Commissioner of Domestic Taxes v Standard Chartered Bank Kenya Limited (Tax Appeal E123 of 2020) [2023] KEHC 18381 (KLR) (Commercial and Tax) (12 June 2023) (Judgment)

Neutral citation: [2023] KEHC 18381 (KLR)

REPUBLIC OF KENYA

IN THE HIGH COURT AT NAIROBI (MILIMANI COMMERCIAL COURTS)

COMMERCIAL AND TAX

TAX APPEAL E123 OF 2020

DAS MAJANJA, J

JUNE 12, 2023

BETWEEN

COMMISSIONER OF DOMESTIC TAXES ..... APPELLANT

AND

STANDARD CHARTERED BANK KENYA LIMITED ..... RESPONDENT

(Being an appeal against the Judgment of the Tax Appeals Tribunal at Nairobi dated 18th September 2020 in Tax Appeal No. 302 of 2018)

JUDGMENT

Introduction and Background

1. The Respondent is a commercial bank licensed by the Central Bank of Kenya to provide financial services. Sometime in 2018, the Appellant ("Commissioner") carried out an audit of the Respondent's tax affairs for the years 2013 to 2017 in relation to Value Added Tax (VAT) on business cards. The Commissioner communicated its findings through the letter dated 6th June 2018 where it stated that the Respondent had not been declaring VAT on payments made to card companies and for marketing and management services offered to both the merchants and Acquiring Banks contrary to the provisions of sections 2, 5 and 6 of the VAT Act (Chapter 476 Laws of Kenya) ("VAT Act (Repealed)") and section 5 of the VAT Act, 2013.

2. The Commissioner stated that it was aware that the Respondent is a member of networks established by various card companies such as MasterCard Incorporated, VISA International Service Association and that the networks enable the Respondent, either as an Acquiring and Issuing Bank to provide their customers with credit, debit and prepaid cards to make payment for services and goods purchased from contracted retail outlets. That to effectively carry out this task, the Respondent recruits, screens and accepts merchants into the associations' credit card systems and enters into contractual relationships

with the recruited members which is distinct from the card companies and that it deploys credit card terminals at the point of sale, carries out risk management and other marketing activities. That as an Issuing Bank, the Respondent provides other Acquiring Banks authorization, settlement and clearing services through the activities of receiving the transaction information, checking to ensure it is valid and whether there is sufficient balance, responding by approving or declining the transaction request, and reimbursing the Acquiring Bank. The Commissioner therefore concluded that the Respondent earns an interchange fee from the card payment processing service.

3. The Commissioner further stated that the Respondent enters into contractual agreements with the card companies which define the mode of operations between the parties and that to enable the Bank access the global network, the card companies grant the Respondent license and in return, it makes payments to the card companies such as clearing fee, settlement fee, risk monitoring fee, non-compliant fee which are for use of the trademark. The Commissioner stated that these payments made to the global service network are in the form of royalty thus subject to VAT at the general rate and that the services offered by the Respondent to merchants and Acquiring Banks facilitate payments through debit or credit cards across the global network and fall within the ambit of section 2, 6(6) and 6(7) of the VAT Act (Repealed) and section 8(2) of the VAT Act, 2013.

4. In regard to the payments made to the card companies, the Commissioner observed that the VAT Act (Repealed), defined services imported into Kenya as a service provided by a person resident outside Kenya who is not required to register for tax in Kenya. Further, VAT Act, 2013 defined supply of imported services as, 'supply of services that satisfies the following conditions —

   (a) the supply is made by a person who is not a registered person to a person who is a registered person or a non-registered person,

   (b) the supply would have been a taxable supply if it had been made in Kenya.

5. The Commissioner therefore observed that from the aforesaid provisions, it is clear that the services offered by the Respondent leading to settlement of an account while executing purchases by a card holder could not fall under the exemption schedule. The Commissioner relied on decision of the Tax Appeals Tribunal ("the Tribunal") in Barclays Bank of Kenya Limited v The Commissioner of Domestic Taxes TAT Appeal No 114 of 2014 (UR) to reiterate that the payments made by the Respondent for the use of the global service network are in the form of royalty which is subject to VAT. The Commissioner therefore concluded that the Respondent was therefore liable to pay additional VAT.

6. The Respondent objected to the assessment through its letter dated 5th July 2018. It stated that a significant amount included in the assessment related to financial services that are specifically exempt from VAT under the VAT law and that a significant number of the income streams did not fall within the realm of interchange fees as interpreted by the Commissioner. The Respondent disagreed with the Commissioner's reasoning that interchange fees are subject to VAT based on the contention that they are fees payable on card payment processing fees that fall within the realm of royalty payments. It contended that Part II of the First Schedule of the VAT Act, 2013 lists financial services which are exempt from VAT and that specifically, Paragraph 1(b) of the Schedule provides that 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 is exempt from VAT.

7. In applying the aforesaid provision, the Respondent contended that the Commissioner ought to have understood exactly how debit and credit card transactions occur and thereafter ascertain its classification from a VAT standpoint. The Respondent elucidated the transaction as follows;A

Cardholder/Accountholder – a person who holds an account with the Respondent and who obtains either debit or credit card from the Respondent.An Issuing Bank – the bank that issues either debit cards or credit cards, in this case the Respondent,The Merchant – any business that provides goods and services and accepts cards as a form of payment, in this case, this is the person from whom the account holders purchase goods and services,An Acquiring Bank (merchant's bank) – the bank that contracts with merchants to allow them to accept card payments and they provide point of sale terminals to accept card paymentsCard associations (e.g. Visa and Mastercard) – they provide networks which facilitate payment transactions.

8. The Respondent further explained that a typical card transaction consists of the following processes; authorization, which is the process of approving or rejecting a transaction by the issuer, clearing which is the process of transmitting final transaction data from the acquirers to issuers for settlement and that during this stage the fees and charges that apply to the transaction are calculated and settlement, which is the actual exchange of funds between the acquirers and the issuers for all transactions that are cleared.

9. The Respondent contended that interchange fees are incidental/ancillary to transfer of money and therefore exempt from VAT as they are fees for the sole purpose of consummating the payment for goods or services by a merchant through transfer of funds and should be defined as services incidental/ancillary to the principal activity of transferring money. That from both the local and international best practice perspective, incidental/ancillary services take the VAT treatment of the principal supply and that this is based on the reasoning that had the principal supply not existed, the ancillary service would not have taken place in the first instance. The Respondent averred that the VAT law in Kenya does not expressly provide guidance on the VAT treatment of interchange fees as a standalone financial service and that in this absence, courts have provided guidance that one may rely on international best practice to inform the treatment of tax in such matters.

10. The Respondent denied that it recruits, screens and accepts merchants into the credit card systems established by various card companies and that it does not own any point of sale terminals and that save for the case of VISA branded ATMs, the Respondent does not act as an acquirer. In any case, the Respondent reiterated that any interchange fees earned by the Respondent through use of its VISA branded ATMs is exempt from VAT in line with Paragraph 1(d) of Part II of the First Schedule of the VAT Act, 2013, which encompasses all ATM transactions. The Respondent stated that it subscribed to the card associations as an issuer and only issues credit/debit cards to consumers on behalf of the card and that the Respondent only acts as an intermediary for the cardholders and the card network by contracting with the cardholders for the terms of the repayment of transactions.

11. In the alternative, the Respondent argued that were the assessed fees to be subjected to VAT, the value of the fees earned by the Respondent ought to have been considered to be inclusive of VAT. The Respondent stated that it does not charge interchange fees, rather, it earns such fees through an allocation process once a discount has been deducted from a merchant transaction. That therefore, the Respondent does not invoice for such fees and that amounts allocated to each of the parties (issuer, acquirer and card network) are based on pre-agreed rates and cannot be altered to include the VAT element. The Respondent further advanced the position that setting interchange rates at the appropriate level helps ensure that both issuers and acquirers deliver services that optimize the effectiveness of the payments system and spur development of innovative payment solutions and that application of VAT on top of such fees would disincentivise merchants from taking up cards as a mode of payment. The Respondent contended that Regulation 19 the repealed VAT Regulations, 1994 allowed registered persons to treat prices of taxable supplies for which no separate amount was declared as VAT as inclusive of VAT and that similar provisions are maintained under Regulation 5 of the VAT Regulations, 2017.

12. The Respondent also opposed the Commissioner's imposition of a shortfall penalty of 20% and termed it a misapplication of the law. In sum, the Respondent called for the abandonment of the demanded taxes as it was clear that the Commissioner sought to collect VAT on services which are exempt under the VAT law.

13. The Commissioner issued an objection decision on 31st August 2018 (erroneously dated 31st July 2018) ("the Objection Decision"). The Commissioner agreed with the Respondent's explanation that ATM commissions are financial services and thus were exempted services under the First Schedule Part II Paragraph 1(d) of the VAT Act, 2013 and the taxed assessed on this item were dropped. The Commissioner also dropped the assessment on annual card renewal fees and overdrawn limit fees. However, the Commissioner stated that the Respondent's trial balance contained interchange fees and other card income which could not be reconciled with the breakdown provided. Hence the decision to charge VAT on this item stood. On interchange fees, the Commissioner rejected the Respondent's argument that the card services between the Respondent and other Acquiring Banks amounted to transfer of money and therefore exempt from VAT. The Commissioner maintained that when the Respondent's customers use credit and debit cards at a merchant, the Respondent becomes the issuer and offers a composite service in form of authorization, settlement and clearance to the Acquiring Bank and that the issuing bank service begins when an authorization request is sent to the Respondent and completed when the Respondent settles the account with the Acquiring Bank.

14. The Commissioner concluded that the Respondent earns interchange fees for supplying issuing bank services to the Acquiring Bank and that section 2 of the VAT Act, 2013 defines a service as "anything that is not goods or money" and that these services fall within section 5, 6(1) and 6(4) of the VAT Act (Repealed) and section 5(1)(a) and 5(2)(b) of the VAT Act, 2013 for the subject period. The Commissioner revised the assessment and issued a demand to the Respondent.

15. The Respondent lodged an appeal to the Tribunal against the Objection Decision. After considering the pleadings, submissions and all documents of the parties, it rendered its judgment on 18th September 2020. The Tribunal was of the view that two issues called for its determination; Whether Interchange fees qualify as services exempt from VAT under Part II of the First Schedule of the Vat Act, 2013 and whether the tax shortfall penalty was applicable in the circumstances.

16. As to whether interchange fees are exempt from VAT, the Tribunal stated that the checks and activities from which the Respondent earns interchange fees must be undertaken to ensure a card payment transaction is completed and that these checks must also be done in any kind of transaction and they are incidental to the completion of a cash withdrawal. That these checks and activities are intrinsic components of any transactions involving the issue, transfer, receipt or any other dealing with money and cannot be separated from such transactions. The Tribunal relied on its decision in Barclays Bank of Kenya Limited v Commissioner of Domestic Taxes (UR) where it defined interchange fees as a fee paid by a merchant's bank (acquirer) to a card holders' bank (issuer) to compensate the issuer for value and benefit that merchants receive when they accept electronic payments. That the interchange service provided by the Respondent is a service to its customers and not the acquiring bank and that the card holder verification process performed by the Respondent is to confirm if the customer's account has sufficient funds to make the purchase and that the role played by the Respondent in verifying the cardholder's information is a normal process related to the money transfer.

17. The Tribunal took the view that in absence of express provisions in our VAT laws in respect of the VAT status of interchange fees, the Tribunal also noted that the Respondent had relied on international best practice and precedent to arrive at its treatment on this matter. The Tribunal considered and relied on its decision NIC Group PLC and NIC Bank PLC v the Commissioner of Domestic Taxes

TAT Appeal No. 361 of 2018 (UR) where it held that interchange fees received by issuing banks are not subject to VAT. It also relied on the court's decision in Barclays Bank of Kenya Limited v The Commissioner of Domestic Taxes TA No. 8 of 2018 [2020] eKLR where the court agreed with the bank therein and found that the service of authorizing the use of the card is a service which is exempt from VAT as provided under the definition of services and as provided under the Third Schedule paragraph 1 (a) and (b) of the VAT Act (Repealed). The Tribunal concluded that the checks and activities are not composite but incidental to the provision of money transfer services and that the cardholder verification process is essentially not distinct from the supply of money by the Respondent and consequently, the Tribunal held that interchange fees are not subject to VAT as they are exempt under the VAT Act, 2013.

18. As to whether the tax shortfall penalty was applicable, the Tribunal stated that a tax shortfall penalty is to be charged in the event that a tax payer knowingly makes a statement to an authorized officer that is false or misleading. However, the Tribunal found that the Commissioner had not demonstrated to its satisfaction that the Respondent knowingly made a statement to it or its authorized officers that was false or misleading. The Tribunal thus found that the tax shortfall penalty was not applicable.

19. As a result of its findings above, the Tribunal allowed the appeal and set aside the Objection Decision. It is this judgment that has precipitated this appeal by the Commissioner which is grounded on the Memorandum of Appeal dated 11th November 2020.

Analysis and Determination

20. The issues in dispute in this appeal concern the interpretation and application of statutory provisions hence fall within the court's jurisdiction under section 56(2) of the TPA which provides that "An appeal to the High Court or to the Court of Appeal shall be on a question of law only". In dealing with matters of law, the court must also pay fealty to the findings of fact by the Tribunal but only intervene if such findings are perverse (see Bashir Haji Abdullahi v Adan Mohammed Nooru & 3 others NRB CA Civil Appeal No. 300 of 2013 [2014]eKLR).

21. From the grounds raised by the Commissioner in its appeal, this court is called upon to determine the same issues dealt with by the Tribunal namely; whether interchange fees are exempt from VAT and whether the tax shortfall penalty applied by the Commissioner was justified.

Whether interchange fees are exempt from VAT

22. The Respondent took the position that interchange fees are incidental/ancillary to transfer of money and therefore exempt from VAT as they are fees for the sole purpose of consummating the payment for goods or services by a merchant through transfer of funds and should be defined as services incidental/ancillary to the principal activity of transferring money. The Commissioner on its part stated that that these payments are made for the global service network system facilitating the transactions and are in the form of royalty thus subject to VAT at the general rate.

23. It is common ground that the provisions of Paragraph 1 (b) of Part II of the First Schedule of the VAT Act, 2013 and Para. 1(b) of the Third Schedule of the VAT Act (Repealed) provide that "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" are exempt from VAT. The Tribunal held that the services of the Respondent are intrinsic components of any transactions involving the issue, transfer, receipt or any other dealing with money and cannot be separated from such transactions and that the role played by the Respondent in verifying the cardholder's information is a normal process related to

the money transfer. The Tribunal also relied on its decision in NIC Group Case (TAT) (Supra) and the court's decision in the Barclays Bank of Kenya Limited Case (HC) (Supra) to arrive at the decision that the interchange fees are exempt from VAT.

24. The Commissioner submits that the court's decision in the Barclays Bank of Kenya Limited Case (Supra) is no longer viable in view of the Court of Appeal decision in Commissioner of Domestic Taxes (Large Tax Payer Office) v Barclays Bank of Kenya Ltd NRB CA Civil Appeal No. 195 of 2017 [2020] eKLR where it held that, "We are persuaded that the evidence on record properly established that the payments paid by the Respondent (Barclays Bank) to the card companies were royalty as defined in the Act and further that the interchange fees paid to issuer banks were for management and professional services as defined in the Act and therefore both payments were subject to withholding tax under the Act." The Commissioner contends that the Court of Appeal has established that interchange fees paid to the issuer banks were management/professional fees with regard to VAT and that the service is subject to VAT and it is in no way related to dealing with money as urged by the Respondent.

25. I have considered the decision of the Court of Appeal and is clear that it was an appeal in respect of Withholding Tax where the Commissioner was demanding taxes on payments made by the bank to three credit card companies, namely, Visa International Services Association, MasterCard, Inc., and American Express Ltd. It was not in respect of VAT as contended by the Commissioner. Further, the issue of royalty therein was in respect of the transaction fees paid by the issuing bank to the card companies and not the interchange fees which are payments made by Acquiring Banks to Issuing banks. The former is what the Commissioner was seeking to charge withholding tax as it was claiming that this was a payment in respect of royalty. It is on this transaction fee paid by the issuing bank to the card companies that the Court of Appeal agreed was payment for the right to use the card companies' trademarks and logos and was thus a royalty payment subject to withholding tax. The Court of Appeal did not find or make a determination that interchange fees was also a royalty payment. What the Court of Appeal stated on interchange fees was that it was management and professional fees as defined in section 2 of the *Income Tax Act* (Chapter 470 of the Laws of Kenya) and thus subject to withholding tax.

26. I therefore reject the Commissioner's argument that the Court of Appeal determined that interchange fees constituted a royalty payment and thus subject to VAT as a reading of the appellate court's decision reveals otherwise.

27. Could the Tribunal be faulted for relying on the court's decision in Barclays Bank Limited Case (HC) (Supra) in finding that interchange fees are exempt from VAT? Definitely not. Let me first state that the Court of Appeal decision in the Barclays Bank of Kenya (Large Tax Payer Office) Case (Supra) was not an appeal from the High Court decision in Barclays Bank of Kenya Limited Case (HC) (Supra). The Tribunal, being subordinate to the High Court, was bound by the decision of the court which is superior to it.

28. Apart from accepting the Tribunal's decision in NIC Group Case (TAT) (Supra), the High Court in the Barclays Bank of Kenya Case (HC) (Supra) as follows:

    (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.

29. It is for the aforesaid reason that I do not find any error of law by the Tribunal in adopting a similar position in the present case, as the same had been affirmed by the court. The Court of Appeal decision in Commissioner of Domestic Taxes (Large Tax Payer Office) Case (Supra) does not apply to this case. This ground by the Commissioner fails.

Tax shortfall penalty

30. Having found that the interchange fees are exempt from VAT, it follows that the Commissioner could not impose any penalty or interest as no taxes were due. In any case, a tax shortfall penalty can only be imposed as provided for under section 84 of the TPA which at the material time provided in part as follows:

> 84. Tax shortfall penalty
>
> (1) This section applies to a person—
>
> a. if that person knowingly makes a statement to an authorised officer that is false or misleading in a material particular or knowingly omits from a statement made to an authorised officer any matter or thing without which the statement is false or misleading in a material particular; and
>
> b. if the tax liability of that person or of another person computed on the basis of the statement made by that person is less than it would have been had the statement not been false or misleading (the difference being referred to as the "tax shortfall").
>
> (2) Subject to subsections (3) and (4), a person to whom this section applies shall be liable to a tax shortfall penalty of—
>
> a. seventy-five per cent of the tax shortfall when the statement or omission was made deliberately.
>
> b. Twenty per cent of the tax shortfall in any other case
>
> (3) .....
>
> (4).....
>
> (5) A tax shortfall penalty shall not be payable under subsection (2) when—
>
> (a) the person who made the statement did not know and could not reasonably be expected to know that the statement was false or misleading in a material particular;

(b) the tax shortfall arose as a result of a taxpayer taking a reasonably arguable position on the application of a tax law to the taxpayer's circumstances in submitting a self-assessment return; or

c. the failure was due to a clerical or similar error, other than a repeated clerical or similar error.

(7) Despite subsection (5), the Commissioner or authorised officer may impose a late payment interest in respect of a tax shortfall when the tax is not paid by the due date for payment.

(8) For the purposes of this section, a statement made to an authorised officer includes a statement made, in writing or orally—

a. in an application, certificate, declaration, notification, return, objection, or other document submitted or lodged under a tax law;

b. in information required to be provided under a tax law;

c. in a document provided to an authorised officer;

d. in an answer to a question asked of a person by an authorised officer; or

e. in a statement to another person with the knowledge or reasonable expectation that the statement would be passed on to an authorised officer.

31. I therefore agree with the Tribunal that a tax shortfall penalty only applies when a tax payer knowingly makes a statement to an authorized officer that is false or misleading. Having reviewed the evidence, the Tribunal found as a fact that the Commissioner did not demonstrate that the Respondent gave it false and misleading information. There is no reason to depart from the Tribunal's findings of fact on this score as there is nothing in the evidence that suggests that the decision cannot be supported by the evidence on record. I find that the positions taken by the Respondent were reasonable and arguable in the circumstances and thus could not be stated to have been intentionally false and misleading so as the Commissioner could apply the tax shortfall penalty. This ground by the Commissioner therefore fails.

Disposition

32. The Commissioner's appeal fails for the reasons I have set out above. It is dismissed but with no order as to costs.

DATED AND DELIVERED AT NAIROBI THIS 12TH DAY OF JUNE 2023.

D. S. MAJANJA

JUDGE

Court Assistant: Mr Michael Onyango.

Ms P. Naeku, Advocate instructed by Kenya Revenue Authority for the Appellant.

Mr K. Kimani, SC with him Mr Ruto instructed by Hamilton, Harrison and Mathews Advocates for the Respondent.