Tax Alert: Withholding tax on transaction fees to card companies and on interchange fees to issuing banks

Summary

This alert brings to your attention the Court of Appeal's judgment in the case of *Commissioner of Domestic Taxes* (Appellant) *vs. Barclays Bank of Kenya Ltd (now ABSA)* (Respondent). The two issues before the Court of Appeal were whether:

a) transaction fees paid by a bank to card companies are royalties and

b) interchange fees paid by an acquiring bank to an issuing bank are for management or professional services.

The Court ruled that payments made to card companies are in the nature of royalties subject to WHT. The Court also held that interchange fees qualify as management or professional services hence are subject to WHT.

Facts

Between 2012 and 2013, the Appellant demanded from the Respondent payment of WHT on transaction fees that the Respondent had paid to three card companies (Visa, Mastercard and AmEx) as well as on payments the Respondent had made to other banks (interchange fees) on account of card transactions. The demand by the Appellant was made under Section 35 of the Income Tax Act (ITA) on the basis that payments to the three card companies were royalty payments and those which it had made to other banks (issuers) were for professional or management services. It was the Appellant's argument that under Section 35 of the ITA, the Respondent ought to have withheld tax on both payments.

In response to the demand, the Respondent argued that the payments to the card companies were not royalty payments and that the interchange fees were not for any professional or management services rendered. The Respondent moved to the High Court and successfully quashed the Appellant's tax demand. The High Court in granting the orders stated that the Appellant in its demand did not demonstrate that the payments qualified as royalties or management fees.

Dissatisfied by the High Court's decision, the Appellant moved to the Court of Appeal. The Appellant argued that payments made by the Respondent to the card companies comprised of payments for use of logo, software license fees, trademark licensing and service fees which in totality were payments for the right to use the global network services. On that basis, the Appellant contended that the payments by the Respondent were for the right to use trademarks, patents and licenses which were intellectual property rights and therefore fell within the definition of royalty. Accordingly, the Respondent had an obligation to account for WHT on these payments.

On the issue of interchange fees, the Appellant argued that the payments made to other banks were made in consideration of management or professional services rendered by the issuer banks. The Appellant relied on Section 2 of the ITA on the definition of management or professional fees and submitted that the Respondent paid interchange fees as consideration for co-ordination, managerial, professional and contractual services rendered by the issuer banks.

The Respondent on the other hand argued that the payments made by the Respondent to card companies and to other banks did not constitute royalty or management and professional fees and were therefore not subject to WHT. The Respondent further argued that all it did was pay a fee to access the card companies' network and that no software licence agreements between it and the card companies had been adduced. The Respondent also argued that the trademark agreements between it and the card companies expressly provided that no royalties were payable.

On the issue of the interchange fees, it was the Respondent's contention that the payments were subsidies to incentivise issuer banks to issue the card and did not qualify as professional or management fees subject to WHT as defined under the Income Tax Act.

Issue(s) for determination

The Court of Appeal identified two issues for determination:

(a) Whether the Appellant proved that the fees paid by the Respondent to card companies constituted royalties subject to WHT within the meaning of the ITA

(b) Whether the interchange fees paid by the Respondent as an acquirer bank to an issuer bank constituted management and professional services subject to WHT

Findings

(a) Whether the Appellant proved that the fees paid by the Respondent to card companies constituted royalties subject to WHT within the meaning of the ITA

The Court of Appeal in its analysis began by reproducing the provisions of Section 2 and 35 of the ITA. It highlighted the definition of royalty in the ITA which includes *"any patent, trademark, design or model, plan formula or process."* The Court of Appeal further analysed the agreements which the Respondent had entered into with the card companies and noted that the agreements were entered into on the basis of the card companies being the holders of the trademarks and the Respondent being a licensee with the right to use the trademarks in connection with the various card programs.

The Court of Appeal further noted that the Respondent had to use the card companies' trademarks and logos for the Respondent to access and participate in any of the networks set up by the card companies. Therefore, the Court of Appeal concluded that the Respondent could not contend that the payments to card companies excluded payment of royalty for use of their trademarks and logos. In affirming its decision, the Court of Appeal held that the Appellant had demonstrated that the fees paid by the Respondent constituted in the circumstances, payment for the right to use the card companies' trademarks and logos.

The Court of Appeal in its conclusion on this issue held that the payments made by the Respondent to the card companies were royalties as defined by Section 2 of the ITA and therefore subject to WHT.

(b) Whether the interchange fees paid by the Respondent as an acquirer bank to an issuer bank constituted management and professional services subject to WHT

The Court of Appeal in its analysis of this issue concurred with the Appellant's contention that interchange fees constituted management or professional services. In reaching this conclusion, the Court assessed the totality of the evidence on record, irrespective of how the parties had described or rationalised the payment. In the court's view, there were clear co-ordination, managerial, professional and contractual services rendered by the issuer to the acquirer for which a payment was made. It was thus the Court of Appeal's decision that the payments by the Respondent in its capacity as acquirer to the issuer banks satisfied the definition of management and professional fees as defined under Section 2 of the ITA.

The Court of Appeal held that the interchange fees paid to issuer banks were for management and professional services and therefore were subject to WHT.

Our comments on the judgment

This judgment adds a twist to this long running and hotly contested dispute on the tax treatment of payments made by banks in respect of card transactions. Being a decision of a binding superior court, it will likely be relied upon by the High Court and the Tax Appeals Tribunal when deciding similar matters that are currently before them.

Though the Respondent may opt to appeal to the Supreme Court, the avenues of appeal to the Supreme Court are limited to constitutional issues and matters of general public interest. Considering the far-reaching impact of the ruling on the economy and the huge sums involved, this case might be a good public interest candidate.

Pending a successful appeal or stay of execution of this judgement, it would be wise for banks to review the implications of the ruling on their card payments and card transactions pricing models. In those instances where the banks cannot deduct the withholding tax due to net of tax contracts, it is likely that the cost will either be borne by the banks or be passed on to consumers, increasing the card transactions costs. This is likely to make card payments less competitive compared to cash and mobile money payment solutions.

In addition, the decision by the Court of Appeal on WHT on interchange fees is likely to have implications on the Value Added Tax (VAT) treatment of the services. The High Court in its decision in ***Barclays Bank of Kenya Limited vs Commissioner of Domestic Taxes [2020] eKLR*** held that no services were offered by an acquiring bank to an issuer bank in a card transaction and therefore VAT was not applicable. However, with the Court of Appeal's differing view, it is safe to say the VAT dispute is far from settled.

For the cases still in court and those likely to arise as a result of this ruling, there is an opportunity to distinguish the cases from Respondent's case to ensure that pertinent issues which have been raised before but were not fully addressed by the Court of Appeal in its current ruling are fully canvassed and resolved.

KPMG is happy to assist on any issues arising from this decision.

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