Barclays Bank of Kenya vs. Commissioner of Domestic Taxes

KPMG Tax Alert

Summary

This alert brings to your attention the recent Tax Appeals Tribunal (the Tribunal) judgment in the case of **Barclays Bank of Kenya (Appellant) vs. Commissioner of Domestic Taxes (Respondent)** on the imposition of Value Added Tax (VAT) on interchange fees and excise duty on lending fees and interchange fees.

Facts

The Respondent conducted an audit of the Appellant's tax affairs for the years of income 2011 to 2015. Following the audit, the Respondent assessed the Appellant excise duty and VAT on interchange fees, which are fees paid by a merchant's bank (acquiring bank) to the issuing bank when a customer makes a purchase using a debit or credit card.

Aggrieved by the Respondent's decision, the Appellant appealed to the Tribunal, which appeal and subsequent Tribunal decision forms the basis of this alert.

The Appellant's case was based on the nature of transaction that results to interchange fees. The Appellant contended that where interchange fees are earned from a transaction, there are three parties involved; the acquiring bank, the issuing bank and the card company. The Appellant argued that the Respondent erred in law and fact in finding that;

1. Services provided by the Appellant as an acquiring bank including the issue, transfer, receipt or other such dealing with money are not VAT exempt financial services;
2. The issuing bank deducts interchange reimbursement fees prior to any remittance to the Appellant and therefore, merchant service fees earned are not solely earned by the Appellant;
3. The Appellant is liable to pay VAT on the entire merchant fees, as opposed to acquiring bank fees alone; which income accrues to three independent parties;
4. The issuing bank provides services to the acquiring bank while indeed there exists no contractual relationship between both banks;
5. Excise duty is chargeable on merchant fees earned on goods and services provided by merchants outside Kenya; and
6. Arrangement fees, administration fees, negotiation and other loan related fees are excisable;

In response to the above, the Respondent acknowledged that indeed the Appellant was not the sole party to the card processing and payment transactions. Further, they asserted that the Appellant maintains contractual relationships with the merchants and processes card transactions on their behalf.

However, the Respondent argued that provision of merchant services does not qualify as "the issue, transfer, receipt or other dealing with money" hence the service is not exempt from VAT. According to the Respondent, while the issuance of physical cards is exempt from VAT, usage of such cards is not.

On the issue of excise duty on lending fees, it was the Respondent's assertion that loan administration, negotiation and other such fees are charged separately from interest and are payable upfront and can therefore not constitute interest for purposes of levying excise duty.

Issue(s) for determination

The issues for determination were whether;

1. Services rendered by the Appellant as an issuing bank are subject to VAT;
2. Excise duty is chargeable on the entire merchant service fees;
3. Services provided to merchants outside Kenya are excisable;

4. Excise duty is chargeable on lending fees and bank charges; and
5. Fees and commissions earned prior to 1st August 2013 are chargeable to excise duty.

Findings

Whether services rendered by the Appellant as an issuing bank are subject to VAT

The Tribunal held that the role of the issuing bank is restricted to authorization, settlement and clearing of funds from a customer's account. Accordingly, the issuing bank ascertains the balance in the customer's account, debits the customer's account and remits the same to the acquiring bank.

The contractual relationship is therefore with the customer and not with the acquiring bank and any interchange services are ancillary to the mandate of the bank to transfer funds from its customers' accounts and similar VAT exemption treatment will apply.

The Tribunal referred to its judgment in ***NIC Group & NIC Bank Ltd v Commissioner of Domestic Taxes*** and the High Court Judgment in ***Barclays Bank of Kenya Limited v Commissioner of Domestic Taxes (2020) Eklr*** where it was held that interchange fees earned by the issuing bank are not subject to VAT.

Whether excise duty was chargeable on the entire merchant service fees

The Tribunal held that the merchant service fees is an aggregate of fees accruing to three distinct parties; the issuing bank, the acquiring bank and the card companies. The Tribunal ruled that being distinct parties, it would be unfair to shift the entire tax burden to one party. Therefore, each of these parties should bear its own tax burden and the Respondent is at liberty to claim any unpaid taxes from the remaining parties.

Where the issuing banks and card companies are based out of Kenya, the Respondent could not purport to collect tax from them as they are not subject to the Kenyan excise duty regime.

Whether excise duty is chargeable on Appellant in relation to services provided to merchants outside Kenya.

The Respondent assessed excise duty on interchange fees earned by the Appellant from customer transactions at merchant premises outside Kenya.

The Tribunal held that such transactions were exported services and were therefore not chargeable to excise duty. The repealed Excise Duty Act defined excise duty as "duty of excise imposed on goods manufactured in Kenya or imported into Kenya and specified in the Fifth schedule." There was no further provision for taxation of exported services. The Tribunal held that taxation can only be done on the premise of clearly worded and unambiguous provisions which were absent in the matter at hand. As such, it would be unfair to impose duties on the exported services and hold the Appellant liable for tax.

Whether lending fees and bank charges are chargeable to excise duty

In determining whether lending fees were excisable, the Tribunal considered the provisions under the Repealed Customs and Excise Act and the Income Tax Act. The Fifth Schedule to the Repealed Customs and Excise Act provided that excise duty charged on financial institutions shall be ten per cent and would be levied on among other things; other fees charged by financial institutions. The Act defined other fees as ***"any charges or commissions charged by financial institutions but does not include interest."*** It did not define interest.

The Tribunal relied Section 2 of the Income Tax Act which defined interest as ***"interest payable in any manner in respect of a loan, deposit, debt, claim or other right or obligation and includes a premium or discount by way of interest and commitment or service fee paid in respect of any loan or credit..."***

It found that lending fees amount to interest, which is not subject to excise duty.

Whether the Appellant was liable to excise duty for the period prior to 1st August 2013

The Tribunal held that the out of court settlement entered between the Kenya Bankers Association (KBA) and the Respondent did not to waive their members' obligation to pay excise duty for any period prior to 1st August 2013.

Instead, the correspondence was meant to ensure that the KBA would guide its members to ensure excise duty compliance with effect from 1st August 2013. The Respondent was therefore right in demanding excise duty against the Appellant for fees and commission earned prior to 1st August 2013.

Our Comments

This judgment reaffirms the TAT position that merchant service fees earned by issuing banks are exempt from VAT. It further confirms the position of the Tribunal that where issuing banks earn interchange fees from customer purchases, these will be exempt from VAT due to their ancillary nature to services that are exempt from VAT. This has also been the position of the High Court in ***Barclays Bank of Kenya Limited v Commissioner of Domestic Taxes (2020) Eklr***

The assertion that the bank's mandate extends to clearing and settling customer transactions, including facilitating payment for services or goods is valid and reliable. It gives cognizance to the fact that the bank is in a contractual relationship with the customer and not the other bank and is only dispensing its duties in that capacity.

Further, the decision of the Tribunal that exported services provided to merchants outside Kenya are not chargeable to excise duty buttresses the legal position that excise duty is a domestic tax chargeable to consumers in Kenya on the eligible goods and services.

Finally, the pronouncement of the Tribunal that lending fees and bank charges amount to interest which is not excisable provides much needed clarity on an issue that has been the cause of conflict between the KRA and banks.

The judgment of the Tribunal reinforces the Tribunal decisions in ***Co-operative Bank of Kenya Limited v Commissioner of Domestic Taxes*** (***2020) eKLR*** and ***Stanbic Bank Kenya Limited v Commissioner of Domestic Taxes (2020) eKLR*** in which it was held that loan administration fees, moratorium interest derived from re-negotiation of loans and flexi interest from short term loans are not chargeable to excise.

The consistency in recent judgments relating to chargeability of excise duty on loan related fees is a welcome trend as it creates certainty to taxpayers.

What remains to be seen is how the issue of excise duty for the period prior to 1st August 2013 will finally be resolved given that the KRA has backtracked on the consent it entered into with the banks at the High Court, where it undertook not collect the excise duty for the period prior to August 2013.

Regards

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