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Tax & Legal Viewpoint
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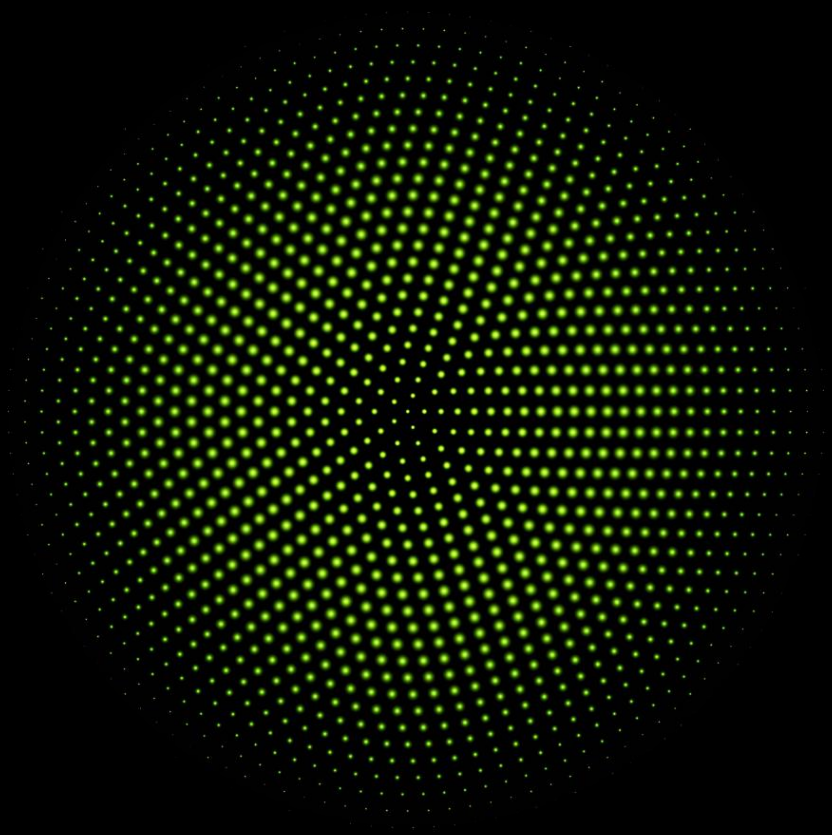


Tax Alert

The Court of Appeal ruling on payments to card companies and interchange fees

The Court of Appeal ("COA") has pronounced judgement on the applicability of withholding income tax ("WHT") in a matter pitting Absa Bank Kenya Plc (formerly Barclays Bank of Kenya) ("the Bank") against the Kenya Revenue Authority ("KRA") through the Commissioner of Domestic Taxes ("the Commissioner").

In its judgement, delivered on 6 November 2020, the COA held that WHT is applicable on transaction fees (broadly referred to as payments to card companies in the judgement) paid by acquiring and issuing banks to global credit and debit card companies, such as Visa International Card Services Association, Mastercard, Inc., and American Express Limited ("the Card Companies") on the basis that they amount to royalty payments pursuant to Section 2 of the Income Tax Act ("ITA").

Further, the COA held that interchange fees payable by acquiring banks to issuing banks constitute management or professional fees, as defined under Section 2 of the ITA, and are therefore subject to WHT in Kenya pursuant to Section 35 of the ITA.

Background

The tax dispute commenced following an audit undertaken by the Commissioner, which culminated in the issuance and subsequent confirmation of formal assessments against the Bank.

Aggrieved by the decision of the Commissioner, the Bank initiated a Judicial Review application before the High Court of Kenya in 2013 wherein it sought an order of certiorari quashing the Commissioner's demand for payment of WHT with respect to transaction fees paid to the Card Companies and interchange fees paid to issuing banks. Further, the Bank sought an order of prohibition to prohibit the Commissioner from demanding payment of WHT on transaction and interchange fees paid to Card Companies and issuing banks, respectively.

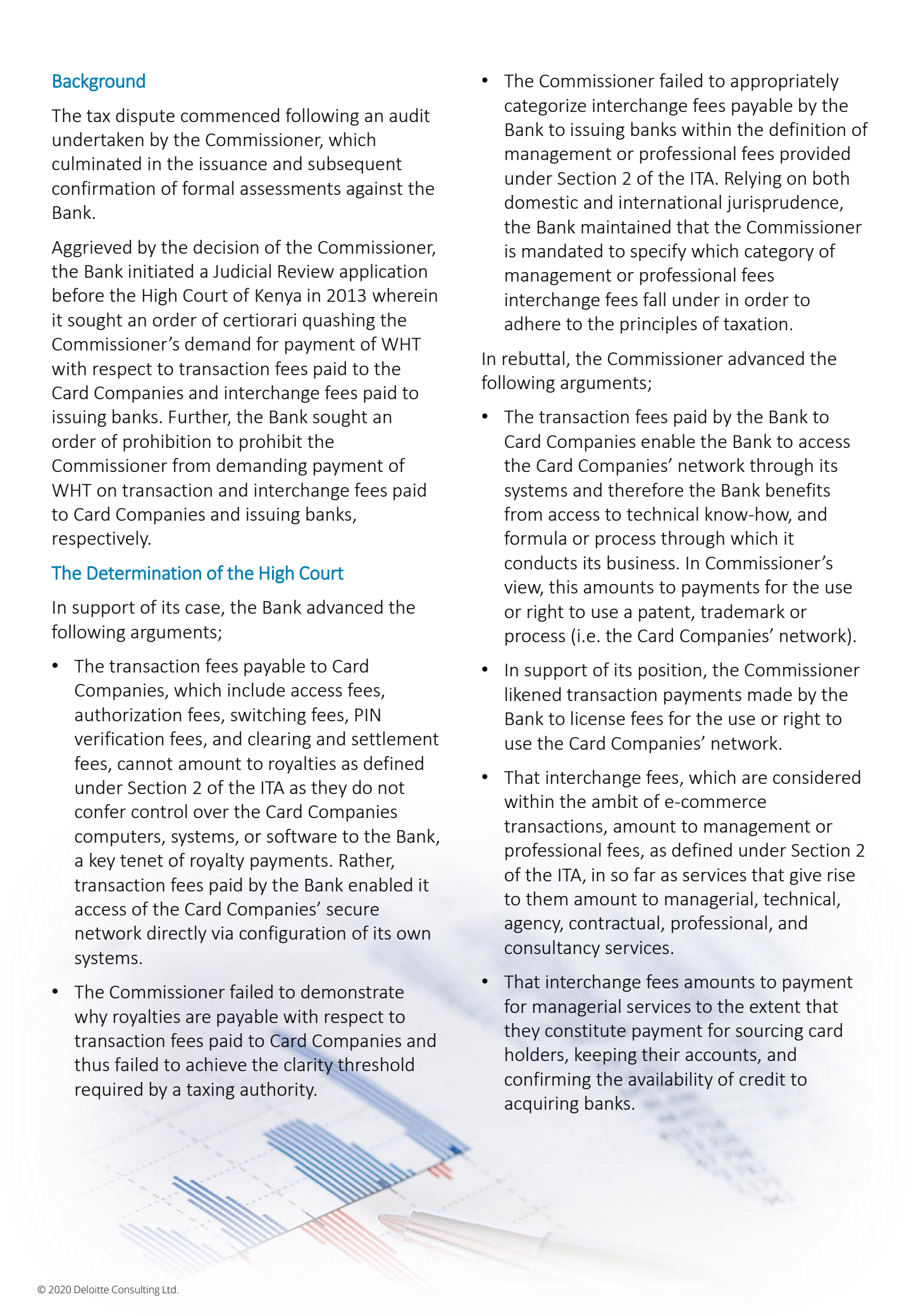
The Determination of the High Court

In support of its case, the Bank advanced the following arguments;

- The transaction fees payable to Card Companies, which include access fees, authorization fees, switching fees, PIN verification fees, and clearing and settlement fees, cannot amount to royalties as defined under Section 2 of the ITA as they do not confer control over the Card Companies computers, systems, or software to the Bank, a key tenet of royalty payments. Rather, transaction fees paid by the Bank enabled it access of the Card Companies' secure network directly via configuration of its own systems.
- The Commissioner failed to demonstrate why royalties are payable with respect to transaction fees paid to Card Companies and thus failed to achieve the clarity threshold required by a taxing authority.
- The Commissioner failed to appropriately categorize interchange fees payable by the Bank to issuing banks within the definition of management or professional fees provided under Section 2 of the ITA. Relying on both domestic and international jurisprudence, the Bank maintained that the Commissioner is mandated to specify which category of management or professional fees interchange fees fall under in order to adhere to the principles of taxation.

In rebuttal, the Commissioner advanced the following arguments;

- The transaction fees paid by the Bank to Card Companies enable the Bank to access the Card Companies' network through its systems and therefore the Bank benefits from access to technical know-how, and formula or process through which it conducts its business. In Commissioner's view, this amounts to payments for the use or right to use a patent, trademark or process (i.e. the Card Companies' network).
- In support of its position, the Commissioner likened transaction payments made by the Bank to license fees for the use or right to use the Card Companies' network.
- That interchange fees, which are considered within the ambit of e-commerce transactions, amount to management or professional fees, as defined under Section 2 of the ITA, in so far as services that give rise to them amount to managerial, technical, agency, contractual, professional, and consultancy services.
- That interchange fees amounts to payment for managerial services to the extent that they constitute payment for sourcing card holders, keeping their accounts, and confirming the availability of credit to acquiring banks.



The High Court, in its judgment of 20 May 2015, faulted the Commissioner for seeking to levy WHT on transaction fees as royalty payments where the transaction fees in question do not fall squarely within the letter of the law. Further, the Court held that the Commissioner erred by failing to identify the specific subsets of management or professional fees that interchange fees payable by the Bank to issuing banks fall under.

With reference to both domestic and international jurisprudence, the judgment of the High Court upheld the principles of clarity and certainty with respect to tax legislation and found in favour of the Bank.

The Court of Appeal Decision

In its ruling delivered on 6 November 2020, the COA overturned the decision of the High Court.

The COA held that both transaction fees and interchange fees ought to be subjected to WHT in Kenya as royalty payments and management or professional fees, respectively.

Specifically, the COA held that:

- The definition of royalties per Kenyan tax legislation was wide and without ambiguity, and appropriately captured transaction payments made by the Bank to Card Companies.
- The transaction fees afforded the Bank the use of the Card Companies' trademarks and logos through which it gained access to the Card Companies' network for the benefit of its business, therefore falling squarely within the confines of royalty payments.
- The interchange fees paid by the Bank to issuing banks fell within the ambit of management or professional fees and was therefore subject to WHT in Kenya. The COA was of the view that services provided by acquiring banks that give rise to interchange fees encompass all aspects of management or professional fees including managerial, technical, agency, contractual, professional, and consultancy services which are subject to WHT in Kenya pursuant to Section 35 of the ITA.

Implications of the Court of Appeal Decision

In the absence of a successful appeal, this decision establishes precedence on the applicability of WHT on payments made to Card Companies and interchange fees. Banks will be expected to account for WHT on all the payments that fall within these categories going forward with a possibility of the KRA reopening past periods subject to the statute of limitation clause (currently 5 years).

Besides WHT, this decision might have far reaching consequences on applicability of Value Added Tax ("VAT") on payments made to Card Companies and interchange fees. Previously the High Court held that interchange fee is a payment charged for money transfer service to its customers (and not a distinct service) and therefore it is exempt from VAT.

There has been recent decisions in favour of this view at the Tax Appeals Tribunal ("TAT"). The decisions have been appealed before the High Court. Unless the facts are materially different, the decisions at the High Court are likely to be highly skewed towards the COA ruling.

Perhaps based on the fact that this is a complex area as noted in the TAT Appeal No 114 of 2015, it is opportune timing for the taxman and the affected taxpayers to engage under the Alternative Dispute Resolution ("ADR") framework to resolve the disputes outside the Court, and possibly, mutually agree on a practical solution going forward especially on the specific categories of transaction fees that should be subject to WHT.

Our view

While clarity with respect to this issue in the form of a conclusive determination from the Courts is welcome, it is noted that the ruling sets a "somewhat" unfortunate precedent on both issues based on the following broad observations;.

- In arriving at the conclusion that the transaction fees falls within the ambit of royalties, the COA appears to have placed significant weight on the use of branded cards to access network and equated it to the use of a trademark. In our view, the question of whether the transaction fee was a mere charge in relation to the financial services offered was not adequately addressed. This gap increases the risk in a myriad of transaction related charges across various sectors within the ambit of WHT;
- The COA did not dive into the principle of certainty, the basis in which the High Court had ruled in favour of the Bank.

Imposition of WHT may negatively impact affordability of accessing financial services in Kenya. This is premised on the fact that the WHT, applicable at a considerably high rate of 20% with respect to payments made to non-resident Card Companies, is likely to be passed to the final consumers of the financial services

This comes at a time when Kenya, and the world at large, is banking on growing cashless transactions. In addition, Kenya is also grappling with deepening financial inclusion. To achieve the aforementioned as well as other objectives, we opine that there is need to ensure that the cost of accessing financial services is significantly lower. We believe that this was one of the major reasons that informed exemption of financial services under the VAT Act, a practice across various jurisdictions in the world.

Based on the above, we recommend legislative interventions to explicitly exempt interchange fees and payments made to card companies from the ambit of WHT and VAT. This is particularly key, noting the prominent role that is expected to be played by banks and Card Companies in the legislature's efforts to capture transactions in the digital economy. The anticipated role of banks and Card Companies in collecting revenues from transactions in the digital space would positively benefit from reduced transaction costs.

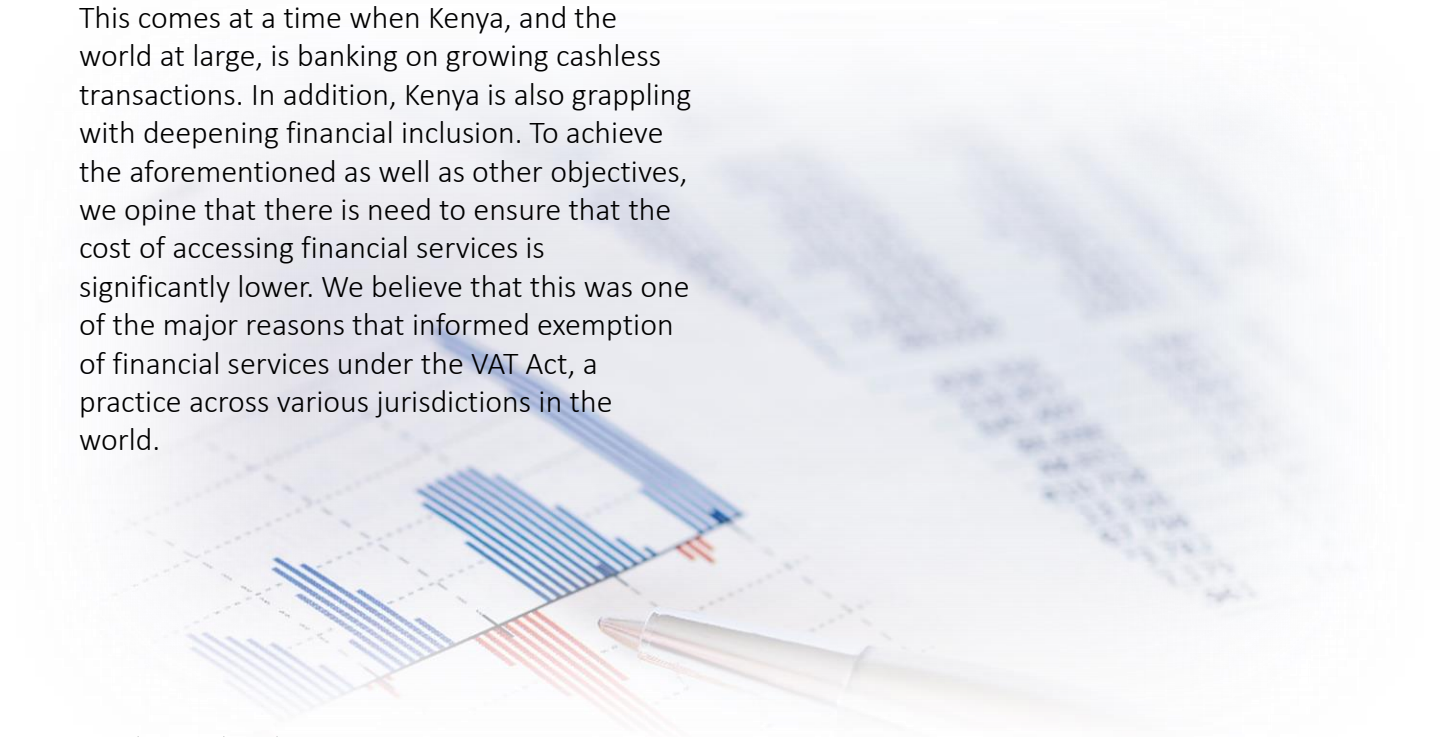
Conclusion

Despite the limitations on matters that may be canvassed before the Supreme Court, we note the public interest nature of the matter, may afford the Bank leeway in having the matter admitted for appeal by the Supreme Court.

In absence of a successful appeal, the current decision is precedent setting and the lower courts are bound to stick by it in line with the doctrine of "stare decisis".

That said, we note that there is need to relook at the implications and address the gaps in the legislation.

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.



Contacts for this viewpoint:

Fred Omondi
Tax & Legal Leader, Deloitte East Africa
fomondi@deloitte.co.ke

Lilian Kubebea
Tax & Legal Partner
lkubebea@deloitte.co.ke

Walter Mutwiri
Tax & Legal Partner
wmutwiri@deloitte.co.ke

Patrick Chege
Associate Director
pchege@deloitte.co.ke

Maurice Lugongo
Senior Manager
mlugongo@deloitte.co.ke

Fredrick Kimotho
Manager
fkimotho@deloitte.co.ke

Kimutai Kandie
Consultant
dkandie@deloitte.co.ke