Financial Services Sector Report

Q1 2023

MMAN ADVOCATES

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BANKING

On 22nd March 2023, the Central Bank of Kenya announced the issuance of the Kenya Foreign Exchange Code ('Forex Code') to commercial banks for purposes of setting out standards for commercial banks and ultimately to strengthen the integrity and effective functioning of the wholesale Forex market in Kenya.

I. Guidelines, Notices and Circulars

On 22nd March 2023, the Central Bank of Kenya ('CBK') announced the issuance of the Kenya Foreign Exchange Code ('Forex Code') to commercial banks. CBK noted that the Forex Code sets out standards for commercial banks and aims to strengthen the integrity and effective functioning of the wholesale Forex market in Kenya. The Forex Code is based on the following six principles that are to be adhered to by institutions:

- ethical and professional behaviour when operating in the Forex market;
- implementation of a sound and effective governance framework overseeing the Forex market activity;
- exercising due care when negotiating and executing transactions;
- clarity and accuracy in communication;
- development and maintenance of a robust control and compliance framework; and
- ensuring predictable, smooth and timely settlement of Forex transactions.

In the press release, the CBK observed that Kenya's Forex market has expanded with global developments and is an enabler of trade, investments and remittances into and out of the Kenyan economy. In this regard, the Forex Code has been issued to enhance regulation and for the surveillance of the Forex market considering its growing complexities and emerging risks to fair and effective trading.

II. Judicial Decisions

Commissioner of Domestic Taxes v Bank of Africa Limited (Civil Appeal E127 of 2020) [2023] KEHC 1036 (KLR) (Commercial and Tax) [2023][1]

Facts:

On **18 September 2020**, the Tax Appeals Tribunal in TAT No. 319 of 2018, allowed an appeal filed by Bank of Africa against an assessment by the Commissioner of Domestic Taxes of KShs. 87,729,030.00 (later amended to KShs. 15,158,378.00), being undeclared Valued Added Tax (VAT) on payments made to various (credit and debit) card companies. Under Part II of the First Schedule to the VAT Act, money transfer related services undertaken for the benefit of a customer are exempt from VAT.

In allowing the appeal, the Tax Appeals Tribunal held that VAT is not chargeable on interchange fees pursuant to the exemptions under Part II of the First Schedule to the VAT Act.

The Commissioner challenged the decision of the Tax Appeals Tribunal at the High Court. The

[1] http://kenyalaw.org/caselaw/cases/view/251786/

Commissioner argued that the Tax Appeals Tribunal erred, *inter alia*, in finding that the service rendered by the issuing bank that resulted in payment of interchange fees was not a taxable service.

Key Issues for determination:

i. Whether 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;
ii. Whether the Tribunal erred in finding that interchange fee was not a payment for professional and or management services.
iii. Whether 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.
iv. Whether 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 the interchange fees received by the Respondent as(sic) fees in relation to money transfer services.
v. Whether 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;
vi. Whether the Tribunal erred in law and fact in finding that the interchange fees received by the Respondent as (sic) fees in relation to an operation of a bank account.
vii. Whether the Tribunal erred in law and fact in finding that a cardholder verification and money transfer service were similar services.
viii. Whether 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.

Held:

In determining whether interchange fees are subject to VAT, the High Court had to appreciate how a card payment transaction occurs. In summary, an electronic card payment transaction proceeds as follows:

- The issuing bank issues a credit or debit card to its customer.
- A cardholder swipes their card at the merchant's Process Data Quickly (PDQ) machine.
- An authorization message is transmitted to the card network for the issuing bank to accept the card.
- The issuing bank confirms the authenticity of the cardholder, whether they are authorized and/or eligible to use the card and whether the cardholder has sufficient funds in their account to complete the purchase. For credit cards, the issuing bank verifies whether the intended purchase is within the cardholder's credit limit.
- The issuing bank, upon verifying the above information, transmits a payment authorization to the acquiring bank. This authorization functions as a commitment by the issuing bank to settle the amounts expended by the cardholder at the merchant's premises.
- The acquiring bank relays the authorization from the issuing bank to the merchant who generates a charge slip or transaction receipt.
- The merchant keeps a copy of the charge slip/transaction receipt which it

subsequently submits to the acquiring bank for settlement.

- The acquiring bank deducts a portion of the funds from the amount due to the merchant, i.e., Merchants Discount Rate ("MDR"), and remits the remainder to the merchant. Another portion of the MDR is paid to the issuing bank and the networks involved.

The court thus held that VAT on interchange fees was not payable for two reasons:

a) First, the court agreed with the Appellant and the Tax Appeals Tribunal that the financial service in question was one provided by the issuing bank primarily to its card-holder customers. Specifically, the issuing bank provided the service of conducting a verification process to confirm, among other things, the identity of the customer-cardholder, that the customer's account has enough funds to complete the transaction. This service, to the extent that it constituted a money transfer related service, is expressly exempted from the imposition of VAT under Part II of the First Schedule to the VAT Act.

   The court rejected the Commissioner's argument that the service rendered by the issuing bank leading to the payment of the interchange fee was merely ancillary to financial services, hence not expressly exempted under the VAT Act.

b) Second, the Court held that VAT on interchange fee was still not payable because the acquiring bank already paid VAT on the MDR. The court noted that it is the acquiring bank which collected MDR comprising interchange fee. It is also the acquiring bank which had the obligation to account for and remit VAT based on the gross MDR collected. As such, the court held, it would amount to double taxation for the issuing bank to account for and pay VAT on interchange fee.

Implication:

It is clear, at least now, that banks issuing credit and debit cards are not liable for payment of VAT on account of interchange fees. Such fees constitute a financial service exempt under the First Schedule to the VAT Act.

However, the matter remains far from settled considering that the Court of Appeal has, in a different case,[2] held that interchange fees are subject to withholding tax because they are primarily paid for management and professional services. The issue of whether interchange fees paid to issuing banks should be classified as management or professional fees liable to taxation and subject to withholding tax is currently pending before the Supreme Court.

MMAN Advocates will be happy to assist on any issues arising from this decision.

INVESTMENTS

On 27 January 2023 the Cabinet Secretary of National Treasury and Economic Planning published the Income Tax (Financial Derivatives) Regulations, 2023.

[2] Commissioner of Domestic Taxes (Large Tax Payer Office) v. Barclays Bank of Kenya Ltd [2020] eKLR

I. Subsidiary Legislation

The Income Tax (Financial Derivatives) Regulations, 2023, Legal Notice No. 4 of 2023

The Income Tax (Financial Derivatives) Regulations, 2023 (the **"Regulations"**) were published on 27 January 2023 by the Cabinet Secretary of National Treasury and Economic Planning pursuant to section 9(4) of the Income Tax Act, Cap. 470 (the **"Income Tax Act"**) which requires the Cabinet Secretary to issue regulations to actualise the taxation of gains from financial derivatives.

Section 2, 3, 6 and 22 of The Finance Act, No. 22 of 2022 amended the Income Tax Act by introducing amongst others:

- The definition of financial derivatives;
- The requirement to tax gains from financial derivatives excluding those traded at the Nairobi Securities Exchange; and
- The requirement that gains from financial derivatives accrued to non-resident persons are subjected to 15% withholding tax.

Consequently, the Regulations seek to provide clarity and guidance on the treatment of income accruing from financial derivatives.

In brief, the Regulations provide the following:

a) Scope of gains from financial derivatives

Any realised gain to a non-resident person, being a realised loss to the resident person who is a party to the financial derivative contract, shall be chargeable to tax in accordance with the Income Tax Act. The taxable derivatives unless exempted under the Income Tax Act include:

- A futures contract[3] including interest rate futures, stock index futures, volatility futures, weather futures or a similar futures contract whether cash settled or not;
- A forward contract[4], whether cash settled or not;
- A swap contract[5] including a contract for interest rate swap, currency swap, credit default swap and hybrid swap;
- An options contract[6] including put options, call options and options spreads; or
- Any other financial derivative instrument.

b) Realisation of gain or loss

A gain or loss from a financial derivative shall be deemed to have been realized at the earlier of:

- The underlying asset changing hands;
- The settlement of the contract; or
- The expiry of the contract.

Provided that, in the case of an options contract, the gain or loss shall be deemed to have been realised at the time of payment of the option premium and at the time the option is exercised.

A realised loss by a resident person from a financial derivative shall be allowed as a

[3] A futures contract means a standardised agreement traded in a recognised exchange market for the acquisition or disposal of an underlying asset whose delivery is to be made at a future date and at a price agreed upon when the contract is entered into and shall include a reference to a date and a price determined in accordance with the terms of the contract.

[4] A forward contract is a customised, over-the-counter traded financial derivative contract that provides for the purchase or sale of an underlying asset whose delivery or settlement is to be made at a future date at a price agreed upon when the contract is entered into.

[5] A swap is a contract to purchase or sell an underlying asset at a stipulated price at a certain time and may involve several settlements before maturity.

[6] An option contract means a financial derivative which offers the holder the right, but not the obligation, to buy or sell the underlying asset or security at a specific price on or before the option's expiration date.

deduction against any gain accruing from similar activities to the extent that it has not been claimed.

c) Record and characterisation of income from financial derivatives

A person involved in a financial derivatives transaction shall keep a record of all contracts and financial derivatives activities resulting from such a contract.

Any income from a financial derivative transaction shall be characterized as other income (financial derivative gains/losses) in the tax returns for the period and be treated as a separate source in accordance with section 15(7) of the Income Tax for a resident person or a permanent establishment in Kenya.

d) Payment of taxes

The tax payable under these Regulations shall be due and payable by the 20th day of the month after which the loss from the transaction with the non-resident person is realised.

You may find a copy of the Amendment Regulations here.

Nairobi Securities Exchange ('**NSE**') published a press release on 2nd February 2023 advising the amendment of its Trading Rules to allow for Block Trades. Block Trades are the sale of shares whose value:

II. Guidelines, Notices and Circulars

The Nairobi Securities Exchange ('**NSE**') published a press release on 2nd February 2023 advising the amendment of its Trading Rules to allow for Block Trades. Block Trades are the sale of shares whose value:

- exceeds KShs 3 Billion in value and constitutes 5% or more of an issuer's total issued shares subject to a maximum of 24.99%; or
- is less than KShs 3 Billion in value and constitutes more than 15% of an issuer's total issued shares subject to a maximum of 24.99%.

The NSE noted that the amendment was necessitated by an increase in block trades

coupled with the inability to conclude such trades via the normal trading board which in turn compelled investors to seek exceptions for transfer outside the NSE thereby compromising transparency as such trades would not be reported. The Block Trades Board will be guided by international best practices in other exchanges and aims to drive more liquidity in the Kenyan market.

RETIREMENT BENEFITS

The Retirement Benefits Authority invited the public and stakeholders to comment on the draft Post-Retirement Medical Funds Regulations.

I. Guidelines, Notices and Circulars

On 2nd March 2023, the Retirement Benefits Authority ('RBA') posted on its website an

invitation for public and stakeholder comments on the draft Post-Retirement Medical Funds Regulations. The RBA scheduled public forums for oral submission of comments on the regulations from 6th March 2023 to 16th March 2023 while submission of written proposals would close on 5th March 2023. The draft regulations intend to codify the Retirement Benefits (Post-Retirement Medical Funds) Guidelines, 2018 whose objectives include setting out the framework for the management and administration of post-retirement medical funds, providing guidance to schemes to provide for additional voluntary contributions by members and providing guidance on transfers and access to post-retirement medical funds.

The RBA published a reminder notice on 24th March 2023 reminding trustees, scheme administrators and service providers of retirement benefits schemes whose financial year ended on 31st December 2022 to submit their financial statements by 31st March 2023 and pay the Retirement Benefits Levy by 30th April 2023.

SACCO SOCIETIES

Communication by SASRA was sent out to all Non-deposit Taking Sacco Societies concerning the submission of audited financial statements and appointment of external auditors including the legal requirements for this submission.

I. Guidelines, Notices and Circulars

On 3rd March 2022, the Saccos Societies Regulatory Authority ('**SASRA**') issued a public notice inviting public and stakeholder comments on draft Guidelines on Complaints Management.

SASRA noted that the guidelines aim to ensure Saccos have swift and effective redress mechanisms for their members. The notice also indicated that SASRA intends to gather data on consumer complaints which can inform policy decisions and highlight areas requiring regulatory supervision. Submission of feedback on the guidelines closed on 17th March 2023.

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