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DEFAULT INTEREST IMPOSED BY FINANCIAL INSTITUTIONS NOT SUBJECT TO EXCISE DUTY:

KES 176 million win for SBM Bank Kenya Limited against the Commissioner of Legal Services and Board Coordination.

In the classicus case of Cape Brandy Syndicate vs. Inland Revenue Commissioner [1921] 1 KB 64, the Court held that in a Taxing Act, one has to look at what is clearly said. There is no room for intendment as to a tax. Nothing is to be read in, nothing it to be implied. One can only look fairly at the language used…If a person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be.

The Tax Appeal Tribunal applied the aforementioned rule in determining whether the late payment interest imposed by SBM Bank Kenya Limited constituted additional interest income derived from outstanding loans hence not subject to Excise Duty, rather than being classified as a 'fee' which attracts Excise Duty.

BACKGROUND:

The dispute arose when the Commissioner of Domestic Taxes conducted an audit of the books, records and accounts of SBM Bank Kenya Limited (hereinafter the "Bank") for the period September 2018 to September 2023. The audit involved a review of the Bank's tax affairs, and the

examination covered the Bank's Excise Duty obligation for the audit period.

Following the tax audit, the Commissioner raised tax assessments and demanded additional taxes of KES. 176,442,491.00 being principal tax, penalties and interest. The Bank being dissatisfied with the Commissioner's assessment, lodged its Objection and on 4th March 2024 the Commissioner issued the Objection Decision.

The Bank filed the Appeal in the Tax Appeal Tribunal challenging the Commissioner's Objection Decision on grounds that the Commissioner erred in law and fact by demanding Excise Duty on interest on loans, contrary to the provisions of the Excise Duty Act, 2015.

THE BANK'S ARGUMENTS ON DEFAULT INTEREST EARNED IS INTEREST INCOME AND NOT A 'FEE'

Paragraph 4 of Part II of the First Schedule of the Excise Duty Act levies Excise Duty on other fees charged by financial institutions.

Part III of the Excise Duty Act defines the term 'other fees' to include;

"Any fees, charges or commissions charged by financial institutions relating to their licensed activities, **but does not include interest on loan or return on loan or return on loan** or any share of profit or an insurance premium or premium based or related commission specified in the Insurance Act or regulations made thereunder…**"**

The Bank averred that in the course of providing loan facilities, the terms and conditions of the loan facilities include an agreed repayment period, the interest rate, a default interest rate and other fees associated with the loan, including other special conditions that may apply.

The Bank argued that the default interest relates to additional interest that it charges its customers for loan repayments which remain outstanding beyond the stipulated dates. The Bank therefore submitted that the default interest earned is additional interest received on outstanding loans and not a 'fee' and from the definition of 'other fees', there is an express exclusion of interest and return on loans. It was therefore apparent that the intent of the tax law, from the onset, was to exclude interest income earned by financial institutions from Excise Duty.

The Bank submitted that it was erroneous and an abuse of power for the Commissioner to attempt to reclassify the default interest payments with an aim of collecting tax, contrary to the express provisions of the Excise Duty Act and allowing the Commissioner to charge tax on interest would be in contradiction to the rules of interpretation of tax statutes in Kenya.

The bank further submitted that the subject matter of the Appeal was specifically determined in the case of the **Commissioner of Domestic Taxes vs. Kenya Microfinance Bank Limited (Tax Appeal E031 of 2022)** in which both the High Court and the Tax Appeal Tribunal reaffirmed the definition of the term interest and stated that Excise Duty was not chargeable on the interest charge for late repayment by borrowers.

KRA' ARGUMENTS AND SUBMISSIONS ON CLASSIFYING DEFAULT INTEREST AS A 'FEE'

The Commissioner submitted that it deduced that when a borrower fails to pay monthly instalments as prescribed in the Bank's loan contract, a fine is charged on the monthly instalments due over and above normal interest rates on the principal amounts due. The Commissioner therefore submitted that the extra charge is what it classified as penal income which falls under other fees.

The Commissioner submitted that the Bank in its contracts described the penal income as additional interest with the intent of misleading the Tribunal. It further submitted that the definition in Black's Law Dictionary is clear that at no point can a penalty become interest payment as the two are completely different and independent of each other.

THE TRIBUNAL'S DETERMINATION ON WHETHER THE ADDITIONAL AMOUNT CHARGED BY THE BANK, DEFAULT INTEREST, IS INTEREST OR A 'FEE'.

Based on the definition of 'other fees' in the Excise Duty Act, the Tribunal noted that there was an express exclusion of interest and return on loans. The Tribunal held that the provision of the Act makes it clear that *interest income earned by financial institutions is excluded from being charged Excise Duty*.

The Tribunal further held that the High Court in ***Commissioner of Domestic Taxes vs. Kenya Microfinance Bank Limited*** found in favour of the taxpayer in its finding that it was not persuaded that the Commissioner had established that the bank ought to pay Excise Duty on the interest charge for late repayment of loans by borrowers.

In conclusion, the Tribunal held that based on the law and the High Cour decision, the Commissioner erred in law and in fact by assessing Excise Duty on amounts that are not subject to Excise Duty under the Excise Duty Act.

NOT ALL AMOUNTS TERMED AS INTEREST BY FINANCIAL INSTITUTIONS ARE EXEMPT FROM EXCISE DUTY.

It is imperative to clarify that the decisions rendered regarding interest income not being subject to Excise Duty do not apply to all amounts termed as interest by financial institutions.

In ***Stima Cooperative Savings & Credit Society Limited vs Commissioner, Legal Services and Board Coordination (Income Tax Appeal No. E212 of 2024)*** the High Court in sustaining the KRA's assessment against the Stima Sacco in the sum of KES. 435million, agreed with the findings in Commissioner of Domestic Taxes v Stima Cooperative Savings & Credit Society Limited (Tax Appeal E090 of 2021) [2022] KEHC 12993 (KLR) (Commercial and Tax) (26 August 2022) (Judgment) wherein the High Court held that the tribunal erred when it held that the charges for bridging loans, appraisal, boosting deposits and deferred on appraisal are interest and exempt from excise duty.

The High Court held that obviously, *these charges are just but fees that is christened 'interest' and are not interest strictu sensu. They are not exempt from excise duty*. Despite the use of the term

'loan' by the Sacco, those are basically charges. There is no money that is passed on to the members. These are mere book entries that are made to enable the Saccos's members either borrow more from the Sacco or are mere administrative expenses such as appraising the members loans. They are but expenses or charges exerted by the Sacco on its members and not interest per se. The Sacco is not kept away from its money for a period to justify those charges to qualify as interest.

CONCLUSION: A SUBJECT IS NOT TO BE TAXED UNLESS THE WORDS OF THE TAXING STATUTE UNAMBIGUOUSLY IMPOSE THE TAX UPON IT.

Tax Law in entirely a creature of statute. Payment of tax is an obligation imposed by the law; it is not a voluntary activity. That being the case, a taxpayer is not obliged to pay a single coin more than is due to the taxman. Equally Article 210 of the Kenyan Constitution, 2010 mandates that no tax or licensing fee may be imposed, waived or varied except as provided by legislation.

Ultimately, this case reinforces the principle that if a person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free.

Financial institutions should exercise prudence in their interpretation and application of tax laws to prevent potential legal consequences.

HOW WE CAN HELP

At **CM Advocates LLP**, our tax team is fully equipped to advise taxpayers on the interpretation and applicability of tax laws. We are further equipped to assist from the moment a taxpayer receives an intention to audit through to the final resolution of the matter. We possess deep knowledge of procedures and the law, ensuring that taxpayers can effectively and comprehensively fulfill all their obligations under the law. This allows you to concentrate on your core business while we focus on resolving the matter conclusively. For any inquiries, please contact **Purity Mwangi** at ***pmwangi@cmadvocates.com***



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