Commissioner of Domestic Taxes v Bank of Africa Limited (Civil Appeal E127 of 2020) [2023] KEHC 1036 (KLR) (Commercial and Tax) (17 February 2023) (Judgment)

Neutral citation: [2023] KEHC 1036 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

CIVIL APPEAL E127 OF 2020

EC MWITA, J

FEBRUARY 17, 2023

BETWEEN

COMMISSIONER OF DOMESTIC TAXES ..... APPELLANT

AND

BANK OF AFRICA LIMITED ..... RESPONDENT

(Appeal from the decision of the Tax Appeals Tribunal dated September 18, 2020 in Tax Appeal No 319 of 2018, Bank of Africa Limited v Commissioner of Domestic Taxes)

JUDGMENT

Introduction

1. This appeal arises from the decision of the Tax Appeals Tribunal (TAT) dated September 18, 2020 in TAT No 319 of 2018. The TAT allowed an appeal by Bank of Africa Limited (Bank of Africa) against VAT tax assessment by the Commissioner of Domestic Taxes (the Commissioner).

Background

2. On June 12, 2018, the Commissioner issued a tax assessment of Kshs 87,729,030 for undeclared VAT on payments made to card companies and for marketing and management services offered to both the merchants and acquiring banks for the period January 2013 to December 2017. This followed a review of tax affairs of Bank of Africa on its financial services to ascertain the bank's level of compliance with tax obligations. Bank of Africa objected to the assessment through a notice of objection dated July 10, 2018 contesting that entire assessment.

3. The Commissioner issued an objection decision dated September 5, 2018, amended the assessment and reduced the assessed VAT on interchange fees to Kshs 15,158,378. On September 25, 20178 the Commissioner provided calculations on how the assessment had been arrived.

4. Bank of Africa lodged an appeal before the TAT on October 4, 2018 and issued a decision dated September 18, 2020. The TAT allowed the appeal holding that the Commissioner erred by introducing a new assessment in the objection decision where the amended assessment Bank of Africa named as an issuer and Interchange fees was a new issue which denied Bank of Africa sufficient time to consider the assessment. This was due to the fact that the Commissioner provided workings on the assessment on September 25, 2018, three weeks after the objection decision had been issued. The TAT further held that interchange fees is not subject to VAT.

5. Regarding the tax shortfall penalty of 20% slapped on the Bank of Africa, the TAT held that the tax shortfall penalty under section 84 of the *Tax Procedures Act* was not applicable since the Commissioner did not demonstrate that Bank of Africa knowingly made a false or misleading statement. The assessment was set aside.

Appeal to this Court

6. The Commissioner was dissatisfied with the decision by the TAT and filed a memorandum of appeal dated November 13, 2020, raising 8 grounds, namely:

    1. That the Tribunal erred in law and fact in stating that interchange fee is a compensation paid by the acquirer to the issuer for value and benefit that merchants receive when they accept electronic payment;

    2. That the Tribunal erred in finding that interchange fee was not a payment for professional and or management services.

    3. That the Tribunal erred in law and fact in finding that the services provided by the Respondent are to the Cardholder and not the Acquirer bank.

    4. That the Tribunal erred in law and fact in misapplying the exemptions provided by Part II of the First Schedule of the *VAT Act 2013*; in finding that Interchange fees received by the Respondent as(sic) fees in relation to money transfer services.

    5. That the Tribunal erred in law and fact in finding that the services provided by the Respondent in a credit or debit card transaction are not taxable services as provided for by Section 5, 6 (1) and 6 (4) of the VAT Act Cap 476 and Sections 5(1) (a) and 5 (2) (b) of the *VAT Act 2013*;

    6. That the Tribunal erred in law and fact in finding that Interchange fees received by the Respondent as (sic) fees in relation to an operation of a bank account.

    7. That the Tribunal erred in law and fact in finding that cardholder verification and money transfer service were similar services.

    8. That the Tribunal erred both in law and fact [by] ignoring all material facts placed before it and based its judgment on a biased approach without due regard to the balance of the scales of justice.

7. The Commissioner prayed that the appeal be allowed with costs, the decision of the TAT be set aside and the objection decision be upheld.

8. This appeal was disposed of through written submissions with oral highlights.

Commissioner's submissions

9. The Commissioner filed written submissions dated July 1, 2021 and supplementary written submissions dated December 17, 2021. The Commissioner argued that interchange fees paid to an issuing bank (issuer) is subject to VAT because issuer for provides services aimed at ensuring that a debit takes place at the point of sale to the acquiring bank which is neither an account holder nor a client. The issuer then deducts interchange fees before forwarding the funds subject to the transaction to the acquiring bank.

10. The Commissioner relied on the decision in *Commissioner of Domestic Taxes (Large Tax Payer Office) v Barclays Bank of Kenya Ltd* [2020] eKLR for the holding that payments by a bank in its capacity as an acquirer to the issuer satisfies the definition of management and professional fees as defined in section 2 of the *VAT Act*.

11. The Commissioner took the view that interchange fee is not payment for the operation of an account and that although the service provided by the issuer bank is ancillary to financial services, it is not expressly exempted under Part II of the First Schedule to the VAT Act. The Commissioner posited, therefore, that the mere fact that a service is essential for completing an exempt primary transaction, does not warrant the conclusion that the service is also exempt from VAT.

12. Although the Commissioner admitted that the TAT had held that a new issue could not be introduced in the objection decision, it was aggrieved by that holding and raised the issue in ground 8 of the Appeal. According to the Commissioner, ground 8 should be read and understood to cover the fact that the TAT erred in holding that a new issue had been raised in the objection decision.

13. It is the Commissioner's view that there was no new issue since the issue of interchange fees was in the assessment dated June 12, 2018, a fact the TAT failed to consider. The Commissioner maintained that it is entitled to amend an assessment in the objection decision as happened in this case.

14. The Commissioner admitted that the decision in the Barclays Bank case was not on the VAT Act but the *Income Tax Act*. That notwithstanding, the Commissioner argued, the definition in one Act can be used in another Act where they are pari-materia.

15. The Commissioner urged the Court to allow this appeal with costs, set aside the impugned decision and uphold the objection decision.

Bank of Africa's submissions

16. Bank of Africa filed written submissions dated September 16, 2021 and attacked this appeal on three fronts. First, that the procedure for raising the tax assessment was not in tandem with section 51 of the *Tax Procedures Act*. According to Bank of Africa, the Commissioner's objection decision dated September 5, 2018 amended the assessment to reflect the Bank as the issuer and not the acquirer as had been stated in the objection decision and introduced interchange fees. This, Bank of Africa posited, was a new assessment within an objection decision, thus denied it an opportunity to respond.

17. I n the view of Bank of Africa, the Commissioner should have dropped the assessment altogether and issue a new assessment which would have given it an opportunity to respond as required by section 51 of the Act. Bank of Africa relied on Article 47 of the *Constitution* on fair administrative action. Bank of Africa further argued that although the TAT upheld its appeal that interchange fee was a new issue, the Commissioner did not raise that issue in this appeal.

18. Bank of Africa maintained that in the assessment, the Commissioner had demanded Import VAT on imported services but since the appeal succeeded, and having bee categorized as an issuer, the Commissioner could not demand import VAT.

19. That notwithstanding, Bank of Africa argued that under paragraph 1(b) of Part II of the First Schedule to the VAT Act 2013, verification services offered by the issuer to the cardholder qualifies for exemption as money transfer service. According to Bank of Africa, the service cannot exist without transfer of money from bank to bank as the transaction is conducted by the customer at the point of sale.

20. Bank of Africa asserted that the cardholder is the consumer of the money transfer service and, therefore, interchange fee arises in the course of provision of that services. Bank of Africa relied on *CSARS v Respublica (Pty) Ltd* (1025/2017), *NIC Group and NIC Bank Kenya PLC v Cmmissioner of Domestic Taxes* (TAT) Appeal No 361 of 2018 and *Barclays Bank of Kenya Limited v Commissioner of Domestic Taxes* [2020] eKLR.

21. Bank of Africa contended that the decision in *Commissioner of Domestic Taxes v Barclays Bank of Kenya Ltd (Barclays Bank case)* (*supra*) relied on by the Commissioner is distinguishable because the issue in that case was whether there was a supply made by the issuing bank to the acquiring bank for purposes of withholding tax. The issue in this appeal, however, is not whether there was a supply but whether the supply was exempt from VAT by virtue of Paragraph 1(b) of Part II of the First Schedule to the Act.

Determination

22. I have considered the appeal, submissions by parties and the record of proceedings before the TAT. From the grounds of appeal, and submissions by parties, the core issue for determination in this appeal is whether the interchange fee paid to the issuer is subject to VAT. The other issues are whether the amendment to the tax assessment in the objection decision was in tandem with section 51 of the *Tax Procedures Act* and whether the Commissioner was right in charging the 20% penalty.

23. The Commissioner's case is that interchange fee falls under the definition of managerial, professional and contractual services as defined under section 2 of the VAT Act, 2013, thus subject to VAT. The Commissioner argued that the TAT was wrong in holding that interchange fee is exempt from VAT. The *Commissioner relied on the decision in Commissioner of Domestic Taxes v Barclays Bank* (*supra*) case, to urge that the process of using a card constitutes managerial, professional and contractual services rendered to the issuer by the acquirer. The Commissioner however later admitted that the decision was on the *Income Tax Act* and not VAT Act.

24. The Commissioner faulted the TAT for not only holding that interchange fee was not a payment for professional and or management services but also for holding that Bank of Africa provided a service to cardholders and not the acquirer banks.

Card transactions

25. In a card transaction, different players are involved. The issuer, issues a debit/credit card to customers for instance Master Card or Visa. The acquirer installs swiping machines at merchants' premises. A customer, the cardholder, walks into a merchant's store to buy goods or services using the card. The customer hands the card to the merchant who swipes the card in the swiping machine at the merchant's premises. Information is transmitted to the Issuing bank through networks. The issuer verifies the authenticity of the cardholder, his eligibility to use the card and availability of sufficient funds to cover the purchase or service provided by the merchant. A response is sent to the acquirer and then to the

merchant after the verification by the issuer. A charge slip is then generated from the swiping machine which the cardholder signs and takes a copy. The merchant retains a copy which is later submits to the acquirer for payment. The acquirer deducts some money from the merchants' money known as Merchant Discount Rate(MDR), then pays to the balance to the merchant. The acquirer pays part of the MDR to the networks and the issuer. The money paid to the issuer is known as interchange fee.

26. The point of note, is that there is no contractual arrangement between the cardholder and the merchant; no contractual arrangement between cardholder and the acquirer and no contractual arrangement between the issuer and the merchant. There is, however, an arrangement between the issuer and acquirer to facilitate completion of the transaction through the networks. The issue, therefore, is whether Bank of Africa rendered a service to the cardholder and what service it was.

27. Bank of Africa's customers use the cards at point of sale. In that process, Bank of Africa is called upon to verify details of the customers, including identity, eligibility and whether the customers have sufficient funds to pay for the purchases or services at the point of sale. Bank of Africa's role in this chain of transactions is to verify identity of customers and relay the information to the merchant through the acquirer to enable the cardholder purchase goods or services. Bank of Africa, as the issuer, authorizes or denies cardholders the ability to pay for particular transactions and releases payments to the acquirer once purchases are made.

28. In that capacity, the issuer is the gatekeeper to the cardholders' accounts from which it transfers money to the acquirer for cardholders' purchases and earns interchange fee in return. Taken in that context, the issuer's primary service is to the cardholders as customers. This is so because once a card is issued to customers/cardholders, the issuer will continuously monitor the cardholders' accounts to ensure that they have sufficient funds to cover the costs of each transaction. The service to the acquirer is secondary to the service the issuer renders to cardholders.

29. The nature of service the issuer renders to card holders is, in my view, a financial is service. This is because the issuing bank owes cardholders a duty to verify not only their details and eligibility to use the cards but also deduct money from their accounts and pass it to the acquirer, thus enabling them complete their purchases. Verification of cardholders' details and eligibility to use the cards, precedes the decision to allow the cardholder to purchase goods which is later followed by transferring money from the cardholders' accounts to the merchant through the acquirer. In this respect, I agree with the TAT's holding that Bank of Africa, as issuer, rendered service to the cardholders.

VAT on Interchange fee?

30. The question then, is whether the interchange fee the issuer earns in this card process is subject to VAT. Both parties agree that interchange fee is paid to Bank of Africa from card transactions. The Commissioner argued that interchange fee is subject to VAT because it is earned from service rendered to both the merchant and acquirer. Bank of Africa took a divergent view, arguing that it provided a financial service which is exempted from VAT.

31. The TAT considered the issue and the definitions of interchange fee by both Master Card and Federal Deposit Insurance Corporation (FDIC), and concluded that what takes place between the issuer and acquirer is a service to the customer and is meant to enable the customer make purchases and, therefore, it is exempt from VAT.

32. According to the Federal Deposit Insurance Corporation (FDIC) Interchange fee is paid by one bank to another (usually the acquirer to the issuer) to cover handling costs and credit risk in a card transaction. The fees take care of authorization costs, fraud and credit losses, and the average bank cost of funds.

33. Similar explanation is found in the Wikipedia online Dictionary, that interchange fee is transaction fee the merchant's bank (acquirer) pays to the issuer whenever a customer uses a credit/debit card to purchase goods or services from the merchant. It is intended to cover "handling costs, fraud and bad debt costs and the risk involved in approving the payment."

34. Interchange fee is, thus, a form of insurance intended to cover costs that may be incurred by the issuer in the process of verifying the cardholder's identity and eligibility for purposes of completing purchase of goods or services using credit/debit cards.

35. Should interchange fee paid to Bank of Africa, as the issuer, be subject to VAT? The TAT held that it should not because Bank of Africa offered a service to its customers/cardholders to facilitate completion of purchases at the points of sale. The Commissioner argued that interchange fee is not payment for the operation of an account and that although the service provided by the issuer bank [Bank of Africa] is ancillary to financial services, it is not expressly exempted in Part II of the First Schedule to the VAT Act. According to the Commissioner, the "mere fact that a service is essential for completing an exempt primary transaction, does not warrant the conclusion that the service is also exempt from VAT."

36. The Commissioner appreciates that Bank of Africa provided service that was "ancillary to financial services". However, the Commissioner goes on argue that the service rendered, though essential for completing an exempt primary transaction, should not lead to the conclusion that the service is also exempt from VAT.

37. To resolve this contestation, one has to pay attention to the law, in particular, Paragraph 1 (b) and (d) Part II of the First Schedule the Act. Part II, headed "Services", states that the following services shall be exempt supplies:

1. The following financial services-

(a) .....

(b) the issue, transfer, receipt or any other dealing with money, including money transfer services and accepting over the counter payments of household bills, but excluding the services of carriage of cash, restocking cash machines, sorting or counting of money.

(c) .....

(d) automated teller machine transactions, excluding the supply of automated machines and the software to run it.

38. It is of significance to note the law exempts the "issue, transfer, receipt" "or" "any other dealing with money" and then uses the word "including". Paragraph 1(b) has two parts because of the use of the word "or" which means the paragraph should be read disjunctively. Understood that way, then financial services mean the issue, transfer and receipt of money. The second part comes in after "or" so that financial services mean "any other dealing with money." The paragraph then uses the word "including" "money transfer services and accepting over the counter payments of household bills."

39. It is appropriate to note that the first part of the paragraph talks about issue, transfer and receipt of money. The second part after "or" still talks about "any other dealing with money" and goes on to use the word "including" thus leaving the list of what constitutes financial services inconclusive. A holistic and literal reading of paragraph 1(b), would yield to the conclusion that financial services mean any dealing in money namely; money transfer services, accepting money over the counter and payment of household goods, among other services, excluding, however, "services of carriage of cash, restocking

cash machines, sorting or counting of money." The list of exempted financial services is, therefore, inconclusive because the legislature used the word" including" to define financial services.

40. When interpreting the law, the court should bear in mind that the legislature was conscious of the circumstances it was legislating on and what it the law was intended to cover. Where the definition of the words is inconclusive, it creates an ambiguity.

41. In *Govind Saran Gang Saran v Commissioner of Sates Tax and others* 1985 AIR 1041; 1985 SCR (3) 1885, the Supreme Court of India observed that the taxing statute identifies the subject of the levy, or the taxing event, indicates the person on whom the levy is imposed, who has to pay the tax, the rate imposed and the measure or value to which the rate will be applied to compute the tax liability.

The court then stated:

> If these components are not clearly and definitely ascertainable, it is difficult to say that the levy exists in point of law. Any uncertainty or vagueness in the legislative scheme dealing with any of those components of the levy, will be fatal to its validity.

42. Where the legislature uses an inconclusive definition of what constitutes financial services, like in this case, it is not open to this court to say that the service Bank of Africa rendered to cardholders, as the issuer, was not a financial service. If that were to be the case, then the law, as enacted, would be ambiguous which would then be interpreted in favour of the taxpayer.

43. In the circumstances, I agree with the TAT that Bank of Africa rendered a financial service to cardholders when verifying their identities and eligibility to use the cards when purchasing goods or services and eventually deducted money from their accounts which was a financial service exempted from VAT.

44. There is another reason why interchange fee should could not be subject to VAT. In its response to the assessment by the Commissioner, Bank of Africa argued that the acquirer paid VAT and, therefore, demanding VAT from it would amount to double taxation. As already seen earlier in this judgment, there was no relationship between the merchant and the cardholder. The merchant's contractual arrangement was with the acquirer who supplied and installed the swiping machine in the merchant's premises. The merchant paid for this service through MDR when cards were used to purchase goods and services from him. The acquirer collected money from the issuer and paid the balance to the merchant after deducting MDR. MDR was the gross value which included interchange fee paid to the issuer. Since interchange fee was part of MDR which came from a single transaction through the acquirer, the acquirer was responsible for the collection VAT. In that respect, once VAT was paid on MDR by the acquirer, VAT could not be collected again from Bank of Africa as this would amount to double taxation.

45. This issue was the subject of discussion in *Commissioner of GST and Central Excise v Citi Bank &others* (Civil Appeal No 8228 consolidated with No 89 of 2019). Division Bench of Supreme Court of India considered an appeal on this issue from the Customs, Excise and Taxes Appellate Tribunal, which had held that an issuer does not have to pay service tax on interchange fee. The two-member bench was split, with Justice K M Joseph holding that service tax was payable on the interchange fee, while Justice S Ravindra Bhat agreed with the Tribunal that service tax was payable because that would amount to double taxation. With the split decision, the holding by the tribunal stood and the appeals were dismissed.

46. Justice Ravindra Bhat, opined:

> (35) The basis for levying service tax, is the total or "gross" value of the amount charged from the service recipient. In the present case, the MDR is the "gross value; it includes the interchange fee. In the circumstances, since the collection of service tax is by the acquiring bank, which remits it to the revenue, the insistence that both elements should be segregated and separate returns filed reflecting the interchange fee, with respect, serves no purpose other than paperwork, and burdening banks and revenue officials with paperwork. If it is the aggregate amount (of which interchange fee, is part, and the acquiring bank's amount, another part), the law is satisfied.

47. Justice Ravindra Bhat was of the view, that the segregation of the whole MDR (which includes interchange fee) by sharing it into two portions, i.e. the interchange fee and acquiring bank's charges, solely for the purpose of obligating all parties to reflect these in separate returns, only serves to complicate matters.

48. The circumstances the court was dealing with is, on all fours, similar to what is in this appeal, interchange fee. I am persuaded by the reasoning of Justice Ravindra Bhat, that the acquiring bank collected MDR, the gross amount for purposes of VAT, which included interchange fee. The acquiring bank had the obligation to account for VAT based on the MDR. Calling on Bank of Africa to account for interchange fee and or pay VAT on it, yet it was part of MDR accounted for by the acquirer, would amount to double taxation.

New issue in objection decision

49. The Commissioner blamed the TAT for holding that a new issue had been introduced in the objection decision. Bank of Africa argued that the TAT having determined that the Commissioner had introduced a new issue in the objection decision, the Commissioner did not appeal against that finding and, therefore, the decision of the TAT on that aspect remained unchallenged. In response, the Commissioner maintained that ground 8 in the memorandum of appeal (since ground 4 was repeated in ground 5), covered that aspect of the decision of the TAT.

50. Ground 8 (formerly 9) states that the TAT erred both in law and fact by ignoring "all material facts placed before it and based its judgment on a biased approach without due regard to the balance of the scales of justice."

51. The Commissioner did not specifically raise a complaint regarding the holding by the TAT that a new issue had been introduced contrary to section 51 of the *Tax Procedures Act*. I agree with Bank of Africa on this submission. The Commissioner should, have raised a specific complaint on this issue if it did not agree with the holding by the TAT. As it is, the Commissioner raised a general complaint without specifying which aspect of the evidence the TAT ignored to enable this court deal with the issue. Instead, the Commissioner blamed the TAT for basing its decision on a biased approach without due regard to the balance of the scales of justice, without evidence of bias on the part of the TAT.

52. That notwithstanding, it is true that the Commissioner issued its objection decision on September 5, 2018 but provided workings on September 25, 2018, ten (10) days to the thirty days window the law allowed Bank of Africa to lodge an appeal against the objection decision. In that respect, I agree with the TAT that the Commissioner did not give Bank of Africa sufficient time to study the report on workings, thus denied the bank an opportunity know why the decision had been arrived at as it was.

Interest and shortfall penalty

53. The issue here, really, is whether the Commissioner lawfully charged 20% tax shortfall penalty. After considering section 84, the TAT held that the section applies where a tax payer knowingly makes a false or misleading statement to an authorized officer. The Commissioner had however failed to demonstrate that Bank of Africa had done so. For my part, I do not fault the TAT on this finding. The Commissioner did not even raise this issue in the memorandum of appeal.

Conclusion

54. Having considered the appeal submissions and the record, the conclusion I come to, is that the TAT did not err in the decision it arrived at. The TAT was right that Bank of Africa rendered a financial service which was is exempt from VAT in terms of paragraph 1 Part II of the First Schedule to VAT Act 2013. I also find that calling on Bank of Africa to pay VAT on interchange fee would amount to double taxation given that MDR is the gross value on which service tax VAT is based and is collected and accounted for by the acquirer.

55. Further, the Commissioner did not appeal against the holding by the TAT that a new issue had been introduced in the objection decision, and that the Commissioner denied Bank of Africa an opportunity to know how the Commissioner arrived at the decision. The TAT was also correct to hold that penalty could not be imposed under section 84 of the *Tax Procedures Act* since there was no evidence that Bank of Africa knowingly made a false or misleading statement to an authorized officer.

56. In the circumstances, this appeal lacks merit and is dismissed. Each party will bear own costs.

DATED, SIGNED AND DELIVERED AT NAIROBI THIS 17TH DAY OF FEBRUARY 2023

E C MWITA

JUDGE