

Kenya's Court of Appeals rules that withholding tax is due on payments to card companies and interchange fees

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Executive summary

The Kenya Court of Appeals (COA), on 6 November 2020, ruled on an eight year tax dispute between a Kenyan Bank (the Bank/the Respondent) and the Kenya Revenue Authority (KRA/the Appellant) with respect to the nature of certain services between parties involved in card transactions and the applicability of withholding tax (WHT) on payments made for these services. Specifically, the case dealt with payments to credit card companies and payments to banks that issue debit and/or credit cards.

The Appellant held that payments to card companies constitute royalties while payments to issuing banks by acquiring banks in the form of interchange fees fell within the definition of professional and management fees. Both types of payments were therefore subject to WHT under the *Kenya Income Tax Act* (ITA).

The COA ruled in favor of the Appellant on the applicability of WHT on both types of payments to card companies and issuing banks.

This Alert summarizes the COA's Decision.

Detailed discussion

Background

The Bank, which is a limited liability company licensed to carry on banking business in Kenya, is a member of networks created by three international card companies (card companies).¹ Membership to these networks allows the Respondent, as an acquiring bank, to offer and process card payment services for goods and services purchased from specific merchants.

The Bank was required to pay an access fee to the card companies for accessing their networks in order to process card payments. The Bank had signed agreements with the respective card companies and two of the agreements expressly indicated that the right to use the trademark/license was royalty free. The third agreement was, however, silent as to whether a royalty was payable or not.

Several parties are involved in a card transaction among them being an acquiring bank and an issuing bank. An acquiring bank is the bank that offers and processes card payment services. The issuing bank is the cardholder's bank. An interchange fee is payable by an acquiring bank to the issuing banks for among other things approving the credit status of the cardholder thus ensuring that the acquiring bank is able to process the payment. The Respondent as an acquiring bank had paid interchange fees to various issuing banks in Kenya.

Following an audit that was conducted by the Appellant on the Banks' operations, the Appellant assessed and demanded WHT from the Respondent on payments made to the card companies as well as on interchange fees paid to issuing banks on the grounds that they fell under the definition of royalties and professional and management fees respectively.

The Respondent on its part opined that the payments did not constitute a royalty or a management and professional fees and were thus not subject to WHT. The Respondent applied to the High Court of Kenya for a judicial review. The application was heard, and the High Court quashed the demand and stopped the Appellant from demanding the said taxes.

Accordingly, the Appellant then submitted an appeal to the COA.

The issues for determination were whether:

1. Payments made to card companies constituted a royalty for which WHT was due;
2. Interchange fees constituted payment for management and professional fees which were subject to WHT.

The Appellants' position

Payments made to card companies

The KRA contended that:

- i. There was a contractual relationship between the Bank and the card companies which granted the bank the license to use the card companies' trademarks.
- ii. Royalties are not confined to payments made for tangible items such as design, model, plan and formula but it also encompasses payments for intangible items such as consideration for the use of or the right to use a patent, trademark or process.
- iii. The payments made by the Bank to the card companies comprised payments for use of a logo, trademark licensing and service fees.
- iv. Therefore, payments to the card companies fell within the definition of royalty as defined in the ITA.

Interchange fees paid to issuing banks

The KRA contended that:

- i. Interchange fees paid by the Bank to issuing banks fell within the definition of management and professional fees.
- ii. Payments in e-commerce transactions for sale of services in a virtual environment constituted management or professional fees.

The Respondent's position

Payments made to card companies

The Respondent's position was:

- i. The Appellant had failed to precisely identify which specific service under the ITA justified the payment of WHT.
- ii. The terms "formula" and "process" as referred to in the ITA with respect to a royalty did not apply to the payment made by the Bank to the card companies. These terms imply something tangible and identifiable and the appellant failed to demonstrate what formula or process the card companies provided the Respondent with.
- iii. The Appellant had not submitted any evidence for a software agreement or software license between the Respondent and the card companies.

- iv The clearing, settlement and payment functions were performed by the card companies. The Respondent merely paid an access fee to the network without involving a software license.

Interchange fees paid to issuing banks

The Respondent contended that:

- i The Appellant failed to demonstrate how interchange fees constitute management or professional fees.
- ii Management or professional fees as defined in the ITA includes payment for varying types of services and Appellant did not specify which category of service the interchange fees related to.
- iii Interchange fees were a balancing mechanism and an incentive to the issuing banks as opposed to management or professional fees.
- iv No agency relationship was proven between the Bank and the card payments.

COA's Decision

Whether payments made to card companies constitute a royalty subject to WHT

The COA ruled that the transaction fees payable to the card companies constituted a royalty. In arriving at the ruling, the COA observed that the Bank had to make use of cards bearing a logo or trademark of a particular card company in order to access the network of the specific card company. It is only through access to the network of the card company that the Bank was able to provide and facilitate card payments.

Whether interchange fees paid by acquiring banks constitute management fees subject to WHT

While noting that the definition of professional and management fees in the ITA comprises several services including managerial, technical, agency, contractual or consultancy services, the COA stated that a service does not necessarily have to fall within one category only.

A service can cut across one or more services. The COA ruled that the services that are provided by issuing banks to the Respondent comprised of coordination, managerial, professional, and contractual services which are subject to WHT in accordance with the ITA.

Next steps

The judgment raised significant principles that banks and taxpayers in general should put into consideration when interpreting tax statutes and their dealings with the KRA. These are:

- i. The importance of the principle of substance over form - the nature or presence of a service should not be merely based on the terms of written agreements. Reference should be made to the terms of the statute, the written agreements and the totality of the relationship between the parties including the actual dealings between the parties.
- ii. Taxpayers should be wary of judgments made by lower Courts in favor of a taxpayer due to perceived deficiencies in the description of the issue before the Court as opposed to the merits of the tax principle being enunciated by the parties to the case.
- iii. Whereas tax legislation must be construed strictly, the construction must be reasonable based on the text of the statute and the circumstances of each case.
- iv. Management and professional fees do not have to fall within only one of the services defined in the ITA, they can cover one or more of the services listed under the definition.
- v. The description or rationalization of a payment by a taxpayer cannot be the sole basis of determining the applicability of WHT.
- vi. Where there is ambiguity in the legislation, the same must be construed in favor of the taxpayer. Conversely, where the meaning of legislation is clear, courts will give effect to the law.

Endnote

1. Visa International Services Association, MasterCard, Inc., and American Express Limited. Membership.

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