

Credit Card Transactions

TDS Applicable on Service Fees

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An Article on:

Whether merchants are required to deduct tax at source u/s 194h on service fees retained by bank on credit card transactions

A. Introduction

In this era, credit card has become a need for the people in their daily routine. It is a commonly used financial tool. Engaging in any financial activity will involve credit cards in one way or the other. In the credit card transaction, the benefit to merchant is that it is more secure than other forms of payment, such as cheques, because the issuing bank commits to pay the merchant the moment the transaction is authorized, regardless of whether the consumer defaults on the credit card payment except for legitimate disputes, which can result in charges back to the merchant. For this, it is usually charged a service fees/discount/merchant discount rate (MDR)/commission of around 1% to 3% of the value of each transaction paid for by credit card. The benefit to the card holder is that it allows them small short-term loans & more fraud protection. The cost to them is that they are to pay the fees & interest to the credit card issuing bank.

B. Credit Card Processing

- (i) A customer on purchase of goods makes payment to merchant by different credit cards like Master Card, Visa Card, Diners Card, American Express Card etc. Various bankers are the processor and members of these cards. For this purpose, they install an electric capture terminal at the premises of the merchant where the card is swapped.
- (ii) The merchant on receipt of credit card from its customers swaps the same on the electronic capture terminal after verification of all the details. On swapping the card, the swapping machine print out the credit slips. This slip indicating the amount of sale is signed by the customer. At the end of the day, the batch total of all the transaction on the specific card swap machine is taken out. This along with the signed credit slip is sent to the bank for collection. The bank after deducting certain amount named as service fees/discount/merchant discount rate (MDR)/commission makes the payment to the merchant.

C. Issue

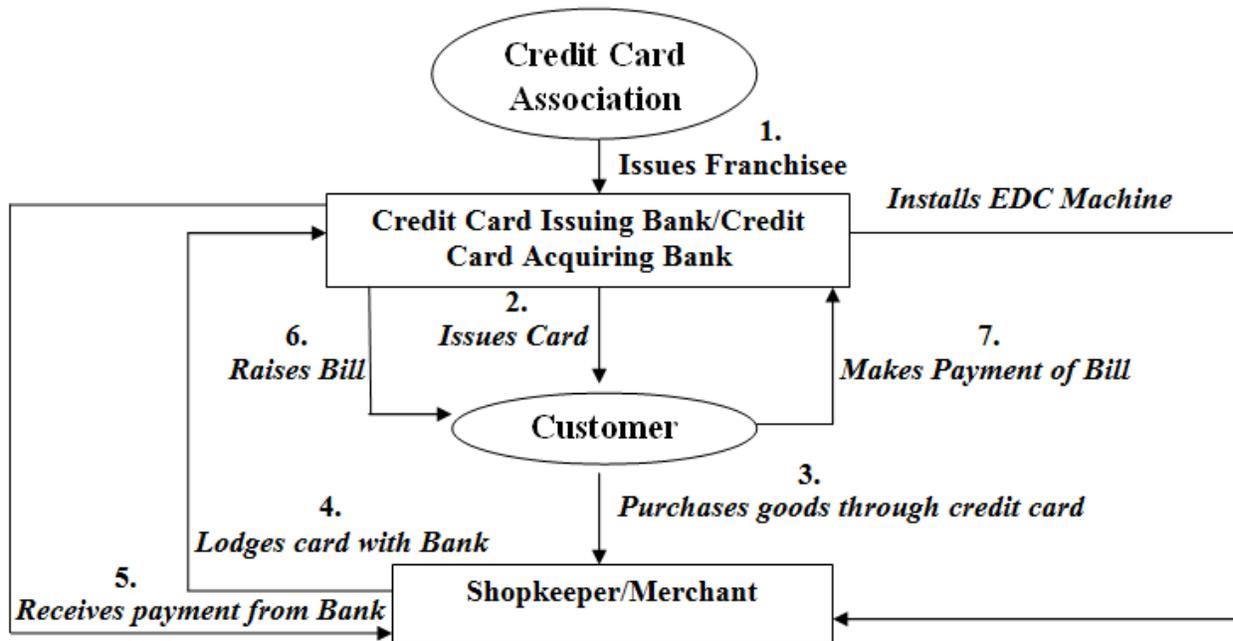
The taxing authorities are holding that the service fees/discount/merchant discount rate (MDR)/commission retained by the bank is payment of commission by merchant liable for deduction of tax at source u/s 194H. The reasons for the same are as under:-

- (i) Agreements entered by the acquiring bank with the merchants/shopkeepers for establishing the EDC machine shows that these banks are providing acquiring services/payment processing services to the shop keepers for which they are charging sales commission fees/service fees/merchant discount rate from the shop keepers. Therefore, there is an agreement between the bank, shopkeepers and card issuing concern. The acquiring bank therefore exchanges funds with the issuing banks on behalf of the merchant.
- (ii) Merchant authorizes the bank to act for him in business dealings with the customers & the bank represents the merchant by deriving his power & authority to collect the money from the customers & also to deal with the card associations/card issuers.
- (iii) Acquiring bank is acting on behalf of the merchant because the contract is between the merchant & the bank & not between the card holder & bank.
- (iv) Reference to the various clauses of the agreement between the merchant & the acquiring/issuing bank particularly the clauses relating to settlement of credit card transaction & chargebacks shows that the merchant is responsible for the unrealized amount from the customers.

D. Analysis

- (i) For deciding the nature of service fees/discount/merchant discount rate (MDR)/commission retained by the bank in respect of credit card transactions, the parties involved in the transaction & the terminology used in such transactions needs to be understood.

The parties involved in the transactions can be better understood from the following diagram:



Credit Card Issuing Bank/ Credit Card Acquiring Bank thus converts the credit card into functional currency & makes payment after retaining service fees/ discount/MDR/commission. It raises bill on the customer & collects payment from him

- (ii) The role of each of the parties involved in the credit card transactions is as under:

Credit Card Association (CCA):

An association of card-issuing banks such as Discover, Visa, Master Card, American Express, etc. that set transaction terms for merchants, card-issuing banks, and acquiring banks. Thus, CCA is providing platform for credit card operation and access to server to credit card issuing bank. In other word CCA is issuing franchisee for issue of the credit card under the title of Master Card/ Visa Card.

Credit Card Issuing Bank:

The financial institution or other organization that issues the credit card to the cardholder. This bank bills the consumer for repayment and bears the risk that the card is used fraudulently. Thus, these banks represent the individual card holders during credit transactions. In exchange for taking on the risk of representing the customer, they profit from interchange fees charged to merchants with every transaction as well as interest payments and fees from their card holders. It is having franchisee arrangement with CCA.

Credit Card Acquiring Bank:

The financial institutions accepting the payment for the products or services on behalf of the merchant. It installs the EDC (Electronic Data Capture) Machine at the shop keeper's premises. They act as the middleman between merchants and issuing banks. They receive all credit card transactions from card-issuers, and present all payments in a time period to the merchant. In exchange, the acquiring bank charges merchants a fixed amount for its services, as well as a variable sum dependent on the volume of the merchant's sales. The Credit Card Issuing Bank and the Credit Card Acquiring Bank can be same bank or different.

Shopkeepers/Merchants:

The individual or business accepting credit card payments for products or services sold to the cardholder. Thus, it is the person who sale goods to the customer against the credit card. Shopkeeper receives the payment of sale proceeds from Credit Card Acquiring Bank.

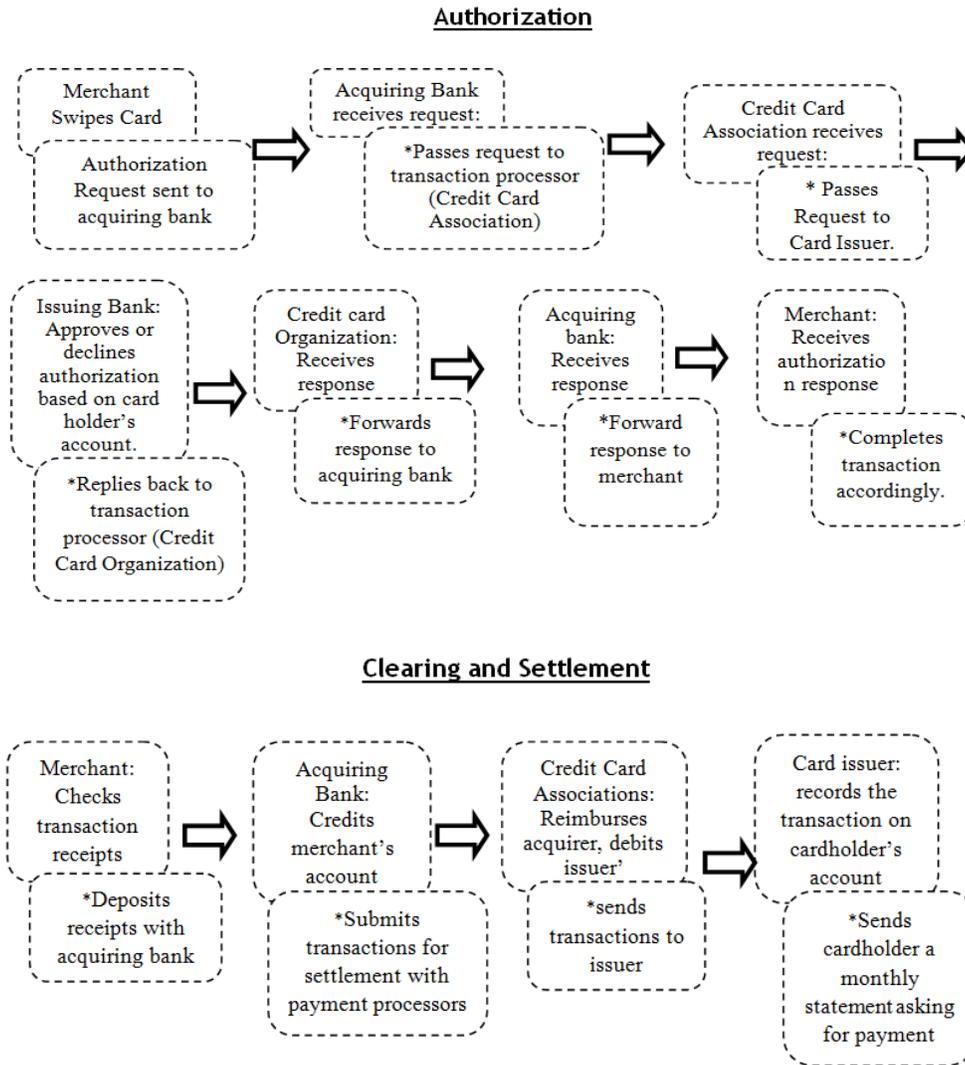
Customer:

He is a credit card holder and purchases the goods through credit card. The credit card is issued to him by the card issuing bank.

(iii) The credit card transactions takes place in the following manner:

- **Authorization:** The cardholder presents the card as payment to the merchant and the merchant submits the transaction to the credit card acquiring bank. The acquiring bank verifies the credit card number, the transaction type and the amount with the credit card issuing bank and reserves that amount of the cardholder's credit limit for the merchant. An authorization will generate an approval code, which the merchant stores with the transaction.
- **Batching:** Authorized transactions are stored in "batches", which are sent to the credit card acquiring bank. Batches are typically submitted once per day at the end of the business day. If a transaction is not submitted in the batch, the authorization will stay valid for a period determined by the issuer, after which the held amount will be returned to the cardholder's available credit.
- **Clearing and Settlement:** The credit card acquiring bank sends the batch transactions through the credit card association, which debits the credit card issuing bank for payment and credits the credit card acquiring bank. Essentially, the issuer pays the acquirer for the transaction.
- **Funding:** Once the credit card acquiring bank has been paid, it pays the merchant. The merchant receives the amount totaling the funds in the batch minus either the "discount rate," "mid-qualified rate", or "non-qualified rate" which are tiers of fees the merchant pays the acquirer for processing the transactions.
- **Chargebacks:** A chargeback is an event in which money in a merchant account is held due to a dispute relating to the transaction. Chargebacks are typically initiated by the cardholder. In the event of a chargeback, the issuer returns the transaction to the acquirer for resolution. The acquirer then forwards the chargeback to the merchant, who must either accept the chargeback or contest it.

The authorization & the clearing & settlement of credit card transactions can be better understood by the following diagram:



(iv) If we analysis the transaction amongst the above parties from the point of view of prevailing card in the market, position emerges as under:

- In respect of Amex/ diners club card, there is only one party who function as CCA, credit card issuing bank as well as credit card acquiring bank. Both these cards are issued and monitored by the respective banks and they themselves are making the payment to shopkeepers/merchants and collect the payment from customers. Thus in these two credit cards, there are only three parties i.e. customer, shopkeeper and the credit card issuing bank. All the three parties work independently. No one is agent of another.
- In respect of Master Card/ Visa Card, CCA is allowing platform for credit card operation to credit card issuing bank. These master/Visa card are universally accepted and functions like plastic money. Credit card issuing bank issues the credit card, raises the bills on customers, collects the payments from customer and make the payment to shopkeepers/merchants. Sometime credit card issuing bank as well as credit card acquiring bank is the same and some time they can be independent parties. But in any case both these parties are functioning independently vis a vis the merchant/shopkeepers. If Credit Card Issuing Bank and Credit Card Acquiring Bank are different person, they settle their account at their own as per their internal understanding. Shopkeepers/ merchant is not at all concerned whether they are one person or different person as he is concerned only with the bank who installed EDC machine at his premises.

(v) If all the above transactions is seen in light of the transaction undertaken by the merchant firm, the following position emerges:-

- The merchant firm is selling the goods on the basis of credit cards.
- The merchant is accepting credit cards as plastic currency and get the same converted into currency from the banker who has installed EDC machine at his premises
- The merchant firm has no concern with CCA or credit card issuing bank if issuing bank is different person than acquiring bank.
- The amount deducted by the bank for converting the plastic currency into functional currency is collection charges similar to bill discounting charges commonly named as service fees/discount/merchant discount rate (MDR)/commission by different credit card acquiring banks.
- The Credit Card Issuing Bank/Acquiring Bank is not the agent of the shopkeeper/merchant for collection of the debt arising on sale of goods to the customer on the basis of the credit card. The merchant is not concerned when the banker realizes the payment from the customer or from where it gets the funds. The issuing bank commits to pay the merchant the moment the transaction is authorized, regardless of whether the consumer defaults on the credit card payment except for legitimate disputes, which can result in charges back to the merchant

E. Conclusion:

(i) The provisions of section 194H reads as under:

“Any person, not being an individual or HUF, who is responsible for paying, on or after the 1st day of June, 2001, to a resident, any income by way of commission (not being insurance commission referred to in section 194D) or brokerage, shall, at the time of credit of such income to the account of the payee or at the time of payment of such income in cash or by the issue of a cheque or a draft or by any other mode, whichever is earlier, deduct income tax thereon at the rate of ten percent.

Explanation (i) “Commission or brokerage” includes any payment received or receivable, directly or indirectly, by a person acting on behalf of another person for services rendered (not being professional service) or for any services in the course of buying or selling of goods or in relation to any transaction relating to any assets, valuable articles or things, not being securities;”

From the above definition, it can be noted that for falling under this section the recipient of income should act on behalf of another person for services rendered. In the present case, as explained in earlier Paras, the acquiring bank who makes payment to the shopkeeper does not act on behalf of the merchant/shopkeeper. It works independently for which it retains certain fees/charge for the services rendered by it to the shopkeeper for converting credit card into functional currency. Therefore, service charges retained by the bank are not a payment of commission or brokerage by the shopkeeper.

(ii) The view taken/interpretations given by the taxing authorities can be countered as under:

- The acquiring bank and the issuing bank can be the same bank where the question of exchange of funds would not arise. The funds are ultimately realized by the acquiring/issuing bank from the customers. The realization of the funds from the customer is not on behalf of the shop keeper. Had it been so, the bank would have recovered the unrealized amount of customer from the shopkeeper. This is not the case in the present situation.
- Authorized transactions are stored in "batches" by the merchant which are sent to the credit card acquiring bank. On receipt of the same, the credit card acquiring bank credits the merchant account & submits the transaction for settlement with the payment processor. Thus, the acquiring bank does not act on behalf of the merchant but act independently as one of the party to the entire credit card transaction mechanism.

- The contract between the merchant & card acquiring bank is to honor & settle the valid credit card transactions. There is separate agreement between the credit card issuing bank & the customer. The issuing bank represents the individual card holders during credit transactions. Both these agreements are independent agreements. In terms of the agreement between the merchant & the card acquiring bank, the merchant gets the payment against the credit card accepted by it from the customers & for such service he pays service charge/commission to the acquiring bank. In terms of the agreement between the card issuing bank & the customer, the issuing bank collects the payment from the customers & for this customer has to pay charges to the issuing bank for obtaining the card & interest for delayed payment.
- In terms relating to settlement of accounts/chargebacks there is no condition that the merchant will be responsible for the unrealized amount from the customers. In fact as per the scheme of credit card transactions, the acquiring/issuing bank has to honor the valid credit card transactions & even if the amount is not realized from the customers it is a loss to the acquiring/issuing bank & not of the merchant. So far as chargebacks are concerned, it is an event in which money in a merchant account is held due to a dispute relating to the transactions which are initiated by the cardholder. In the event of a chargeback, the issuer returns the transaction to the acquirer for resolution. The acquirer then forwards the chargeback to the merchant, who must either accept the chargeback or contest it. In fact the following conditions of **Para 7 of the Agreement with Andhra Bank** clearly depicts that bank does not act as an agent of the merchant.
 - The merchant undertakes to submit the valid sales draft on a day to day basis with a maximum period of 3 days from the date of transaction to the designated branch of the bank & the bank undertakes to purchase the said sales draft at a discount rate of%.
 - If the sales draft is received by the bank after the 3rd day & before the 15th day from the date of transaction, the same will be accepted on collection basis only & merchant will be paid the amount covered by the sales draft less discount after the amount is received from the card holder/issue of card.
 - It is agreed by both the parties that obligation to collect the amount of sales draft representing the transaction by the card holder shall be upon the bank
 - In no case sales draft submitted after 15th day from the date of transaction will be accepted even on collection basis

(iii) From the above, it can be noted that the charges paid by the merchant to the bank is most akin to collection charges or discounting charges. It is like a bank charges which does not fall within the ambit of the provisions of deduction of tax at source. The CBDT in Circular No. 65 dated 02-09-1971 has clarified that where the supplier of goods makes over the usance bill/hundi to his bank which discounts the same and credit the net amounts to the suppliers account straightway without waiting for realization of the bill on due date, the property in the usance bill/hundi passes on to the bank and the eventual collection on the due date is a receipt by the bank on its own behalf and not on behalf of the supplier. For such case of immediate discounting the net payment made by the bank to the supplier is in the nature of a price paid for the bill. Such a payment can't technically be held as including interest and, therefore, no tax need be deducted at source from such payments by the bank.

From this circular it can be noted that when bills are discounted, bank acts on its own behalf and not on behalf of others. Similar is the situation in present case. Here the Credit Card acquiring/issuing bank makes payment to the shop keeper immediately. The eventual collection on the due date is a receipt by the bank on its own behalf and not on behalf of the shop keeper/card issuing association. Hence the amount of charges retained by the bank is not a payment of commission by the shopkeeper to the banker.

(iv) In case of **Ahmedabad Stamp Vendors Association Vs. Union of India (2002) 257 ITR 202 (Guj.)** [See also Kerala State Stamp Vendors Association Vs. Office of the Accountant General (2005) 150 Taxman 30 (Ker.)], it was held that the definition of "commission or brokerage" in the Explanation (i) to section 194H is not so wide as to cover any payment receivable, directly or indirectly, for services rendered or for any service in the course of buying or selling of goods. The element of agency is essential to attract

Explanation (i) to section 194H. Hence, discount given by the Government to licensed stamp vendors on sale of stamp paper to them, is not "commission" or "brokerage" u/s 194H. In present case also, there is no agency relationship between the merchant i.e. merchant & card acquiring bank & therefore section 194H is not attracted.

- (v) **Hon'ble Jaipur Tribunal Bench in case of & M/s Gems Paradise in ITA No. 746 & 841/JP/11 for A.Y. 08-09** decided this issue in assessee's favour by giving the following findings vide **Para 27** of its order dt. **02.02.2012**:

"Section 194H is applicable where any commission has been paid by the Principal to the commission agent. This is not a case of commission agent as assessee sold its goods through credit card & on presentation of bill issued against credit card, the bank makes payment to the assessee after deducting agreed fees as per terms & conditions in case of credit card. This is not a commission payment but a fees deducted by the bank. If there is an agreement, that is agreement between the credit cardholder & the bank. Bank is a Principal & to spread over its business, a scheme is floated by bank i.e. issuance of credit cards. Bank issues credit card to various customers who purchases various credit cards on the agreed terms & conditions. One of the major condition is that if credit card holder does not make payment within the prescribed time limit, then they charge 2% penal amount of bill which is raised by the shopkeeper against the sale of its items through credit card. Bank cannot refuse the payment to the shopkeeper who sale their goods through credit card. Only in those cases, where goods are found damaged & credit card holder inform the bank that the material purchased by them is damaged or defective & request the bank not to make the payment, in such cases only bank can withhold the payment, otherwise the bank has to make the payment to the shopkeeper. Therefore, in our considered view, there is no such relation between the bank & the shopkeeper which establishes the relation of a Principal & Commission Agent. Technically, it may be written that bank will charge certain percentage of commission but this is not a commission because assessee sells its goods against credit cards, & on presentation of bills, the bank has to make the payment. It is not the case that bank has advised the assessee to sell their goods to its customers then he will pay the commission. It is reversed in a situation as bank issued credit cards to the credit card holders on certain fees or whatever the case may be & the card holder purchases material from the market through his credit cards without making any payment & that shopkeeper presents the bill to the bank against whose credit card the goods were sold & on presentation of bill as stated above the bank makes the payment. Therefore, in our considered view, provisions of section 194H are not attracted in this type of transaction."

- (vi) In **Notification No. 56/2012 dt. 31.12.2012**, the Central Government in exercise of the powers conferred by sub-section (1F) of section 197A has notified that no deduction of tax under Chapter XVII is to be made on the payments towards credit card or debit card commission for transaction between the merchant establishment & the acquirer bank in case such payment is made to a bank listed in Second Schedule of RBI Act, 1934 excluding a foreign bank. This notification is made effective from 01.01.2013. Therefore, a question may arise whether on payment made prior to 01.01.2013, there is a liability for deduction of tax at source on the credit card commission. It may be noted that section 197A(1F) is inserted by Finance Act 2012 w.e.f. 01.07.2012. Prior to this there was no power given to notify specified payment as not liable for TDS. The notification dt. 01.01.2013 should therefore be construed as clarifying the law as it was already existing. The notification has not specified that payment of credit card commission was liable for TDS under any specific section under Chapter XVII & now exemption is given u/s 197A(1F). This notification has even specified that no tax is to be deducted on payment of bank guarantee commission on which no tax at source was otherwise being deducted by any person. Therefore, on the basis of this notification, the Department should not take a view that prior to the date of notification, credit card commission was liable for deduction of tax at source.

(vii) Reliance is further placed on following cases:

ACIT Vs. Jet Airways (India) Ltd. (2014) 146 ITD 682 (Mum.) (Trib.)

Payments made to banks on account of utilization of credit card facilities would be in the nature of bank charges and not in the nature of commission within the meaning of sec.194H.

Marudhar Hotels (P) Ltd. Vs. JCIT (2013) 92 DTR 33 (Jd.) (Trib.)

Assessee has entered into an agreement with a service provider bank to avail credit card acquiring services for collection of receipts from the customers using credit cards at assessee's hotel. Assessee only receives the net amount from the bank i.e. amount charged from the card holders less bank charges for the credit card facility. It was held that credit card acquiring fees is not credited to the account of bank in the assessee's books. Therefore, assessee has no obligation to deduct tax at source u/s 194H. Consequently, credit card acquiring fee cannot be disallowed u/s 40(a)(ia).

Tata Teleservices Ltd. Vs. DCIT (2013) 140 ITD 451 (Bang.)(Trib.)

Assessee had arrangement with several banks whereby customers of assessee, who also held credit card of such banks, could make payment for communication services utilized by them from assessee through credit card. Revenue authorities opined that fee retained by bank was in nature of commission and, therefore assessee ought to have deducted tax at source on such payment. It was held that payments to banks on account of utilization of credit card facilities would be in nature of bank charges and not in nature of commission within meaning of sec.194H.

In view of above, the amount retained by the acquiring bank as service fees/discount/merchant discount rate (MDR)/commission is not a payment of commission by the merchant & therefore section 194H is not attracted.

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