

LEGAL OPINION
(For My Senior at the Firm)

Dear Sir,

1. Please refer to your email dated 00.00.2017 in which you asked me for my opinion on the merits of the case of *Special Federal Excise Reference Application No. 00 of 0000* titled as, *Commissioner Inland Revenue versus ABC Bank (Pakistan) Limited*.

I. FACTS

2. The material facts communicated to me and gleaned from the case file on record are:
 - a. ABC Bank (Pakistan) Limited (“ABC”) is a banking company engaged, *inter alia*, in the business of credit cards. By way of this business, it earned *interchange fee* and *processing fee* in the year 2010.
 - b. The Assessing Officer, vide its Order-in-Original (“Order”) No. 00/00/0000 dated 00.00.0000 claimed, after having scrutinized the annual financial statements of ABC for the year ended 00.00.0000, that ABC earned Rs. 280 Million as gross merchant discount (Rs. 271 Million as *Interchange fee* and Rs. 9 Million as *processing fee*) by providing credit card services during the period from January 2010 to December 2010 but did not charge Federal Excise Duty (“FED”) at 16% worked out at Rs. 44 million under Rule 40A of Federal Excise Rules, 2005 (“FER, 2005”). Such amount along with 5% penalty under section 19(1) of Federal Excise Act, 2005 (“FEA, 2005”) amounting to Rs. 2,243,098 is therefore recoverable along with default surcharge under section 14 and 8 of FEA, 2005.
 - c. Being aggrieved and dissatisfied with the Order of Assessing Officer, ABC filed Appeal before the Commissioner Inland Revenue (Appeals-III), Karachi (“CIRA”). The CIRA, vide its Judgment dated 00.00.0000, held that the entire credit card transaction involved funds of ABC for making payment to the acquiring bank/merchant within maximum three days after the goods are handed over to the cardholder. It is then paid later by the cardholder. Hence, notwithstanding the name or nomenclature assigned to the income earned by the ABC for using its own funds to make payments, such incomes are markup/interest income. Therefore, such incomes do not attract levy of FED by virtue of the exemption provided for in Rule 40A(4) of FER, 2005.
 - d. Being aggrieved and dissatisfied with the Judgment dated 00.00.0000 passed by CIRA, the Commissioner Inland Revenue, Zone-II, Large Taxpayers Unit, Karachi (“Commissioner”) filed an Appeal before the Appellate Tribunal Inland Revenue (“ATIR”). The ATIR, vide its Order dated 00.00.0000, upheld the Judgment of the CIRA and dismissed the Appeal on the same factual and legal reasoning as was highlighted by the CIRA.

- e. In the instant matter, the Commissioner has filed a Reference Application under Section 34A of the FEA, 2005 before the Honorable Sindh High Court against the Order of the ATIR dated 00.00.0000.
- f. ABC claims that both *interchange fee* and *processing fee* are its interest income/markup and, hence, exempt from FED under the Act.
3. In light of the above facts, the issue at hand is:
- i. “Whether income earned by ABC by way of its credit card business is interest income or not.”

II. RELEVANT STATUTORY PROVISIONS

4. Section 3 of the FEA, 2005 provides that services provided in Pakistan are liable to FED at the rate of 15% ad valorem, except the services specified in the First Schedule, “*which shall be charged to federal excise duty as, and at the rates, set-forth therein*”. At the same time section 16 provides, in its subsection (1), that all services provided or rendered in Pakistan are exempt from the whole of the FED, except those as are specified in the First Schedule. The combined effect of these provisions, therefore, is that only those services that are specified in the First Schedule are liable to FED. If any service is not specified in the First Schedule, it is exempt from FED even if it comes within the definition contained in section 2(23). The First Schedule comprises of two parts, and the second part (Table II) lists the services that are liable to FED. It is Entry 8 of this table that is relevant for present purposes.
5. Since the demand for FED relates to the calendar year 2010, it seeks to tax transactions from 01.01.2010 to 31.12.2010. Entry 8 at such time read as follows:

TABLE II
(EXCISABLE SERVICES)

<i>S.No.</i>	<i>Description of goods</i>	<i>Heading/Sub-heading No.</i>	<i>Rate of Duty</i>
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>
8	<i>services provided by banking companies or non-banking financial companies</i>	98.13	<i>sixteen percent of the charges</i>

6. The reference in the third column is to the Tariff Heading No. 98.13 under Chapter 98 of the First Schedule to the Customs Act, 1969. It may be noted that credit cards are listed against sub-heading 9813.5000 under Tariff Heading 98.13. It reads as follows:

FIRST SCHEDULE TO THE CUSTOMS ACT, 1969
[For duties on Services see Sections 2(23) & 3]

Chapter 98

(SERVICES)

<i>Heading</i>	<i>Description</i>
98.13	<i>Services provided or rendered by banking companies, insurance companies, cooperative financing societies, modarabas, musharikas, leasing companies, foreign exchange dealers, non-banking financial institutions and other persons dealing in any such services.</i>
9813.5000	Issuance, processing and operation of credit and debit cards

(emphasis is ours)

7. Rule 40A of FER, 2005 provides for a special procedure for collection of FED on services provided by banking companies. Sub-Rule (4) of Rule 40A of FER, 2005 provides exemption to the banking companies from payment of FED on those incomes that are of the nature of mark-up or interest. It reads as:

“40A. Special procedure for collection of excise duty on services provided by banking companies, financial institutions and non-banking finance companies.—(1) The provisions of these rules shall apply for collection and payment of excise duty by persons providing or rendering financial services as notified under the First Schedule to the Act.

(2) Every banking company and non-banking financial company shall pay the excise duty leviable on all services rendered or provided to any person except the services of utility collection, Umra and Hajj service, cheque book issuance, cheque return, Musharika and Modaraba Financing.

(3) ...

(4) The duty under these rules shall be paid by the banking company or financial institution or non-banking finance company on the gross amount charged for service provided to the customers, excluding mark-up or interest.”

(emphasis is ours)

8. The transactions of “gross merchant discount” or “interchange fee and processing fee”, could, if at all, only relate to “issuance, processing and operation of credit and debit cards” against sub-heading 9813.5000 under Tariff Heading 98.13 and within such entry specifically to credit card “processing and operation”.

III. RELEVANT FINDINGS:

9. It would now be useful to examine the findings of the Assessment Officer in relation to gross merchant discount in his Order-in-Original which are reproduced below:

“The taxpayer’s contention does not hold good as the amounts received by the respondent do not constitute the interest/mark-up receipts and those are the receipts in the form of extra amount of payment from customers which they pay to the respondent bank as service charges. Furthermore the taxpayer has conceded that the amounts so received are in lieu of provision of services. The contention of the taxpayer that the above services are fund services is also not tenable as the term “non fund banking services” has been defined in the provision of sub section (16A) of section 2 of the Federal Excise Act 2005 as under:

non-fund banking services: includes all non-interest based services provided or rendered by the banking companies or non-banking financial institutions against a consideration the form of a fee or commission or charges.

A plain reading of the above provision of law makes it abundantly clear that even if the funds of the respondents are involved in the operations of the credit/debit card, the receipts from such transactions are not for fund services as the element of interest is not involved in such receipts and the respondent has received such amounts for the provision of the services both in capacity of an acquiring as well as issuing bank.”

10. The question that thus arises is whether the amounts received by ABC on account of *processing and operation of credit cards* in relation to gross merchant discount is markup/interest income. If so, it would fall outside the purview of FED by virtue of the exemption provided for in Rule 40A(4) of FER, 2005 or service fee/commission and, therefore, attracts FED under Rule 40A(2) of FER, 2005.
11. In order to answer this question, it is essential to first understand the nature of credit card transactions undertaken by ABC.

IV. NATURE OF TRANSACTIONS:

There are 5 parties, namely:

- (a) **Cardholder:** a cardholder is someone who obtains a bankcard (credit or debit) from a card issuing bank. They then present that card to merchants as payment for goods or services.
- (b) **Merchant:** Technically, a merchant is any business engaged in the sale of goods or services. But, only merchants that accept bankcards as a form of payment are pertinent to our explanation. So with that said, a merchant is any business that maintains a merchant account that enables them to accept credit or debit cards as payment from customers (cardholders) for goods or services provided.
- (c) **Acquiring Bank (Merchant Bank):** An acquiring bank is a registered member of the card association such as Visa and MasterCard (limited to these two for ease of understanding). An acquiring bank is often referred to as a merchant bank because they contract with merchants to create and maintain accounts that allow the business to accept credit and debit cards, (i.e. merchant accounts). Acquiring banks provide

merchants with equipment and software to accept cards, promotional materials, customer service and other necessary aspects involved in card acceptance.

- (d) **Issuing Bank (Cardholder Bank):** An issuing bank issues credit cards to consumers. The issuing bank is also a member of the card associations (Visa and MasterCard). Issuing banks pay acquiring banks for purchases that their cardholders make. It is then the cardholder's responsibility to repay their issuing bank under the terms of their credit card agreement.

- (e) **Card Associations (Visa/MasterCard etc.):** Visa and MasterCard aren't banks and they don't issue credit cards or merchant accounts. Instead, they act as a custodian and clearing house for their respective card brand. The *Interchange fee* is set by the card associations.

A typical credit card transaction:

12. A credit card purchase transaction typically includes (1) an authorization process to enable the merchant to obtain the issuing bank's authorization for the cardholder's purchase and (2) a clearance process to transmit information regarding credit card transactions among the merchant, the acquiring bank, and the issuing bank. Credit card purchase transactions also includes a separate flow of funds for settling accounts between issuing banks, acquiring banks, and merchants. Visa and MasterCard each operate electronic network systems to process their respective card transactions, including approval, consolidation, and settlement.

13. A typical credit card purchase transaction is initiated by a cardholder who wants to make a purchase from a merchant. The cardholder presents the card to the merchant in payment for goods or services. The merchant swipes the cardholder's card in a credit card terminal, and data (including the purchase amount, cardholder identifying information, and merchant identity) flows from the merchant to the acquiring bank and then from the acquiring bank through the association to the issuing bank. Approval or denial of the transaction then flows from the issuing bank back through the association to the acquiring bank and then to the merchant. This flow of information typically takes place in a matter of seconds. Once the merchant receives approval of the transaction, the cardholder provides the merchant with a signed transaction receipt, the merchant issues a receipt to the cardholder (sales receipt), and the cardholder departs with the goods.

Payment Mechanism:

14. Cardholder buys goods of worth \$100. He presents the card to the merchant in payment for goods. The merchant swipes the cardholder's card in a credit card terminal.

15. Usually within 24 hours of the transaction, merchant will raise invoice for the acquiring Bank.

16. Within maximum 3 days thereafter, acquiring Bank will pay \$97 to the merchant. This \$3 discount is known as "**gross merchant discount**". The difference between the total price of the goods or services sold to cardholders and the amount paid to the merchant by the acquiring bank is known as the merchant discount or gross merchant discount. The merchant discount is typically a fixed percentage of the total price of the goods or services sold and compensated acquiring banks for the services they provided to the merchant.

Unlike interchange, the merchant discount is not determined by the association. Rather, merchant discounts are negotiated between acquiring banks and their respective merchants. The difference between the amount the acquiring bank receives from the issuing bank and the amount the acquiring bank sends to the merchant is generally known as the net merchant discount or processing fee; i.e., the difference between the gross merchant discount and the *interchange fee*.

17. This \$3 i.e the gross merchant discount consists of 2 components, namely (i) *interchange fee*, and (ii) *processing fee*. *Interchange fee* is for the issuing bank; *processing fee* is for the Acquiring Bank. *Interchange fee* is a major component of merchant discount.
18. Assuming *interchange fee* is \$2, the Issuing Bank will pay \$98 to the acquiring bank normally within 24 hours to 72 hours from the time the acquiring bank makes payment to the merchant.
19. Since the payment of \$98 is made to the acquiring bank through an association, the card association (say VISA) will itself withhold a couple of cents (say \$0.25) as its fee from \$98 being paid to the acquiring bank. Hence, acquiring bank will receive \$97.75. Remember, acquiring bank paid \$97 to the merchant (see paragraph 16). Hence, the acquiring bank ended up getting \$0.75 as *processing fee*. In a \$100 transaction merchant discount was \$3, issuing bank got \$2 (*interchange fee*), acquiring bank got \$0.75 (processing/service fee) and VISA got \$0.25. The cardholder paid \$100 to the Issuing Bank and the merchant received \$97 for his goods worth \$100 sold to the cardholder. It is pertinent to note that the *processing fee* of \$0.75 includes interest as well since the acquiring bank also tied its funds by paying merchant immediately and getting reimbursed later by the issuing bank. However, it is difficult to segregate the two.
20. If a bank is both an acquirer and an issuer (as was the case with ABC in 2010), then for accounting purposes, both *interchange fee* and *processing fee* are segregated and shown separately as Merchant Discount and *Interchange fee* respectively.

V. RESPONSE TO THE ISSUE:

Whether *interchange fee* / *processing fee* is a fee for a service or economically equivalent to markup or interest?

21. 'Interest' is defined in Advanced Law Lexicon 3rd Edition Volume 3 as, "A sum paid for the use of borrowed capital, usually expressed in terms of a rate or percentage of the capital involved (the interest "rate"), which is normally higher when the risk (including the probability of inflation) is greater. The same dictionary defines 'markup' as "An addition to cost price for gross profit to arrive at the selling price. (Commerce)"
22. In dictionary titled, Excellent Legal Words & Phrases, the word 'interest' is defined as, "Payment made for the loan or use of money, and calculated according to a specified rate. The word has a basic meaning of advantage or profit and with reference to a loan it means the profit or advantage of the creditor which he gets by giving to another the use of his money. If the contract stipulates that for the use of the creditor's money a certain profit shall be payable to the creditor, that profit is interest, by whatever name it is called, or if it is called by no name at all."

23. In a case titled as *Capital One Financial Corporation And Subsidiaries versus Commissioner of Internal Revenue*, the United States Tax Court dilated upon the historical roots of the credit card industry and the nature of credit card transactions and income generated therefrom for the banks. The said Court came to the conclusion that the income earned by banks by way of its credit card business in the form of merchant discount and *interchange fee* is actually interest income. It may be noted that the case belongs to a foreign jurisdiction and, hence, not a binding precedent. However, it is similar to the facts in the present matter and, therefore, the ratio laid down by the United States' Tax Court applies on all fours to the present matter. In the absence of a relevant binding precedent, the Honourable Sindh High Court may choose to follow such persuasive precedent.
24. Careful understanding of the entire payment mechanism highlighted above and close reading of the definitions and the United States Tax Court's Judgment makes it evidently clear that both *interchange fee* and *processing fee* (which has only a small element of interest) earned by ABC is simply its interest income. There are many people who pay their balance in full every month and in such cases *interchange fee* is the only revenue that ABC will earn. The length of ABC's loan to one such person may be as little as a day or two (if the cardholder pays ABC immediately upon making a charge) or as long as 40 days. Whether for 1 day or 40, ABC has forgone the use of those funds, and payments for such use resemble interest. Interchange compensates ABC for the expenses and costs associated with lending money to cardholders, including financial carrying costs and credit and fraud risks. Credit and fraud risks are also costs associated with lending money. Interest compensates lenders for the time value of their money, the risk that the borrower may not repay principal and the expenses of pursuing delinquent debtors. Therefore, *interchange fee* is not a fee for any service other than lending money to cardholders, income from which is treated as interest. It compensates the ABC for the costs of lending money.
25. Also, when acting as an acquiring bank, the ABC will use its own funds to pay the merchant for the goods he sold to a cardholder of some other bank almost within 24 hours. Such a transaction is a financing one, where the ABC has used its own funds to pay for the merchant's dues on behalf of the issuing bank's cardholder. Hence, the acquiring bank too, in a way, takes credit risk by paying almost immediately to the merchant (usually within 24 hours) but getting paid later (usually within 72 hours) by the issuing bank. The acquiring bank's funds are tied up till the time it is being paid by the issuing bank. Hence, the amount of *processing fee* also has an element of interest/mark-up (which is difficult to identify/segregate from *processing fee*). Therefore, the 'gross' merchant discount valued at Rs. 9,613,204 has an element of both *processing fee* and *interchange fee* (interest). However, it may be noted that FED would have been leviable on *processing fee* had it been possible to segregate *processing fee* and *interchange fee* in Rs. 9,613,204.

Conclusion

Although this is a case of first impression, it can safely be concluded, in view of the foregoing, that:

- (a) *The credit card services provided by ABC fall under Tariff Heading No. 98.13 under Chapter 98 of the First Schedule to the Customs Act, 1969.*
- (b) *The income earned in the form of interchange fee and processing fee (both components of merchant discount) in relation to credit card services is markup/interest income. Therefore, said income does not attract levy of FED by virtue of sub-Rule (4) of Rule 40A of FER, 2005.*