-pronged approach for cross-border transactions:

- First, determine whether the non-resident entity properly qualifies for treaty access under the domestic Limitation of Benefits provisions under Section 41 of the ITA; and
- Once the treaty entitlement is firmly established, taxing rights must be strictly allocated according to the written text of the DTAA itself, without administrative overreach.

This distinction will become increasingly important as KRA intensifies scrutiny of treaty entitlement, beneficial ownership, and economic substance in cross-border transactions. The emerging jurisprudence, therefore, reflects a balancing act between two competing objectives: preserving Kenya's taxing rights on one hand while upholding the sanctity of treaty obligations on the other. The High Court has clearly stated that treaty access must first be earned under a domestic Limitation of Benefits clause, and once granted, the treaty must be applied exactly as written.

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