REPUBLIC OF KENYA

IN THE HIGH COURT OF KENYA

AT NAIROBI

COMMERCIAL AND TAX DIVISION

TAX APPEAL NO. 8 OF 2018

BARCLAYS BANK OF KENYA LIMITED.....APPELLANT

- VERSUS –

THE COMMISSIONER OF DOMESTIC TAXES....RESPONDENT

JUDGMENT

1. This judgment relates to the background transactions that take place in respect to the credit or debit cards issued by banks to their customers.

2. BARCLAYS BANK OF KENYA LIMITED (hereinafter BBK) has filed this appeal against the Tax Appeals Tribunal's decision of 16th March 2018. By that decision the Tribunal upheld the tax assessment of the **COMMISSIONER OF DOMESTIC TAXES** (hereinafter the Commissioner) and thereby upheld the Commissioner's demand from BBK for Value Added Tax (VAT) in respect to interchange fees.

3. BBK is a member of network set up by various credit card companies such as **Visa**, **Master Card** and **America Express** (hereinafter the Card Companies). It is through that network that the transaction, which brings about the **interchange fee** comes about. It is that fee that the commissioner by letter dated 27th December 2012 made a demand for VAT. BBK filed its appeal against the stated assessment before the **Tax Appeals Tribunal** (the Tribunal) whose judgment is the subject of this appeal.

4. In this modern society generally everyone is familiar with credit and debit cards issued by the banks. Some of the well-known cards are visa, Master Cards and American Express. Banks issue their customers with such cards which their customers use to make payments using credit, debit or pre-paid cards. Those banks that issue cards to their customers are known as **Issuing Banks.**

5. In the card companies' network there is the **Merchant**. The merchant sells goods and services to the card-holder. Of importance is that the merchant does not have a contract with the issuing bank nor is merchant a customer of the issuing bank. The merchant in accepting payment through the credit/debit card agrees to get, from the issuing bank a payment which is less than the value of the product it sells or has been purchased by a card holder. That is, it agrees to give a **merchant discount**. The issuing bank receives interchange fee which is a fraction of that merchant discount. The interchange fee retained by the issuing bank is intended to be an incentive for that bank to continue issuing the cards to its customers.

6. There is another bank in the afore stated network known as **Acquiring Bank**. Barclays Bank of Kenya Limited (BBK) was the Acquiring Bank in respect to the assessment by the Commissioner in this matter. The acquiring bank is the one that recruits, screens and accepts merchants into the network of the card system. The acquiring bank enters into agreements with the merchants regarding merchants' acceptance of the cards. The acquiring bank provide services to the merchant such as providing **Process Data Quickly** (PDQ) machines, back-end customer services, risk management and marketing activities. The acquiring bank undertake the liability to settle payments for goods or services provided by the merchant and consumed by the card-holder irrespective of the acquiring bank getting reimbursed by the issuing bank.

7. The commissioners' assessment of VAT is in respect to the interchange fee retained by the issuing bank.

8. That transaction of using a card in a purchase was explained by the BBK's learned counsel as follows: the card holder presents the card to the merchant/supermarket for a purchase, the merchant swipes the card on the **Point of Sale** (POS) machines supplied by the acquiring bank. By swiping the card in the acquiring bank's POS machine the merchant seeks the authorization through the network to accept the card. The network switches the transaction from the acquiring bank to the issuing bank. The issuing bank on confirming the card holder has sufficient funds to satisfy the payment or if it is a credit card on confirming that the purchase is within the card holder's credit limit sends authorization, this is a commitment by the issuing bank to settle the merchant's funds. Once that authorization is received by the acquiring

bank the acquiring bank sends it to the merchant. The merchant generates a transaction receipt, a merchant's copy and a card holder which is signed by the card holder. The card holder then takes possession of the purchased goods. The merchant receives payment from the issuing bank less the merchant's discount. The issuing bank retains the interchange fee and remits the balance of the money through the card company's network.

9. The commissioner by its letter to BBK dated 27th December 2012 demanded from BBK additional assessment of VAT for the years of income 2007 to 2010. The VAT additional assessment in that demand was as follows:

VAT	Tax due	Legal Authority
Card business Royalties WHT	12,401,822	Section 6(6)and 6(7)
International Local Commissions	121,881,461	Section 6(6)and 6(7)
Interchange International Commissions		Section 6(6)and 6(7)

10. It will be seen from the above assessment the commissioner demanded from the Bank Card Business Royalties and local and international interchange commission (fee). During the hearing before the tribunal the assessment on Royalties was resolved and the only issue that remained to be determined by the Tribunal was the VAT payment on interchange local fee. Further in the course of hearing of the appeal before the Tribunal parties reached a consent whereby the commissioner abandoned the assessment of interchange fee for the years 2007 to 2009.

11. When the Tribunal rendered its decision through the judgment dated 16th March 2018 it determined issues that had been resolved and abandoned, as stated above. In other words, the Tribunal determined the assessment as though part of the assessment had not been resolved or as though the commissioner had not abandoned the assessment for VAT for the years 2007 to 2009.

ANALYSIS AND DETERMINATION

12. The Bank has brought the grounds of appeal as here under:

i. The Tribunal erred in law and fact in proceeding to make a finding on alleged payment of royalties to card companies which was not an issue for determination before it.

ii. The Tribunal erred in law in failing to make a finding on the issue for determination before it which was whether the interchange fees retained by the issuing banks was a payment for provision of services to the appellant.

iii. The tribunal erred in law and fact in failing to make any finding as to whether the retention of interchange fees by the issuing bank was for management or professional fees as alleged by the Respondent.

iv. The Tribunal erred in fact and law in failing to distinguish between the card companies and the banks.

v. The Tribunal erred in law and fact in failing to find that no interchange fees is paid by the Appellant to the issuing banks as the impact of the retention of the interchange fees is felt by the merchants and not the appellant.

vi. Notwithstanding and without prejudice to the foregoing, the Tribunal erred in law and fact in failing to hold that neither the additional assessment dated 27th December 2012 nor the Amended Assessment dated 21st January 2013 identified the services in respect of which the Respondent was claiming VAT.

vii. The Tribunal erred in law in failing to uphold the Judgments of the Honourable Court in Misc Application No. 1223 of 2007 R v Commissioner of Domestic Taxes ex parte Barclays Bank of Kenya Limited and Misc Application No 46 of 2013 R v Commissioner of Domestic Taxes ex parte Barclays Bank of Kenya Limited wherein it was clearly held that the Respondent is under a statutory obligation to state its tax claim with clarity.

viii. The Tribunal erred in law and fact in holding that the services provided by issuing banks to the merchants were consumed by the Appellant.

ix. The Tribunal erred in law failing to determine whether if any services were provided by the issuing banks to the Appellant, the services were in any event exempt under the Third schedule of the VAT Act.

x. The Tribunal erred in law in failing to determine whether any VAT was payable on interchange fees to local banks.

xi. The Tribunal erred in law and fact in failing to find that the Appellant could not in any event have withheld VAT as no VAT had been charged by the issuing banks.

13. Having considered this appeal and the submission made by the learned counsel for BBK and for the commissioner it is evident that the parties hereof confirmed that the interchange fee is retained by the issuing bank when remitting the payment due to the merchant through the card company's network or infrastructure. It was clear that both parties before court did not allege the acquiring bank paid the issuing bank the interchange fee. It is with that in mind I find that the issues for determination in this appeal are:

a. Whether retention of the interchange fee by the issuing bank is for any service rendered by the issuing bank to BBK.

b. If the answer to (a) above is in the affirmative whether that service is exempt from charge of VAT.

c. Who will bear the costs of this appeal?

14. BBK submitted that interchange fee is not for service to it because there was no service which was provided by the issuing bank. That the purpose of interchange fee is that it acts as a balancing mechanism which operates for the benefit of the card company's system and is also an incentive for the issuing bank. To support the above submission, BBK relied on the article by Visa Inc. on interchange fee as here under:

"The visa payment system is what economists call a "two sided" market because it consists of two distinct groups cardholders and merchants that provide each other with benefits. Cardholders want a payment card they can use at many merchants as possible. Merchants want to accept a payment card that is carried by many customers as possible."

15. The BBK submitted that the above shows that interchange fee arises out of the relationship between the merchant and the issuing bank, due to the cards the issuing banks issued to their customers and is not payment for services to BBK.

16. The BBK further faulted the commissioner for failing to identify the service which he seeks to assess VAT on.

17. In respect of that latter submission the commissioner by his written submission failed to identify the service he seeks to assess VAT other than saying BBK consumed the service. However, at the hearing of the appeal the learned counsel for the commissioner identified the service targeted by the commissioner as the authorization by the issuing bank for the cardholder to use the card. The learned counsel argued that it is the acquiring bank (in this case BBK) which was given that service of authorizing the use of the card.

18. The case of the commissioner is that the cardholder is not charged anything in the form of interchange fee. The commissioner relied on the case STANDARD CHARTERED BANK and others vs CST MUMBAI Misc. Application No 93629 of 2015. It was submitted by the commissioner in respect to that case that the service provided by the issuing bank was "composite service which should not be broken down to distort it from the taxing regime."

19. I begin in considering the first issue identified above by referring to section 5 of the Value Added Tax Act Cap 476 as follows:

"a tax, to be known as value added tax, shall be charged in accordance with the provisions of this Act on the supply of goods and services in Kenya (including anything specified by the minister as such a supply) and on the importation of goods and services into Kenya."

20. The same Act defines services to mean:

"(a) any supply by way of business that is not a supply of goods or money; or

(b) anything which is not a supply of goods but is done for consideration (including, if so done, the granting, assignment or surrender of any right);

21. The issuing bank, as stated before and it was accepted by the parties before court, retains the interchange fee when remitting the payment through the card company's infrastructure to pay for the goods purchased from the merchant by its customer, the cardholder. I am persuaded by the submissions of BBK, in as far as interchange fee is concerned, that it relates to the relationship between the different players in a card transaction is to enable the cardholder transfer money form the cardholder's account to the merchant's account. I will add to that submission that the acquiring bank is in a sense a conduit in that transfer of information relating to the transmitted in the network. It follows that the authorization of use of the card by the issuing bank is part and parcel of the issuing bank's operation of its customers (the cardholder's) account. That being the finding of this court it follows that the said service of authorizing the use of the card is a service which is exempt from VAT as provided under the definition of services, set out above, and as provided under the Third Schedule paragraph 1 (a) and (b) of Cap 476. That section exempts financial services from VAT as follows:

"(a)the operation of current, deposit or savings accounts, including the provision of account statement;

(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 of cash machines, sorting or counting of money;

22. I am in concurrence with Tax Appeal Tribunal case **NIC Group and NIC BANK KENYA PLC v COMMISSIONER OF DOMESTIC TAXES (TAT) APPEAL NO. 361 OF 2018** in its finding on the nature of service that bring about the interchange fee thus:

> "15.The foregoing definitions invariably negate the Respondent's contention that the card services between the Appellant as the issuing bank and the acquiring bank do not amount to transfer or money or operation of bank account, and that they are subject to value added tax under section 5(1) & (2) of the VAT Act, 2013. We find that the service provided by the Appellant is to its customers and not to the acquiring bank, it involves a money transaction and it is not considered as a service subject to the value added tax. In fact, the service of money transfer is exempt from value added tax under the provisions of the paragraphs 1 of Part II of the First Schedule to the Value Added Tax Act 2013……
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> 16.The Respondent also contends that the cardholder verification process is a distinct service from that of money transfer to the acquiring banks. This in our minds is an argument that cannot be sustained. In the first instance, a cardholder verification process is necessitated by a customer's intended purchase. All that the appellant bank is doing is confirming that indeed the customer's account has sufficient funds in order that the customer may continue with the purchase. We find that the role played by the Appellant bank in verifying the cardholder's information is a normal process appurtenant to money transfer. If not online, the cardholder will have to present themselves physically in an over the counter transaction, wherein verification still has to take place."

The Tribunal in the NIC case (supra) further stated, and which again is in my humble view the correct position:

> "In light of the above finding, the cardholder verification process is not a distinct but an ancillary role played by the appellant in the transfer of money."

23. It follows from the above that I find and hold that the interchange fee by the issuing bank is not for any service rendered by the issuing bank to the acquiring bank, here BBK. Having answered the first issue in the negative there is therefore no need to proceed to determine whether the service is exempt from the change of VAT because no service was offered by the issuing bank to BBK.

24. Before proceeding to determine the third issue in this matter I will consider whether indeed the commissioner identified the service it alleged the issuing bank provided to the acquiring bank. In the letter dated 27th December 2012 the commissioner stated that the interchange fee paid to BBK, as an acquirer to the issuing bank, was professional or management fee. The commissioner did not however identify, to BBK, the type of service it assessed as being VAT chargeable. Indeed, at paragraph 2.5.3 of that letter the commissioner simply stated:

> "**…** therefore…. the payment of interchange fee is in respect of a service provided."

25. In the Standard Chartered Mumbai case (supra) the case the tribunal thereof referred to the case of St. Aubyn (LM) vs A.G as per Lord Simonds as follows:

> "that in interpreting a section in a taxing statute, the question is not at what transaction the section is according to some alleged general purpose aimed, but what transaction its language according to its natural meaning fairly and squarely hits and this is the one and only proper test."

26. The commissioner not only failed to properly identify the service offered but also cited section 6 (6) of Cap 476 which section relates to services imported into Kenya, which the interchange fee in this case, at bar, did not relate. In that regard I make reference with approval the finding in the case **Republic v Commissioner of Domestic Taxes large Tax Payers office Ex parte Barclays Bank of Kenya Limited (2012) eKLR**:

> "39. Consistent with the decision I have cited above, the duty of the respondent in assessing tax is to identify transactions or payments that attract tax liability especially where there are objections to such categorisation. **Section 35(1)(a)** of the **Income Tax Act** identifies specific types of payments that attract tax, the respondent is obligated by law to state with clarity its claim and state how the transaction falls within the terms of the statute. The respondent cannot exercise its duty like a trawler in the deep seas expecting all the fish by casting its net wide. The respondent's decision in this respect falls below this standard and the transaction caught by the decision cannot be said to fall within the statutory definition of the tax."

TAX APPEAL TRIBUNAL DECISION

27. There is no doubt in my mind that the tribunal by its decision of 16th March 2018 erred in determining matters that were not before it, such as the issue of royalty and income tax period of the years 2007 to 2009. The Tribunal also erred in finding that the issuing bank provided service to BBK which service the tribunal found was correctly assessed as being liable to VAT. My finding is that the said Tribunal's judgment was indeed wanting in many respect and thereby failed, entirely to determine the case before it. In some parts it referred to BBK as the issuing bank. See paragraph 149 of that judgment and other parts it faulted BBK for requiring the commissioner identify the service being subjected to VAT. See paragraph 154/155 of that judgment.

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28. Having determined that BBK's appeal does succeed it follows that the costs of this appeal will follow the event and will accordingly be awarded to BBK.

CONCLUSION

29. This appeal hereby succeeds and accordingly the Tribunal's judgment dated 16th March 2018 is hereby set aside and the Respondent's

assessment dated 27th December 2012 is hereby revoked and annulled. The appellant is awarded costs of this appeal.

DATED, SIGNED and **DELIVERED** at **NAIROBI** this **5th** day of **AUGUST** 2020.

MARY KASANGO

JUDGE

Before Justice Mary Kasango

C/A Sophie

For the Appellant:

For the Respondent:

ORDER

This decision is hereby virtually delivered this **5th** day of **August, 2020.**

MARY KASANGO

JUDGE