"TAXING E-COMMERCE IN THE BANKING INDUSTRY: THE CASE FOR FINANCIAL TRANSACTION TAX IN KENYA"

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DECLARATION

I, **NYABIOSI VINCENT MOSETI**, do hereby declare that this is my original work and has not been submitted and is not currently being submitted for a degree in any other University.

SIGNED.. **Date**..19/11/10..........

NYABIOSI VINCENT MOSETI

This thesis has been submitted with my approval as the University of Nairobi Supervisor,

SIGNED.. **Date**..19/11/2010..........

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DEDICATION

This project is dedicated to my beloved wife Mrs. Clare Asiko Abuodha Nyabiosi, and my daughter Eden Moraa Nyabiosi, the leading ladies in my life, who encouraged and urged me on, in more ways than I could ever imagine, during the course of my postgraduate studies.

LIST OF ABBREVIATIONS

CFA	OECD's Committee on Fiscal Affairs
E-BUSINESS	Electronic Business
E-COMMERCE	Electronic Commerce
E-PROCUREMENT	Electronic Procurement
EFT	Electronic Funds Transfer
EU	European Union
FTT	Financial Transaction Tax
FTSE	Financial Times Stock Exchange
GDP	Gross Domestic Product
GST	Goods and Services Tax
IMF	International Monetary Fund
IT	Information Technology
KES	Kenya Shillings
KRA	Kenya Revenue Authority
OECD	Organisation of Economic Co-operation and Development
PC	Personal Computer
SME	Small and Medium-sized Enterprises
UK	United Kingdom
UN	United Nations
USD	United States Dollar
VAT	Value Added Tax
Y2K	Year 2000

TABLE OF STATUTES

Constitution of Kenya

Customs and Excise Act, Chapter 472 of the Laws of Kenya

Export Processing Act, Chapter 517 of the Laws of Kenya

Income Tax Act, Chapter 470 of the Laws of Kenya

Investment Promotion Act, Act Number 6 of 2004

Value Added Tax, Chapter 476 of the Laws of Kenya

TABLE OF CASES

Bank of Chettinad Ltd. of Colombo v Income Tax Commissioner (1948) Appeal Cases

Joachimson v Swiss Bank Corporation (1921) All ER 92 and at 3 KB 110

Stanbic Bank Kenya Limited v. Kenya Revenue Authority Civil Appeal 77 of 2008, (2009) eKLR

Union Dominions Trust v Kirkwood (1966) 1 All English Reports

TABLE OF CONTENTS

CHAPTER 1

1.0. INTRODUCTION

"They either get us a financial transaction tax or offer us an alternative way to tax them. After all, they can surely afford to be taxed…"[1]

Background

Taxation has been the subject of a number of studies since it entails the mandatory contribution of money to the public coffers by individuals with no commensurate return. The theory and practice of taxation can be likened to "extortion", only that pieces of legislation give the practice some legitimacy, at least on paper. It is arguable that but for its necessity, society would quickly do away with taxation thus bringing in the element of unwilling taxpayers, ever scheming to avoid or even evade paying taxes. However, taxes are here to stay, at least until society comes up with an alternative way to fund the largesse that are our governments and economies. Policy makers therefore keep identifying new ways of getting more money from the taxpayer with a minimal amount of complaint.

New methods of money transfer and new categories of products that can be delivered between jurisdictions without passing any physical borders raise particular problems for taxation purposes. To achieve the twin goals of encouraging such transactions and protecting national revenue bases, international cooperation must be sought in the development of mechanisms to collect tax in the new digital commercial environment. Without a mutual understanding of common interests and respect for domestic tax policies, the changing dynamic in commerce to which the Internet[2] is giving rise may prove an unbeatable barrier to the efficient working of a financial transfer tax system that guarantees fair balance as to banking business and government

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[1] M Ettlinger, VP, Economic Policy at Washington, D.C, Centre for American Progress. Available at http://www.americanprogress.org/issues/2009/11/wall_street_tax.html. Last accessed 18/11/10

[2] The worldwide collection of networks communicating through common languages and protocols. It is also the basic infrastructure for the new economy over which information can be transferred, transactions made and work done.

needs.[3] The underlying rationale is that whichever medium is used, whenever there is a commercial transaction aimed at making gain, the taxman is nigh, meaning that commercial transactions will be taxed wherever they arise, with the difference being which type of tax will be levied.

This thesis is focussed on the banking sector with specific reference to the taxation of financial transactions, since the e-commerce market in the banking sector is changing the ways in which money is transferred, making it difficult to administer and enforce existing tax rules. Tax rules, being directly connected to the government's chosen policy of raising revenue to finance its spending on the public sector, are matters of a sovereign nature, and their efficient working clashes with the borderless and intangible nature of the Internet.

It should be clear that electronic trade and electronic commerce in the banking industry is neither novel within the Kenyan trade circles nor within the tax ambit. This is because, electronic commerce (e-commerce) has been the subject of a number of studies but mostly how it affects and how it is disaffected by the physical establishment principles of taxation. The physical establishment has been defined as a fixed place of business through which the business of an enterprise is carried on.[4] The physical establishment rule has been adopted to govern the tax treatment of goods and services crossing borders and to assert taxing jurisdiction on the basis of source of income and or the residence of the entity earning the income. The main purpose of the concept of physical establishment is to determine the right of a contracting state to tax the profits of an enterprise of the other contracting state.[5]

Present-day computer-based Electronic Fund Transfers (EFT) have revolutionized the way banks and consumers transact, with the aim of avoiding the risk of handling cash in bulk. Consumers

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[3] See generally, E Fridenskold, VAT and the Internet: The application of Consumption Taxes to E-commerce Transactions, *Information & Communications Technology Law*, vol. 13, Issue 2, 2004, pp. 175 - 203

[4] B Philip, *Double Taxation Conventions and International Tax Law*, 2nd Ed, Sweet & Maxwell Ltd, 1994 p. 154

[5] KG Jemutai, *Taxation of E-commerce: The Challenges Posed to the Concept of Permanent Establishment,* a project submitted in part fulfillment of the requirements for the award of the Degree of Master of Laws, LL. M., of the University of Nairobi, 2005, pp. 2-3

also find that as e-commerce and e-banking increase, making purchases, paying bills, and making instalment payments is easier and more secure when transacted electronically. From Electronic Money Transfer (EMT) and online banking, to wire transfers and cash advances, savvy spenders have moved away from paper to digital money. This is mainly because once stolen, cash is difficult, if not impossible, to recover.

To alleviate the possibility of stolen paper money or the difficulty in obtaining letters of credit, the London Credit Exchange Company first issued traveller's checks in 1772 to wealthy nobles.[6] Modern day traveller's checks, purchased at face value at a depositor's local bank, can be used at home and abroad and easily traced and recovered in case of theft or loss. In the 1950s, banks began issuing credit cards to qualifying depositors; and electronic money transfer began to take centre stage. Today, card-based electronic funds transfer has become the norm, not only in the world of banking, but also in the commercial lives of the average consumer. Businesses have gone paperless with direct deposit employee payroll payments; and monies go directly into employees' checking accounts. Most cash-free consumers prefer making online electronic bill payments or direct debits, especially for big ticket items including asset finance.

Presently, bank cardholders can complete almost any financial transaction seamlessly *via* EFT. In addition to credit card payments for products and services, they may receive refunds for overpayments or returns transacted with retail merchants or financial institutions. Cardholders may also use EFTs for withdrawing funds at an Automated Teller Machine (ATM) or to get a cash advance against a major credit card. Deposits to cardholder accounts can be transacted electronically, moving money from card balances to an existing account.

1.1. Problem Statement

Currently, e-commerce is jointly being taxed under the income tax and value added tax brackets, mainly because the Kenyan tax regime does not extensively recognise it as a stand-alone tax base. At this day and age, the fact that E-commerce is a stranger to our tax statutes is a huge set-

[6] See Electronic Money Transfer, Article available at http://www.bizaims.com/articles/ecommerce/electronic%20money%20transfer. Last accessed 15/10/10.

back. This is because, e-commerce has gained momentum as the most preferred way of doing business with local and international companies restructuring and rebranding to meet its requirements. Kenyans now have online ways of paying bills and sending money, something which was a mystery decades ago. Financial transactions are conducted electronically with the paper trail, if any, becoming less distinct, meaning that tech-savvy companies may fail to disclose their actual turnovers for purposes of for example VAT as they are now in a position of transacting their business electronically. The unfortunate bit is that our statutes are still stuck in the "dark ages", so to speak. This slow reaction to e-commerce is further highlighted by the fact that Kenya still does not have an e-commerce policy, despite ICT being one of the pillars of the nation's development. This is fortunately not the case globally with countries such as the UK, USA and Japan fully acknowledging e-commerce.

The archaic laws in place can only do so much when it comes to tapping revenue from e-commerce conducted within Kenya. Tax evaders and avoiders are therefore given an implied leeway to dispense with the payment of taxes, meaning that critical sectors of the economy are exposed to the risk that they may go unfunded; a reality especially of there is no political goodwill. The Kenya Revenue Authority is also not well equipped to tackle challenges arising from e-commerce despite its reliance on the traditional physical establishment test of determining who is to pay the tax in an international transaction. There is therefore the need to establish a new law that specifically and primarily deals with e-commerce and more so e-commerce in the banking industry.

The banking industry in Kenya has grown ~~in~~ leaps and bounds since the licensing of the first bank and more so after independence. The growth of this sector has been fuelled in part with the growth of the economy. A bursting economy means at the very least that numerous financial transactions are conducted on a daily basis and they are mostly channelled through the mainstream banks. On a related front, we find that developing economies such as Kenya finance their budget deficits mainly through taxes and whenever there is a shortfall, tax rates go up. This should not be the case where for instance, there is an avenue to raise more revenue to finance the nation's needs. A strong illustration of how this can be done is through the adoption and implementation of a financial transaction tax which is aimed at levying a token percentage on financial transactions conducted by banks and other financial institutions, including the stock market.

In light of the above, this thesis considers the taxation of e-commerce in the banking industry; assessing whether the Kenyan tax regime can benefit from some of the inroads made in other jurisdictions; and whether it can be replicated locally in as far as a Financial Transaction Tax is concerned.

1.2. Research Objectives

The main objective of this study will be to establish the modalities of taxing e-commerce in the banking sector by application of a Financial Transaction Tax in Kenya.

Specifically, the paper is aimed at establishing the effectiveness of the current e-commerce tax regimes in the Kenyan banking industry and to identify the challenges posed by e-commerce in the applicability of a Financial Transaction Tax in the banking industry. Finally, this paper outlines its findings and makes recommendations on the workings of a financial transaction tax aimed at capturing e-commerce in the Kenyan banking industry.

1.3. Research Question

The study answers the main research question "Can a Financial Transaction Tax be used to capture e-commerce in the banking industry in Kenya?"

The specific research questions include:

1. What role does e-commerce play in the banking industry?
2. Is the current legal framework adequate in taxing e-commerce in the banking industry?

3. What challenges does the current legislative framework face in taxing e-commerce in tha banking industry?

4. How can a financial transaction tax be applied in Kenya?

1.4. Hypotheses

The study is based on the following three hypotheses:

a) That e-commerce is a key *modus operandi* in the banking industry with a large potential of raising government revenue.

b) That the Kenyan tax regime will benefit from identifying a financial transaction tax.

c) That there is need to incorporate a financial transaction tax as a means of taxing e-commerce in the Kenya banking industry.

1.5. Justification of the Study

The reality that moving money at the speed of light to any place in the world over the internet has been reduced to a few keystrokes on a computer has substantially increased the potential that the size of the identifiable tax base will be diminished especially in the banking industry where almost everything is done electronically.[7] This revolution means that banks and other organizations are able to create their own money for transactional and/or investment purposes and literally move these moneys around the globe electronically. The definition of money as a government-created legal tender will become less relevant and the distinctions between money, goods, services and assets will increasingly disappear as they become more interchangeable.

[7] R Rahn *"The New Monetary Universe and Its Impact on Taxation"*, Cato Institute's 14th Annual Monetary Conference, May 23, 1996. Available at http://www.cato.org/moneyconf/14mc-9.html. Last accessed 29/08/10

These blurred definitions present an impossible task to a tax collector who tries to tax things which can be transformed instantaneously into something else and moved to anywhere in the world with no paper trail.

Kenyans have not been left behind with a majority now paying their bills by using debit or credit cards and by inexpensive methods of banking such as mobile banking.[8] This trend of continued reliance on mobile devices to execute monetary transactions is steadily gaining momentum.[9]

However, government tax authorities are both challenged and threatened by this new technology. The electronic age, with virtually instantaneous international financial transactions and with encrypted confidential smart cards substituting for money, makes the taxation of capital transactions, interest and dividends increasingly problematic. It is also arguable that the cost-benefit ratio of implementing such taxes will be punitive. Government officials have two choices: to redesign their tax and monetary systems to reflect technological reality, or to try to create a system in which every investment and every expenditure by every person is known throughout their lives.

This study tries to find a balanced way of having a financial transaction tax, that can be imposed on banking type e-commerce transactions, to improve on government revenues, without getting too deep into financial privacy of citizens, but also ensuring there is a system to counter challenges like evasion. It also seeks ways in which a financial transaction tax can be introduced in the banking industry without discouraging investment in e-commerce.

1.6. Theoretical Framework

Tax has been described as a multi-disciplinary subject encompassing politics, economics, law and business.[10] It thrives on the economy since it is out of business activity (the production of

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[8] All the three mobile providers in Kenya have operating mobile banking systems. Some have even collaborated with some banks to create mobile electronic accounts for their clients.

[9] ADK Njenga, *Mobile Phone Banking: Usage Experiences in Kenya*, CUEA Available at http://www.w3.org/2008/10/MW4D_WS/papers/njenga.pdf. Last accessed 26/10/10

[10] P Sol, International Business Taxation, A study in the Internationalsization of Business Regulation (1992) Quorum Books, NY, p 3.

goods and services) that taxation is effected. There is indeed a symbiotic nexus between taxation and the economy and as a consequence, progressive tax systems are aimed at achieving the objectives of either increasing revenue, removing market distortions, redistributing income, stabilising the economy, combating anti-social behaviour or moderating social variances.[11] Thus, when developed countries worry about how much they allocate to social welfare, developing countries grapple with providing basic needs for the population owing to the insufficient savings and lack of wealth accumulation. Tax is therefore state-specific.

The underlying theory in this thesis is that e-commerce as a variant of IT is quite dynamic. The e-commerce of 1990 is not the e-commerce of 2000 and is certainly not the e-commerce of 2010. Tax law is thus in the unenviable position of playing catch-up with progressions in commerce, always a step behind. The internet is indeed growing at a terrific speed meaning that the solution for today easily becomes obsolete before it is implemented. It is arguable that tax authorities cannot operate at full efficiency with regards to raising maximum revenue because of this challenge. However, it is true that e-commerce is here to stay and thus the systems for taxation should be flexible and dynamic to ensure that they keep pace with the technological and commercial developments.

E-commerce just like any other form of trade needs to be taxed. The current means of taxing e-commerce in Kenya may not be adequate as the laws we rely on such as Income Tax and Value Added Tax may not be tailor made for ecommerce. This is the fundamental rationale behind his research's clamour for the enactment of a new set of laws dealing with e-commerce but more specifically the financial transactions tax.

The banking industry is a good example of an industry which has the potential of raising substantial government revenue from the hitherto untapped electronic commerce. This is due to the nature of their core operations, which are mainly electronic. These operations are geared towards some economic gain, be it to the banker or the customer, and hence their susceptibility

[11] Supra note 5 p 8

to taxation. The numerous financial transfers which banks are engaged in are also fertile ground for taxation purposes.

The amount of tax to be levied as a financial transaction tax for each shilling dealt with through banking (or financial) institutions ought to be minimal. This is to ensure that the tax so levied does not destabilise the market. As this thesis discusses in chapters four and five a lesser rate of FTT will invariably result in higher returns for the exchequer.

It is also important to realise that globally, the clamour for FTT has taken a dual approach. Some proponents argue for a tax on the mainstream financial transactions such as those undertaken by banks while others argue for a FTT that is levied on trading in the stock market. The latter school of thought is more predominant in the UK and the USA. My argument is that these two proposals ought not be mutually exclusive. In Kenya for instance, we can introduce a FTT on the mainstream banking transactions before the economy is in a position to have the same levied on the stock trade. This is mainly because the Kenyan stock market is not well developed and also because presently, banking transactions offer a more viable option as concerns raising revenue. The aggressive marketing conducted by banks in the recent years has made commercial banks and their products more accessible to the Kenyan consumer. As such, the aggregate volume of banking transactions has increased.

Once however the Kenyan stock market has developed adequately, a financial transaction tax can then be introduced not to raise revenue but for its regulation.

1.7. Conceptual Framework

The study reviews and builds up on the concepts of bank and banking business, international banking, indirect tax, financial transfers, financial transfer tax and electronic commerce.

1.7.1. Bank and Banking Business

Section 2 of the Banking Act[12] defines a bank as a company which carries on, or proposes to carry on, banking business in Kenya but does not include the Central Bank. The same Act[13] defines banking business as: the accepting from members of the public of money on deposit repayable on demand or at the expiry of a fixed period or after notice; the accepting from members of the public of money on current account and payment on and acceptance of cheques; and the employing of money held on deposit or on current account, or any part of the money, by lending, investment or in any other manner for the account and at the risk of the person so employing the money.

The statutory definition of a bank given above adopts a monetary dimension with emphasis on the financial nature of business that such a company would conduct. However, this does not mean that any company duly registered under Part 2 of the Companies Act[14] can conduct banking business as this is the preserve of banking institutions as registered under the Banking Act.

In 1948, the English Privy Council in the *Bank of Chettinad Case* [15] described a bank by borrowing heavily from the statutory definition in force at the time in the UK Companies Act when it stated that it was a company which carried on as its principal business, the accepting of deposits of money on current account or otherwise, subject to withdrawal by cheque, draft or order from the customer.

In the *United Dominions Trust Case*[16] (1966), Lord Denning defined a bank as follows:

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[12] Cap 488 Laws of Kenya. This is an Act of Parliament to amend and consolidate the law regulating the business of banking in Kenya and for connected purposes
[13] Under section 2 (1)
[14] Cap 486 Laws of Kenya. This is an Act of Parliament to amend and consolidate the law relating to the incorporation, regulation and winding up of companies and other associations, and to make provision for other matters relating thereto and connected therewith.
[15] *Bank of Chettinad Ltd. of Colombo v Income Tax Commissioner* (1948) Appeal Cases p. 378.
[16] *Union Dominions Trust v Kirkwood* (1966) 1 All English Reports, p. 968.

> "[A]n establishment for the custody of money received from, or on behalf of, its customers. Its essential duty is to pay their drafts on it: its profits arise *from the use of money* left unemployed by them." [emphasis added]

Lord Denning here invites us to appreciate the fact that Banks can and often do invest and conduct transactions using their client's funds. Most of these funds will be transmitted and invested electronically, highlighting the fact that the e-commerce present in the banking sector may also flow from the Banking institutions themselves and is thus not restricted to the customer's use of the funds. In the same matter, Justice Diplock noted that:

> "[W]hat I think is common to all modern definitions of banking and essential to the carrying on of the business of banking is that the banker should accept from his customers loans of money on deposit, that is to say, loans for an indefinite period on running account, *repayable as to the whole or any part thereof on demand by the customer*..."[17] [emphasis added]

From these judicial assertions, we find that a bank undertakes to receive money and to collect bills for its customer's account. The proceeds so received are not to be held in trust for the customer, but the bank borrows the proceeds and undertakes to repay them. The promise to repay is to repay at the branch of the bank where the account is kept, and during banking hours. It includes a promise to repay any part of the amount due against the written order of the customer addressed to the bank at the branch. Bankers never do make a payment to a customer in respect of a current account except upon demand.[18] Bankers are therefore allowed to deal with the money deposits availed to them by their customers.

For purposes of this paper however, the term 'bank' will refer to the traditional commercial banks as we know them.

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[17] Supra note 15

[18] See generally Atkin J. in *Joachimson v Swiss Bank Corporation (1921) All ER 92 and at 3 KB 110.*

1.7.2. International Banking

International banking is the process in which financial institutions allow foreign clients to access and use their services. It therefore means that among the bank, the customer and the payee, at least two of them are separated by an internationally recognised border. Relatedly, individuals and companies may use international banking to minimise and/or evade their tax liability, a fact which has led to international organisations campaigning against the use of international banks as tax havens. International banking fosters global e-commerce which furthers the problem of its taxation.

1.7.3. Indirect tax

An indirect tax is a tax collected by an intermediary from the person who bears the ultimate economic burden of the tax. The intermediary later files a tax return and forwards the tax proceeds to the government with the return. In this sense, the term indirect tax is contrasted with a direct tax which is collected directly by government from the persons, legal or natural, on which it is imposed. As such, a direct tax is one that cannot be shifted by the taxpayer to someone else, whereas an indirect tax can be so shifted. This therefore means that an indirect tax may increase the price of a good so that consumers are actually paying the tax by paying more for the products. In Kenya, examples would be taxes on alcoholic beverages which were increased by 20 percent in the financial year 2010 with East African Breweries Ltd (EABL) raising its prices by as much as 8.5 percent.[19] The fact that EABL is expected to report Earnings per Share (EPS) of Kenya Shillings (KES) 9.61 in the 12 months through June 2011 compared with KES 9 a year earlier shows that the actual burden of the tax was shifted to the ultimate consumer.[20] Another example would be excise duty on motor cars which is paid in the first instance by the manufacturer of the cars but ultimately the manufacturer transfers the burden of this duty to the buyer of the car in form of a higher price. Thus, an indirect tax is such which can be shifted or passed on.

[19] EABL Investor Information available at http://www.eabl.com/inner.asp?cat=financialprice&subcat=investorinfo. Last accessed 29/08/10

[20] Ibid

1.7.4. Financial Transfers

The need to send money across countries and continents has been the major force behind financial transfers, money transfers or even wire transfers which provide a fast and secure means of sending money. Banks and wire-transfer providers have networks of affiliated financial institutions or agents worldwide that complete the requested transfer of funds on a person's behalf, usually for a fee. A large number of money transfers are carried out today by EFT using the Internet.

EFT is a system of transferring money from one bank account directly to another without any paper money changing hands. One of the most widely-used EFT programs is Direct Deposit, in which payroll is deposited straight into an employee's bank account, although EFT refers to any transfer of funds initiated through an electronic terminal, including *inter alia* credit card, ATM, and point-of-sale (POS) transactions. It is used for both credit and debit transfers.[21] In Kenya transactions are processed by the local bank through the Automated Clearing House (ACH) network, the secure transfer system that connects all Kenyan financial institutions.[22] Such financial transfers are the main forms of e-commerce in the banking sector.

1.7.5. Financial Transaction Tax

A tax on cross-border currency trading has been considered on many occasions by politicians worldwide after it was first proposed in 1978 by the economist James Tobin, who won the Nobel Prize in 1981 for his work on financial markets.[23] Today, the debate is mainly focused on a tax to

[21] Payroll payments and mortgage payments respectively
[22] Central Bank of Kenya, *Payment system in Kenya (*2003) available at http://www.centralbank.go.ke/downloads/nps/nps%20old/psk.pdf. Last accessed 28/08/09
[23] He was awarded The Nobel Memorial Prize in Economic Sciences, commonly referred to as the Nobel Prize in Economics, an award for outstanding contributions to the science of economics. It is generally considered one of the most prestigious awards in economics.

be levied not only on currency movements but also on other financial transactions such as trading in derivatives, equities and bonds.[24]

A Financial Transaction Tax is a tax placed on a specific type, or types, of financial transactions for a specific purpose, or purposes. This term has been most commonly associated with the financial sector, as opposed to consumption taxes paid by consumers.

The OECD defines a transaction tax narrowly to those taxes levied on the transfer of securities.[25] On the other hand the 2001 Russian Financial Transaction Tax Law dictates that a Financial Transaction Tax shall be payable on any cash-less payments through accounts, clearing transactions, counter-delivery and any other payment in funds from accounts, change of creditor and change of debtor in a contractual relationship.

The definition of a financial transaction tax is important as it informs our understanding of financial transactions that are taxable. This is because not all financial transactions are taxable. This paper will deal with financial transactions which constitute taxable e-commerce in the banking industry.

1.7.6. E-Commerce

Rayport and Jaworski[26] have defined e-commerce as technology mediated commercial exchanges between parties as well as the electronically based intra or inter-organisational activities that facilitate such exchanges. E-commerce is the flagship trade advancement in this 21st century techno-age, but with an interesting history.[27]

As the digital revolution of the 1990s developed governments became aware of the potential for new communication technologies to deeply transform the way business and citizens operate. A

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[24] *Brussels gets Cold Feet on Financial Transactions Tax*, 2010, Available at http://www.euractiv.com/en/financial-services/brussels-gets-cold-feet-on-financial-transaction-taxnews- 441845. last accessed 27/08/10
[25] See, OECD, June 2004, Glossary, OECD Economic Outlook, Paris, France.
[26] J Rayport and B. Jaworski, *E-Commerce*, Mc Graw Hill, (2001) p. 3
[27] G Schneider, *Electronic Commerce,* Thomson Course Technology, (2007) p. 4

new commercial environment emerged in which businesses had access to world markets at lower cost and where the burden of international borders on their structure rapidly disappeared.

From these humble beginnings in the 1990's e-commerce grew rapidly until the year 2000, when the "dot-com-bust" occurred triggered by Y2K fears worldwide.[28] Come 2003, e-commerce picked up once more, to what is referred to as the second wave of e-commerce,[29] with global enterprises participating in e-commerce, the use of multiple languages on the internet, increase in use of broadband technology for internet connections and customised e-mail marketing strategies taking centre stage. Companies that survived the 2000 down turn started showing growth in profits of about 20-30 percent per annum.[30] The industry has been on an upward trend ever since.

Used in its broadest sense, e-commerce includes all business activities that use internet activities. According to the OECD, e-commerce refers to commercial transactions occurring over open networks, such as the Internet. This includes shopping on the internet, online trading of goods and services, e-business, EFTs, electronic transactions, online publishing, online money markets, e-procurement and electronic data interchanges between and within companies. The EU also takes a broad approach in defining electronic commerce. The 6th EU VAT Directive[31] states that e-commerce is all about doing business electronically.

The above definitions capture the various kinds of business activities that are being conducted electronically, and convey the notion that e-commerce is much more comprehensive than simply the electronic purchase of goods and services. As such, the unmitigated growth of this trade medium dictates that the law should adapt at similar speeds. Its informal structure and lack of central controls makes it difficult in practice for the law of any particular jurisdiction to exclusively control it.

[28] The Year 2000 problem (also known as the Y2K problem, the millennium bug, the Y2K bug, or simply Y2K) was a problem for both digital (computer-related) and non-digital documentation and data storage situations which resulted from the practice of abbreviating a four-digit year to two digits.
[29] Supra note 26
[30] Supra note 26 p.10
[31] On the Uniform Basis of Assessment. Available at http://europa.eu/legislation_summaries/other/l31006_en.htm. Last accessed 23/08/10

In order to adapt tax rules to this new environment, governments adopted the Ottawa Taxation Framework Conditions in October 1998.[32] As a result of these framework conditions the CFA endorsed the Guidelines on the Definition of the Place of Consumption in the Context of E-commerce in 2001 and the Consumption Tax Guidance Series in 2003. However, it soon became clear that the absence of commonly agreed rules for the application of consumption taxes created increasing difficulties for businesses and tax administrations, far beyond e-commerce and more so with the unrelenting surge of international commercial activities of this electronic nature. In 2004, the CFA published a report called "The Application of Consumption Taxes to the International Trade in Services and Intangibles"[33] shedding some light on these issues. As a result of this reflection, in January 2006 the CFA adopted a set of basic principles for the development of the OECD International VAT/GST Guidelines. These ideological advancements show the prominence that e-commerce plays in the taxation of modern economies. The OECD has been a leading light in this regard and its committees constantly conduct research and follow-ups on the guidelines that its member states adopt.

1.8. Literature Review

Though information on the subject of e-commerce abound s the internet, there are scanty scholarly texts on the subject. This is further reflected when considering financial transaction tax. This area is novel and there are presently no published texts on the same. The main reason behind this is that FTT is still being discussed globally, even as recently as the November 2010 G20 summit in Seoul, South Korea. However, a review of the texts and articles consulted is given below:

Todd Paul[34] has discussed the law surrounding e-commerce by highlighting the commercial aspects of e-commerce detailing intellectual property, contracts, encryption and liability issues,

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[32] OECD CFA, *E-Commerce: Taxation Framework Conditions*. Available at http://www.oecd.org/document/29/0,3343,en_2649_33739_40058909_1_1_1_37427,00.html. Last accessed 12/07/10

[33] OECD CTPA, *Application of Consumption Taxes to the International Trade in Services and Intangibles*. Available at http://www.oecd.org/dataoecd/56/36/32997184.pdf. Last accessed 12/07/10

[34] T Paul, *E-Commerce Law*, Cavendish Publishing, 2005.

allocation of domain names and digital signatures. The author critically examines cases and legislation from the US and Singapore as a means of determining aspects of law within other jurisdictions which the UK might consider adopting in the future. Arguably, in a fast moving area of law as e-commerce, the 2005 law stated therein might not be what is applicable now but the text proffers a reliable and informed examination of the development of e-commerce law.

Roy Rohatgi[35] in chapter two of his book, provides us with a broad knowledge of some of the concepts of international tax law, including treaties and regional tax agreements. To this end, the author defines International Taxation as principles derived from public international law that deal with tax conflicts involving cross-border transactions. He also sheds light on the primary sources of International tax laws and specifically highlights multilateral agreements, bilateral double taxation agreements and customary international law. The key limitation of this reading is that it is not as comprehensive as the subject matter could be but it serves as a proper foundational text for the substance of this paper, which has an international tax outlook.

Hellerstein[36] provides an overview of the problems raised by taxation of e-commerce and of the initiatives that were being undertaken to resolve them back in 2001. Part 1 of his paper describes the technological and commercial background out of which these problems arise and the basic questions that these developments raise for tax administration. Part 2 then considers the principal challenges raised by e-commerce for income tax regimes. Part 3 considers the same but for consumption tax regimes. Of interest is the Professor's assessment of e-commerce and consumption taxes because as he rightly notes, the most pressing problems of tax administration raised by taxation of e-commerce are those raised by consumption taxes rather than income taxes. Hellerstein focuses majorly on consumption taxes but his contribution on the tenets of taxing electronic commerce is invaluable to this paper.

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[35] R Rohatgi, *Basic International Taxation*, vol. 1: Principles, BNA International.

[36] W Hellerstein, *Electronic Commerce and The Challenge for Tax Administration*, Paper presented during the 10th Meeting of the Ad Hoc Group Of Experts On International Cooperation In Tax Matters, Geneva, 2001.

Doernburg *et al*[37] have discussed the topic of e-commerce and jurisdiction and have laid emphasis on the guiding principles or cannons of taxation such as neutrality, equity, administrative efficiency and non-discrimination as the core principles of a good taxation system. While discussing taxation of e-commerce, they look at the different stands taken by America and Canada on one hand, which advocate for tax free e-commerce, and the European Union, which insists on e-commerce taxation. These case studies look at e-commerce generally and they do not identify financial transaction taxes. This paper seeks to ascertain the position taken by leading economies in this area.

Hardesty[38] on the other hand brings American thinking into the subject and his work is intended for tax practitioners and corporate keen on planning their e-commerce taxation. It lays a clear foundation on the attributes of e-commerce such as location, remoteness, anonymity, and technology. The book also goes into detail as to how e-commerce works. However, just like Doernburg *et al,* financial transaction taxes are not addressed.

Jemutai[39] delves into taxation of e-commerce but with an emphasis on the challenges posed to the concept of permanent establishment. She looks into the challenges of e-commerce and tax systems approaches to those problems especially in the European Union and in the developing countries. Her 2005 work may have been overtaken with time but it looks at principles which are critical to e-commerce. Though there is no assessment of financial transaction taxes, this work is important as it lays a basis of some working principles adopted by this paper.

Gichuki[40] looks at the challenges of electronic commerce in tax. He goes further to propose reforms towards a sustainable tax policy on e-commerce for sustainable development in Kenya. He looks at the taxation of e-commerce in comparative jurisdictions such as Malta, the United

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[37] R Doernberg, L Hinnekens, W Hellerstein & L Jinyan, *Electronic Commerce and Multijurisprudential Taxation,* Kluwer Law International London, 2001.
[38] D Hardesty, *Electronic Commerce Taxation and Planning,* Warren Gorham & Lamont Boston, 2002.
[39] Supra note 5
[40] See generally, EN Gichuki, *Challenges of Electronic Commerce on Tax: Towards a sustainable Tax Policy on E-Commerce for Sustainable Development in Kenya,* a project submitted in part fulfillment of the requirements for the award of the Degree of Master of Laws, LL. M., of the University of Nairobi, (2005)

States, South Africa and Singapore. His work will be helpful since most of the basic principles he discusses on e-commerce are similar to those I will look at in the issue of financial transaction tax on e-commerce. His work however is on e-commerce generally while this paper proposes to limit itself to e-commerce in the banking sector.

Arwa[41] looks at the basis for laying tax reform in Kenya. His work delves into communitarian economics, human rights and globalization. Of importance is the fact that he assess tax reform in Kenya, a critical aspect of this study which is aimed at proposing a reform of the Kenyan tax legislation to accommodate a financial transaction tax.

Finally, Mwaniki[42] looks at taxation of e-commerce in Kenya. He looks at the implications of e-commerce on taxation while analyzing challenges of e-commerce to indirect taxation and enforcement and compliance. He also looks into the legislative framework of taxing e-commerce in Kenya such as the Income Tax Act, Value Added Tax Act, Investment Promotion Centre Act, Export Processing Zone Act and Kenya Communications (Amendment) Act, 2008. This study will borrow from his assessment of the Kenyan legislative framework on taxing e-commerce. However, its main focus will be on financial transaction taxes.

Other authors who have been consulted in the development of this thesis are Baker[43] who makes a comparative study of FTT and the revenue raised in the USA and UK, Saporta and Khan[44] who give a critical analysis of the workings and gains of the UK stamp duty as an exemplar of an

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[41] See generally, OJ Arwa, *Taxation and Development in a Global Economy - Laying a foundation for Tax Reforms in Kenya,* a project submitted in part fulfillment of the requirements for the award of the Degree of Master of Laws, LL. M., of the University of Nairobi, (2005).
[42] See generally, GM Mwaniki, *"Taxation of E-Commerce: An Appraisal of the Kenyan Taxation Regime,"* a project submitted in part fulfillment of the requirements for the award of the Bachelors Degree of Laws, LL. B., of the University of Nairobi, (2009).
[43] D Baker *The Benefits of a Financial Transaction Tax*, Center for Economic Policy and Research, (2008), Available at http://www.cepr.net/documents/publications/financial-transactions-tax-2008-12.pdf
[44] F Saporta, K Kan, *The Effects of Stamp Duty on the Level and Volatility of UK Equity Prices,* Markets and Trading Systems Division, Bank of England, London, UK. (1996). Available at https://www.bankofengland.co.uk/publications/workingpapers/wp71.pdf. Last accessed 18/11/10.

international stock exchange FTT and Sculmeister who gives an assessment of the merits and demerits of the proposed FTT[45]. Others are Milne[46] and Terzi.[47]

The key focus of this paper is on the use of a financial transaction tax to capture e-commerce in the banking industry, an area which has not been looked into by the above authors. The clamour for a financial transaction tax has taken root recently, explaining why it was not adequately covered. It is however important to look into the abovementioned works as they give an insight into the tenets of taxing e-commerce. As concerns however the applicability of a financial transaction tax in the Kenyan banking sector, there is no scholarly material (including published books, theses and articles) as this area has not been researched on. This is the gap which this research paper will fill, as none of the authors above have even remotely tackled the subject. However, it is hoped that with probable international sanction of FTTs, more inroads in academic research will be made and published in this area.

1.9. Research Methodology

This thesis adopts an analytical approach to the search for solutions of FTT in Kenya and whether it should be adopted or not. The following research methods will be used to gain secondary data on the same:

a) Library Research
b) Internet based Research.

This is because the research area is an academically novel one and the author relied on a number of internet articles and commentaries on the emerging jurisprudence that is financial transaction tax.

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[45] S Schulmeister, *A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal,* WIFO Working Papers, No. 344 October 2009.
[46] A Milne, *The Fall of the House of Credit: What Went Wrong in Banking and What can be Done to Repair the Damage?* Cambridge University Press, 2009
[47] A Terzi, *Is a Transaction Tax an Effective Means to Stabilise the Foreign Exchange Market?* Franklin College, Switzerland

1.10. Limitations of the Study

Taxation in Kenya is governed by slow moving statutes, meaning that the researcher relied on statutory provisions that are two decades old governing an extremely dynamic trade area, the internet.

This study is limited to how a Financial Transaction Tax can be applied to e-commerce in the Banking Industry. To this end, any other means of taxing e-commerce in other industries will be beyond the scope of this paper.

The study has no African case study because the idea of taxing e-commerce using a financial transaction tax has only taken shape in Europe and the Americas. Currently, there is no African state with a policy on its use.

Academic material on the applicability of a FTT to tax e-commerce in Kenya is also scanty. Globally, the arguments for and against FTT are as current as November 2010 and as such the author had limited material to consult.

1.11. Chapter Breakdown

The study is divided into five chapters as follows:

1. **Chapter One: "Introduction"**
   This chapter introduces the financial and legal issues being researched by this paper. This begins with an introduction/background and a statement of the research problem. It is then followed the objectives and research question of this paper. The hypothesis and conceptual framework of the study then follow. The literature review comes after, giving an overview of some of the texts consulted in the conduct of this study. The research methodology proposed to be used during the course of the research is outlined. The chapter concludes with an assessment of some of the limitations of this study.

2. **Chapter Two: "E-commerce in the Banking Industry"**

   This chapter contains a background, an assessment of the types of e-commerce that exist before rounding up on some of the financial transactions that constitute e-commerce in the banking industry. The transactions assessed here include automated teller machine transactions, tele-banking transactions, online banking, automated self banking centre transactions and mobile banking transactions.

3. **Chapter Three: "Current Tax Regimes on E-commerce in the Banking Industry in Kenya"**

   This chapter considers Acts of Parliament that capture e-commerce presently. This includes the Constitution, the Income Tax Act, the Value Added Tax Act, the Customs and Excise Duty Act, the Investment Promotion Centre Act and the Export Processing Zone Act.

4. **Chapter Four: "Financial Transaction Tax: The International Experience"**

   This chapter contains an analysis of financial transaction tax as applied in other jurisdictions. It considers case studies from the UK, Sweden, Japan, Taiwan, Brazil and the US. Arguments for and against a financial transaction tax will also be proffered.

5. **Chapter Five: "Findings and Recommendations"**

   This chapter contains the findings, recommendations and conclusion of the study. Here, and with regards to a financial transaction tax, the paper looks into its revenue and impact, implementation, regulation, evasion, exemption, stability and vested interests.

CHAPTER 2:

2.0. E-COMMERCE IN THE BANKING INDUSTRY

Background

Like traditional commerce in the physical world, e-commerce comes in a number of flavours...[48]

As alluded to in the previous chapter, e-commerce has different definitions depending on the lens used to view its landscape.[49] From a communications perspective, e-commerce is the delivery of information, products and services, or payments *via* telephone lines, computer networks, or any other means. From a business process perspective, e-commerce is the application of technology toward the automation of business transactions and workflows. From a service perspective, e-commerce is a tool that addresses the desire that firms, consumers and management have to cut service costs while improving the quality of goods and increasing the speed of service delivery. From an online perspective, e-commerce provides the capability of buying and selling products and information on the internet and other online services.[50]

Over time, the internet has become modern man's primary source of basic services and necessities including entertainment, communication, networking, advertising, news, shopping and even banking. With easy access through the numerous hot-spots[51] coming up in town centers, the internet has gained prominence as the one-stop shop and reference area, at least for the tech-savvy. Its accessibility and dynamism makes the internet good for business, a fact evidenced from the tremendous interest that businesses have created in using the internet as a marketing and trading medium. Advertising paved way to actual trade and facilitation of the

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[48] SM Helsinki, University of Helsinki Department of Computer Science, 2006

[49] R Kalokota & AB Whinston, *Electronic Commerce: A Manager's Guide* Adison Wesley, 1997, p. 3

[50] See generally ITECH Vision Company Website on http://www.itechvis.com/itech/itechecom.html. Last accessed 26/10/10

[51] A delimited area within which one can access the internet through a wireless network.

trade: e-commerce.[52] Marko and Rahmann[53] argue that the supply and demand of services over the internet[54] increases rapidly as the internet enables new types of commercial transactions and serves as a substitute for traditional types.

Captains of industry and consumers now more than ever are besieged by futuristic scenarios of business as facilitated by e-commerce, making it one of the most exciting trends in business.[55] Commercial advertisements have begun to guide consumers to company websites for additional product or service information, giving e-commerce the prominence it deserves in today's market place

2.1. Types of E-Commerce Generally

Although that is a very broad way of putting it, e-commerce can generally be categorized into four major forms: business-to-consumer, consumer-to-consumer, business-to-business and consumer-to-business e-commerce.[56]

2.1.1. Business-to-Consumer E-Commerce (B2C)

According to Schneider,[57] a consumer shopping on the web is B2C e-commerce as the business sells products or services to individual consumers but over the internet. This is arguably the most common form of e-commerce.

Going by the above definition, B2C financial transactions in the banking industry would include checking of account balances and other details by a customer electronically, whether online or through a mobile phone or an ATM. The Credit card is currently being used extensively in B2C

[52] Dubbed as the "new engine" of growth, e-commerce is helping China sustain its foreign trade at a time when the nation's exports and imports have been decelerating for months, as per Jiang Yaoping, Vice - Minister of Commerce. Available at http://www.marketreportchina.com/report/content /3326/200902/106001.html. Last accessed 01/09/10.
[53] M Köthenbürger & B Rahmann, *Taxing Electronic Commerce.*
[54] Including information services, professional consulting, financial services, business statistics and medical diagnostics.
[55] Ibid note 43, p. 1
[56] There is a further categorisation of e-commerce, Business to Government (B2G) which includes business transactions with government agencies, such as paying taxes and filing requisite returns.
[57] Supra note 26 p. 5

e-commerce despite it being an expensive means of payment. The challenge for banks is to offer a payments system that will be open enough to support multiple payment instruments (credit cards, debit cards, direct debit to accounts, e-checks, digital money etc.) and scalable enough to allow for a stable service regardless of the workload.[58]

2.1.2. Consumer-to-Consumer E-Commerce (C2C)

C2C e-commerce will arise where consumers exchange goods and/or services with each other. The popularity of this strand of e-commerce is pegged on the fact that it allows consumers to gain access to personalized goods which may no longer be on offer in the market, as happens on *eBay* and *Amazon.*[59]

C2C transactions in the banking industry would include electronic money transfers from one customer to another and buying of stocks directly from the current holder.

2.1.3. Business-to-Business E-Commerce (B2B)

According to G. Schneider[60] these are transactions conducted between businesses on the web. The businesses sell products or services to other businesses over the internet. It encompasses the entire spectrum of e-commerce that may occur between two organizations including purchasing and procurement, supplier management, inventory management, channel management, sales activities, payment management and service and support. Such e-commerce interactions facilitate the network form of organization where small flexible firms rely on other "partner" companies for component supplies and product distribution to meet changing customer demand more effectively. B2B e-commerce is more commonly known as Electronic Data Interchange (EDI). EDI was formerly conducted on a direct link of electronic form between the businesses where as today the most popular connection is the internet.

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[58] M Heng, *Implications of E-Commerce for Banking and Finance*, U21Global, Singapore.
[59] Available at http://www.ebay.com/ and http://www.amazon.com/ respectively. Last accessed 02/09/10.
[60] Supra note 26.

In the banking industry, B2B transaction would be electronic transfer of money from one bank to another.

2.1.4. Consumer-to-Business (C2B) E-Commerce

These are the business transactions that occur when consumers band together to form and present themselves as a buyer group to businesses. These groups may either be economically motivated or socially oriented. In this dimension, e-commerce is enabling the customer to have an increasing say and control in what products are made, how they are made and how services are delivered. The consumers learn about products through electronic publishing, buy products with electronic cash and other secure payments, and even have information goods delivered over the networks. All these can be categorized as C2B e-commerce.

2.2. Financial Transactions That Constitute E-Commerce In The Banking Industry

Technological developments particularly in the area of telecommunications and IT are revolutionizing the way business is done. Electronic commerce is now thought to hold the promise of a new commercial revolution by offering an inexpensive and direct way to exchange information and to sell or buy products and services. This revolution in the market place has set in motion a parallel revolution in the banking sector for the provision of a payment system that is compatible with the demands of the electronic marketplace.[61]

The electronic revolution in banking industry has brought on changes in the distribution channels of financial institutions. The basis for the emergence of the modern electronic distribution channels is the result of the evolution of the concept of money. In the days of barter trade, the ability to pay for goods and services was reflected in the physical existence of the goods, which could be used for exchange.[62] Then came hard cash in the form of coins made out of precious

[61] See generally, BK Guru *et al, Electronic Banking in Malaysia: A Note on Evolution of Services and Consumer Reactions* p. 1. Available at http://www.arraydev.com/commerce/JIBC/0001-07.htm. Last accessed 01/08/10.
[62] Ibid

metals.[63] This was then followed by the advent of fiduciary money in the form of modern coins and paper notes. Today, an individual's ability to pay for goods and services is simply reflected in the accounting records of his or her bank.[64] It is thus important to appreciate that money as it is defined today is just simply information, which can be electronically transmitted to facilitate economic transactions. It is this new definition of money, which has resulted in the electronic revolution of financial institutions.[65]

In line with these global trends, banking business in Kenya too has been undergoing tremendous changes since achieving independence in 1963. The first step in the evolutionary process was the introduction of ATM's which can be considered as the first and most visible piece of evidence of the emergent electronic banking in Kenya. This was then followed by the introduction of telebanking, PC-banking and later on mobile banking and internet banking. However, the lack of an adequate legal framework and security of electronic transactions has hampered the continued progress of this evolutionary process.[66]

2.2.1. Automated Teller Machine Transactions

The most visible form of EFT in relation to the Kenyan banking sector is the use of Automated Teller Machines (ATMs).[67] ATMs are advantageous in that banks are no longer physically constrained and customers save on time which would have been otherwise spent queuing. The notion of a 24 hour banking platform was considered heaven-sent in the banking world. Additionally, staff is relieved of some mundane functions like processing withdrawals and over-the-counter fund transfer. Today, the ATM's in Kenya can be used for balance enquiry, cash

[63] Supra note 43
[64] Ibid
[65] Ibid
[66] Ibid
[67] An ATM is a computerised telecommunications device that provides the clients of a financial institution with access to financial transactions in a public space without the need for a cashier, human clerk or bank teller.

withdrawal, transfer of funds between checking, savings and credit card accounts, bill payments, and for making cash deposits.[68]

In view of the high costs involved in ATM operations and the duplication of ATM services at many off-branch premises, some institutions have established ATM network switches. By linking the respective ATM systems of various financial institutions through the switch, cardholders of member institutions of the consortium would be able to carry out transactions at the terminal of any of the other participating financial institutions.[69]

The impact of the above development was that, commercial banks with geographically well spread ATM networks like the Kenya Commercial Bank lost their competitive edge associated with having the largest number of ATM's in the country. However, if a bank customer was to use the ATM facilities of another bank for his transactional needs a prohibitive an extra access fee is charged. Thus, those banks with large number of ATM's can now profitably use these machines as a source of revenue, translating to more revenue for banks through electronic transactions. The government can therefore tap into those extra revenues through a FTT.

ATM's should evolve into virtual branches providing a broader range of remote transactions where customers could interact with bank personnel through video conferencing in the future.[70]

2.2.2. Telebanking Transactions[71]

This is a service provided by a financial institution, which allows its customers to perform transactions over the telephone. The banks use an automated phone answering system with phone keypad response or voice recognition capability. To guarantee security, the customer must

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[68] These functions are not uniform to all banks in Kenya. ATM's for Standard Chartered and Barclays bank can for example allow cash deposits while those for Kenya Commercial Bank cannot.
[69] Today, almost all the domestic commercial banks in Kenya are members of *Pesa Point* and *Kenswitch* ATM networks. The member banks' customers can have access to their accounts via any ATM belonging to the two networks. The visa network is an international model of the same.
[70] See generally, P Jim *Bytes of Cash: Banking, Computing and Personal Finance.* Available at http://131.193.153.231/www/issues/issue5/philips/index.html. Last accessed on 30/8/10.
[71] Telephone banking.

first authenticate through a numeric or verbal password or through security questions asked by a live representative.

According to Leow,[72] telebanking has numerous benefits for both customers and banks. As far as the customers are concerned, it provides increased convenience, expanded access and significant time saving. From the banks' perspective, the costs of delivering telephone-based services are substantially lower than those of branch based services. In addition, there are many users of fixed line telephone services, which would certainly guarantee the critical mass criteria for telebanking services.

Despite all the advantages, telebanking is currently not a major delivery channel for Kenyan commercial banks' products and services. This is as a result of the fact that cash withdrawals and deposits are not possible through telebanking. It may also be due to the lack of customer confidence in online transactions, which are not immediately verified with black and white statements or receipts.[73]

2.2.3. Online Banking

Online banking is the practice of making bank transactions *via* the internet, allowing customers to conduct financial transactions on a secure website operated by their retail banks. For the online banking customer, the convenience is unrivalled. The customer can check the balance at their convenience and need not wait for the monthly statement by post. In addition to checking balances and transactions, one can catch discrepancies in the account right away and deal with them swiftly. This can be done anywhere the customer has access to the internet.

The increasing awareness of the importance of computer literacy has resulted in increasing use of personal computers in Kenyan households. In his last budgetary speech, the former Minister of Finance Hon. Amos Kimunya, zero rated the cost of computers and computer peripherals in a novel attempt to jumpstart the ICT sector. His successor Hon. Uhuru Kenyatta in his 2009/10

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[72] LH Bee, New Distribution Channels in banking Services, *Banker's Journal Malaysia*, (1999), p.48-56.
[73] This may however be contrary to the developments in Europe where it has been reported in LH Bee (ibid) that 95 percent of European banks [were then] considering telebanking services.

budget speech proposed three outstanding measures aimed at encouraging the growth of ICT and infrastructure development. In paragraph 94 of the speech, the Minister proposed to allocate KES 1.3 Billion to purchase mobile computer laboratories for each constituency, launch a one million computer campaign and with the support of the World Bank, roll out digital villages countrywide.[74]

This would certainly support the growth of PC-banking which would virtually establish a bank branch in the customer's home and offer 24 hour service seven days a week.

At present, customers can use their personal computers at home or at their office to access their accounts for transactions by subscribing to and dialing into the banks' Intranet proprietary software system by use of password. The number of customers who use this service is still relatively small. One of the reasons for this may have been the small number of customers who actually have access to personal computer. However, this situation will hopefully change due to the fact that computers are fast becoming a necessary and permanent fixture in our homes.[75]

2.2.4. Automated Self Banking Center Transactions

The Automated Self-Banking Center is another multimedia banking delivery channel which incorporates an information counter, ATM's, telebanking and banking booths. These automated self-banking centers are usually situated in high pedestrian traffic areas such as shopping malls and office complexes. They are not yet operational in Kenya but a commercial bank will soon be installing a few of them as a pilot project.[76]

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[74] GOK, *2009 Budget Speech.*

[75] It is also worth noting that PC-banking is more common among corporate customers compared to individual customers. This may be so since PC-banking has the advantage of reducing cost, increasing speed and improved flexibility of business transactions. To this extent, LH Bee (supra note 59), asserts that on-line banking will emerge as a competitive tool and as a money saver rather than a revenue earner. However, if the banks are fast in adapting to the changing needs of consumers and are prepared to provide new innovative services in line with the demands of the electronic marketplace they may be able to transform this delivery channel into a revenue-generating source as well.

[76] This information was from CK Kiara, Kenya Commercial Bank Lower Eastern Operations Manager, in an interview held in Nairobi on 27/08/10.

2.2.5. Mobile Banking Transactions

The explosion of mobile phone users in Kenya in the last decade has transformed lives. It has brought technology to peoples palms. Not every Kenyan can own a computer but many own mobile phones with internet connectivity. In the last few years leading mobile service providers started their own money transfer services to cater for those who did not have bank accounts.[77] It was, and still is, convenient, fast and readily available service. Banks having seen the potential in this have started collaborating with network providers to allow their customers to use their mobile phones to withdraw or deposit money through their phones.[78]

2.3. Conclusion

E-commerce in the banking industry is not only here to stay but will also be growing in leaps and bounds, what with the recent landing of the undersea fiber optic cable at Mombasa. This means that tapping well into technology, banks will get new sources of revenue from such electronic transactions. This leaves the government with an uphill task of ensuring that there is an effective legal and administrative framework to tax the extra income from such transactions.

E-commerce holds the potential to transform banking and financial systems. There are three aspects in which e-commerce can affect banking and finance. First, banks and financial firms can use the technology and business practice of e-commerce to market their products to the customers. Second, e-commerce provides a business opportunity for banks to offer new products and services to serve the needs of e-commerce. Third, the new business environment associated with e-commerce provides opportunity for institutional innovations in banking and finance, which can help to lay a sounder foundation for the international financial system.[79]

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[77] M-Pesa and ZAP services from Safaricom and Zain respectively. Orange and Essar also have similar services.
[78] Equity Bank with the help of Safaricom started mobile bank accounts for their customers, M-Kesho. Other banks that have services that allow customers to deposit and withdraw money into and from their accounts are Co-operative Bank of Kenya, Kenya Commercial Bank and Family Bank.
[79] Under CAP 488 Laws of Kenya

As R. Murphy[80] puts it, the fact that the bulk of financial information will be available through the internet, is only a matter of time. This means that in time, banks will also do their tax returns through the internet. This will ensure, even, more growth of e-commerce in the banking industry.

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[80] R Murphy, *A Proposed International Accounting Standard—Reporting Turnover and Tax by Location,* Association for Accounting and Business Affairs, p. 10.

CHAPTER 3:

3.0. CURRENT TAX REGIMES ON E-COMMERCE IN THE BANKING INDUSTRY IN KENYA

> **Today's highly centralized and digitized systems for financial transactions...must be placed under democratic control. This is *conditio sine qua non* of greater financial transparency.**[81]

Background

Since the days of absolutism in Europe, laws have had a great role to play in taxation. France, for example, had a longstanding policy to avoid taxation of the nobility allowing taxation of the poor. The merciless taxation of the farming class eventually led to the collapse of the French economy during the era of King Louis XIV.[82] The same was experienced in Russia, Austria and Scandinavia during the days of absolutism.[83] This underscores the fact that financial and other transactions must be regulated and legislated upon. Parliament as the most democratic law making organ should come up with laws that govern for instance, the taxation of e-commerce in the banking sector using a financial transaction tax. This is the "democratic control" alluded to in the introductory quote above, which gives such taxation some legitimacy.[84]

This chapter delves into the tax laws that currently govern taxation of e-commerce in the banking industry. There is no specific law that deals with taxation of e-commerce in the banking industry. The Constitution and various Acts of Parliament however, capture different aspects of such taxation as discussed below.

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[81] Mikael Book, Team Member, Currency Transaction Tax (CTT), See generally CTT Campaigns Network available at http://www.cttcampaigns.info/ftt-1. Last Accessed 13/10/10

[82] 1643 - 1715

[83] See generally, *The Age of Absolutism and Constitutionalism in Europe*, AP World History.

[84] Supra page 1

3.1. The Constitution of Kenya

The Constitution is the supreme law of the republic and binds all persons and all state organs at all levels of government.[85] All law derives their validity from it meaning that taxpayers have a legal right to question the constitutionality of any taxation that is not premised on the Constitution. The constitutionalisation of social and economic rights has brought hope that courts would become important actors in the transformation of our highly unequal society. Taxation is one issue into which courts will be drawn into as they address those rights.

Currently, Kenya is in a constitutional transition period meaning that Articles on taxation and revenue collection can only be operational at the earliest, 18 months after the 27th of August 2010, the date of the promulgation of the new Constitution.[86] Other Articles specifically those dealing with collection of revenue by the county governments will become operational after the year 2012.[87]

There is no mention of e-commerce or banking, except for the Central Bank, in chapter twelve of the Constitution, which deals with public finance. Though this chapter is not yet operational, the study will focus on it since it provides clearly as to taxation and gives specific roles between the county and national governments. The previous Constitution, which still (read presently) governs taxation, does not give any guidelines as to how it is to be done.

The 2010 Kenyan Constitution provides for a devolved government at the National and County level. Under Article 175, county governments shall have reliable sources of revenue to enable them to govern and deliver services effectively, informing the provisions of Article 209 and 210 dealing with their authority to levy taxes. On the other hand, the national government has powers to impose income tax, value added tax, excise tax, custom duties and other duties on import and export goods. The national government may also impose any other tax authorized by an Act of

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[85] Article 2(1) of the Constitution
[86] Unless otherwise expressly provided, "Constitution" here refers to the Current/New Constitution.
[87] See 5th schedule of the Constitution.

parliament, as long as it is not a tax levied by the County governments.[88] County governments are however allowed to impose property rates, entertainment taxes and any other tax that they are authorized to impose by an Act of parliament.[89] From the spirit of section 209, the imposition of taxes by counties should however not prejudice the overall national economic policies, economic activities or the national mobility of goods, services, capital or labour.

The new Constitution provides various avenues through which e-commerce in the banking industry can be taxed. As discussed above, the national government could capture e-commerce through income tax, value added tax, custom duties and any other tax accordingly introduced by Statute. This leaves room for the executive to engage parliament in creation of other laws that would capture taxation of e-commerce in the banking industry. Relatedly, legislation on Financial Transaction Tax in the banking industry could so be enacted but would be specific preserve of the national government as opposed to the county governments. This is further informed on the fact that a financial transaction tax has a national outlook and it should be for the national assembly to legislate on it.

It could also be argued that the county governments will also have powers to tax e-commerce as long as they do not prejudice the national economic policies and activities.[90] It is therefore arguable that the new Constitution lays a very good foundation as to taxation of e-commerce in the banking industry, through a Financial Transactions Tax. Yan[91] argues that the Constitutions of western countries have had a great impact as to taxation. In view of this the Kenyan Constitution can set a starting point into the taxation of e-commerce in the banking industry through a Financial Transaction Tax.

[88] See Article 209 of the Constitution generally.
[89] Article 209(3) of the Constitution
[90] Ibid
[91] Xu Yan, *Taxation and Constitutionalism in the Peoples Republic of China*, a thesis submitted in partial fulfillment of the requirements for PHD at the University of Hong Kong, p. 13.

3.2. Income Tax Act[92]

The Income Tax Act is an Act of parliament that makes provisions for: the charge, assessment and collection of income tax; for the ascertainment of the income to be charged; for the administrative and general provisions relating thereto; and for matters coincidental to and connected to provisions of the Act.[93]

Subject to the Act, income upon which tax is chargeable is income in respect of: gains or profits from; a business, for whatever period of time carried on; employment or services rendered; a right granted to another person for use or occupation of property; dividends or interest; a pension, charge or annuity; and any withdrawal from, or payments out of, a registered pension fund, or a registered provident fund or a registered individual retirement fund; and any withdrawals from registered home ownership savings plan; an amount deemed to be the income of a person under this Act or by rules made under this Act; and gains accruing in the circumstances prescribed in, and computed in accordance with, the Eighth Schedule.[94] It is therefore possible to tax e-commerce in the banking industry under the auspices of the Income Tax Act.

For the purposes of section 3 (2) (a) (ii), an amount paid to: a person who is, or was at the time of the employment or when the services were rendered, a resident person in respect of any employment or services rendered by him in Kenya or outside Kenya[95]; or a non-resident person in respect of any employment with or services rendered to an employer who is resident in Kenya or the permanent establishment in Kenya of an employer who is not so resident, shall be deemed to have accrued in or to have been derived from Kenya. Further, where a business is carried on or exercised partly within and partly outside Kenya by a resident person, the whole of the gains or profits from that business shall be deemed to have accrued in or to have been derived from Kenya.[96] These provisions would ensure that e-commerce in the banking industry, which in most

[92] Chapter 470 Laws of Kenya
[93] See preamble to the Act.
[94] Section 3 (2) (f)
[95] Section 5 (1) (a)
[96] Section 4 (a)

instances is international, is also taxed, giving KRA the statutory authority to tax transactions of such nature entered into by both Kenyan residents and non-residents. As such residency will not be a consideration (read deterrent) in the application of FTT.

The Minister may from time to time by notice declare that double taxation arrangements, having been made with the government of any country with a view to affording relief from double taxation in relation to income tax and other taxes of a similar character imposed by the laws of the country, shall, notwithstanding anything to the contrary in the Income Tax Act or in any other written law, apply in relation to income tax, and that notice shall, subject to the provisions of this section, have effect according to its tenor, as per Section 41 of the Act. The arrangements in the notice may include provisions for relief from tax for periods before the commencement of this Act or before the making of the arrangements and a notice under this section may be amended or revoked by a subsequent notice and an amending or revoking notice may contain such transitional provisions or termination date as appear to the Minister to be necessary or expedient. Such notices have to be laid before parliament.

Though the Act makes the above provision, just a few arrangements have been made with respect to double taxation. These are agreements with Denmark, Norway, Sweden, the UK, Germany and Zambia. E-commerce in the banking industry is mostly international and there are valid risks as to double taxation. This requires the government to enter into more agreements to ensure there is no double taxation of e-commerce in the banking industry.

The Commissioner of Income Tax has discretion to abandon or remit tax in any case where he is of the opinion that he should refrain from assessing to tax, or recovering tax from, a person by reason of: uncertainty as to any question of law or fact; or consideration of hardship or equity; or impossibility, or undue difficulty or expense, of recovery of tax. The Commissioner may, therefore, with prior approval of the Minister refrain from assessing or recovering the tax in question and thereupon liability to the tax shall be deemed to be extinguished or the tax shall be deemed to be abandoned or remitted, as the case may be, and the provisions of this Act other than this section shall no longer apply thereto. The minister could also direct the commissioner to take such measures or seek court guidance.[97] The uncertainty as to taxation of e-commerce, in the banking industry, the difficulty of enforcing such taxation and the cumbersome process of tracking electronic transactions could lead the commissioner of Income Tax to apply this provision.[98]

The case of ***Stanbic Bank Kenya Limited v. Kenya Revenue Authority***[99] is a good example of where the Court of Appeal was faced with an e-commerce transaction and had to decide whether it was taxable under section 35 (1) (a) of the Income Tax Act. The Appellant has subscribed for technical and consultancy information from Reuters (UK). The information was passed electronically. The Court of Appeal upheld the High Court's decision that the transaction was taxable under the Income Tax Act as according to the learned judge, the services rendered by Reuters (UK) to the appellant fell under the management and professional fees category. As such, the appellant bank should have withheld tax for the respondent.

It is quite clear that even though e-commerce is not mentioned in this Act, there is room for its taxation. There need to be deliberate attempts at amending and adapting the Income Tax Act, to ensure that it is responsive to emerging trends of electronic transactions in the banking industry, if Kenya is to fully benefit from increased revenues in the sector.

One major problem with income tax taxation is the ease at which individuals and corporations can evade or avoid it. The EU is starting to improve mechanisms and instruments to limit evasion and avoidance. This is through proposals to amend the Savings Taxation Directive.[100] Kenya should also put into place mechanisms and instruments to curb evasion and avoidance if it is to fully benefit from income tax, especially if a FTT is to be applied in the taxation of e-commerce.

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[97] Section 123

[98] Supra note 40 p. 73-74.

[99] Civil Appeal 77 of 2008, (2009) eKLR.

[100] See generally, Richard Murphy, *Plugging the Gaps: Reform of the EU Savings Tax Directive*, (2008), Tax Justice Network.

3.3. Value Added Tax Act[101]

The Value Added Act, is an Act of Parliament to impose a tax to be known as value added tax on goods delivered in, or imported into Kenya; and on certain services supplied in Kenya and for connected purposes.[102] This means that banking services supplied in Kenya through e-commerce invoke charging of VAT as they would amount to taxable services.[103]

Section (3)(2) provides that the Commissioner shall be responsible for the control and collection of, and accounting for tax, and shall, subject to the direction and control of the Minister for Finance, have the superintendence of all matters relating thereto. The Act further provides that a tax, to be known as value added tax, shall be charged in accordance with the provisions of the Act on the supply of goods and services in Kenya (including anything specified by the Minister as such a supply) and on the importation of goods and services into Kenya.[104]

Tax under the Act is charged on any supply of goods or services made or provided in Kenya where it is a taxable supply made by a taxable person in the course of or in furtherance of any business carried on by him.[105] Tax on any supply of goods or services shall be a liability of the person making the supply and (subject to the provisions of this Act relating to accounting and payment) shall become due at the time of supply[106] while tax on services imported into Kenya shall be payable by the person receiving the taxable service.[107]

Gichuki,[108] argues that section 6(4) did not envisage e-commerce since the person making the supply could be miles away, in a different tax jurisdiction, and it may be impossible to know his identity. Subsection 6 of the same section that places the liability to pay VAT on the person

[101] Chapter 476 Laws of Kenya
[102] See preamble to the Act.
[103] Section 6(3), "...a taxable supply is a supply of taxable goods or services made or provided in Kenya." Section 2 provides that "taxable services" means any services not specified in the third schedule (exemption schedule). The third schedule does not exempt electronically supplied services.
[104] Section 5
[105] Section 6(1)
[106] Section 6(4)
[107] Section 6(6)
[108] Supra note 40, p. 76 - 77.

importing services could make it difficult to implement since following up electronic transactions in the banking industry is not easy. It could also bring up sensitive issues of confidentiality and privacy.

Section 14(1) allows the commissioner of VAT to refrain from assessing or recovering the tax in question where he is of the opinion that there is uncertainty as to any question of law or fact or impossibility or undue difficulty or expense of recovery of tax. The Minister's approval is required. With the main agenda of KRA being revenue collection, this section is largely underutilized, unless in obvious circumstances.

The Commissioner may, by notice in writing, appoint a person who is normally resident in Kenya, as an agent for collecting the tax payable on the service and remitting it to the Commissioner, notwithstanding the provisions of subsection (6), where the supplier of a service to which that subsection applies is normally resident outside Kenya.[109]

The Act also provide for zero rated supplies. The zero rated supplies are the subject of part A of the fifth schedule to the Act. These are those supplies which are taxed but at zero percent. They are deemed as taxable supplies for purposes of offsetting input from output VAT[110] From the provisions most e-commerce supplies in the banking industry would be zero rated hence diminished tax revenues. However, zero rating is strictly a policy issue and the rates can be revised by the government to fit its revenue needs.

3.4. Customs and Excise Act[111]

Customs deals with the regulation of resources by an authority appointed by the state to regulate the movement of resources, including goods and services, into and out of the country.

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[109] Section 6(7)
[110] See section 8.
[111] Chapter 472, Laws of Kenya.

The Customs and Excise Act of Parliament provides for the management and administration of the customs, for the assessment, charge and collection of customs and excise duties and for matters relating thereto and connected therewith.[112]

The Act deals with goods in their physical form and is chargeable on sight and it is therefore not feasible for purely electronic transactions where no physical goods are involved.[113] It could however apply to some e-commerce aspects such as electronic order processing. It is however not easy to apply it in e-banking transactions.

3.5. Investment Promotion Act[114]

This legislation is meant to promote and facilitate investment by assisting investors in obtaining the licenses necessary to invest and by providing other assistance and incentives and for related purposes.[115] The Investment Promotion Centre established under the Investment Promotion Centre Act[116] continues as a body corporate under the Act to be known as the Kenya Investment Authority.

Section 15 of the Act provides for the functions of the Kenya Investment Authority as promoting and facilitating investment in Kenya through assisting foreign and local investors as well as potential investors by *inter alia*, assisting in obtaining incentives or exemptions under Cap 470, 472, 476, *et al.*

It is worth noting that if the Authority is to fully accomplish its mandate, it has to realize the changing trends in e-commerce, and especially electronic transactions in the banking industry, and advise the government, accordingly, to set up legal and administrative structures to capture and accommodate the same.

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[112] See preamble to the Act.
[113] Supra note 40, p.79.
[114] Act No. 6 of 2004
[115] See preamble to the Act
[116] Now repealed

3.6. Export Processing Act[117]

This Act of Parliament provides for the establishment of export processing zones (EPZs) and the Export Processing Zones Authority; to provide for the promotion and facilitation of export oriented investments and the development of an enabling environment for such investment and for connected purposes.[118]

The activities eligible to be carried out within an export processing zone include manufacturing activities, commercial activities or service activities.[119] Banking transactions within the Export Processing Zones, that constitute e-commerce, are therefore covered by this Act.

Since the Act exempts all EPZ operators from all existing and future taxes and duties payable under the Customs and Excise Act and VAT Act, on all EPZ imports for use,[120] it in effect means that e-banking geared towards export markets could be exempt from some taxes. This however needs clearer guidelines since it would be difficult to follow e-commerce in the banking industry on such a platform.

3.7. Conclusion

From the foregoing discussion, there is need for a law to provide for guidelines on not only how to tax e-commerce, but also how to apply it in specific industries like banking. Since most of the financial transactions, nowadays, are electronic, enactment of laws that capture e-commerce in the banking industry can include a FTT law that will regulate and provide for its imposition. A law governing FTT will be a benchmark in taxation for Kenya and the greater East African region.

The abovementioned taxes are specific in their tax bases and hence would not adequately accommodate e-commerce and more so in the banking sector. The nature of e-commerce

[117] Chapter 517 Laws of Kenya
[118] See preamble to the Act
[119] Supra note 117, section 17(1).
[120] Supra note 117, section 29(1).

transactions makes it peculiar in that it cannot adequately be captured under either income or value added taxes. Issues dealing with the physical establishment concept and the electronic nature of the transactions will mean that Kenya should come up with a specific law dealing with e-commerce and its taxation. It would be a good starting point if the government started with an e-commerce policy. This would set in progress a process towards realization of proper taxation of e-commerce in the banking industry, with peculiar emphasis on the adoption of a Financial Transactions Tax as is being clamoured for internationally. One should not lose sight of the fact that in as much as a FTT would be useful in raising revenue, it will have the effect of reducing speculation in financial transactions, a feat which must be protected and governed in new and specific legislation.

CHAPTER 4

4.0. FINANCIAL TRANSACTION TAX: THE INTERNATIONAL EXPERIENCE

"We are in principle in favour of a financial transactions tax, but we have to wait for a global agreement on the matter... "[121]

"A tax on cross-border currency trading has been considered on many occasions by politicians worldwide after it was first proposed in 1978 by the economist James Tobin, who won the Nobel Prize in 1981 for his work on financial markets. The tax named after him, the so-called 'Tobin Tax', is mainly aimed at limiting short-term currency speculation. Today, the debate is mainly focused on a tax to be levied not only on currency movements but also on other financial transactions such as trading in derivatives, equities and bonds. Politicians' renewed attention for the idea was triggered by the financial sector meltdown which hit the world in 2008-2009 and led to a global recession which is still being felt today."[122]

Background

Since the liberalization of the financial markets in the 1980s, the number of financial innovations and transactions has greatly increased, since it is, now, all about free markets and competition means one has to be a step ahead of the others to remain in business. This is especially so in relation to banks. It is also noteworthy that most of these financial transactions involving banks in one way or the other have largely been electronic entirely or at some point in the process.

While most economists, especially in the west, have proposed regulation measures, in particular the increase of capital requirements,[123] to promote a more sustainable and stable banking system,

[121] C Hughes, European Commission's Internal Market Spokesperson, on the adoption of an International FTT
[122] Sourced from http://www.euractiv.com/en/financial-services/brussels-gets-cold-feet-on-financial-transaction-tax-news-441845. Last accessed 08/10/10
[123] As later adopted in the Basel Accords, more so Basel II on the revised international capital framework

there are also proponents of the tax solution. Proponents of the tax solution are for the idea of a financial transaction tax. These are mainly from civil society and a few economists and politicians.

The best known financial transaction tax is the so-called Tobin tax, developed by the US economist James Tobin in 1972. According to him, the tax rate, which should apply uniformly worldwide, would lie between 0.05 percent and 1.0 percent. For transfers such as direct investments or transactions pertaining to merchandise trade, this tax would be negligibly small since the costs incurred are not relevant in relationship to the profits made per transaction. With short-term arbitrage transactions, however, even this very low tax would prevent profits from arising.[124]

A financial transaction tax that covers all financial transactions has not yet been introduced in any country.[125] This is because of the fact that, as this paper shall discuss later, it has not been as successful in practice as it is theoretically propounded. Additionally, given that it will affect global financial markets, all major players and stakeholders have to be in agreement for it to be implemented.[126]

Many countries have applied FTTs in the past and a limited number of countries continue to apply them today. These taxes are primarily levied on spot share trading, but in a few countries, other types of transactions, including derivatives, are taxed as well. The best-known example is the UK's stamp duty, a 0.5 percent tax on the value of spot transactions in shares of UK companies. The tax rate on share trading is one percent in Ireland, 0.5 percent in Korea, while tax rates between 0.15 and 0.3 percent are applied in Australia, Switzerland, Greece, Hong Kong, India and Taiwan. The Taiwanese transaction tax is rather broad and covers various kinds of securities, including bonds and futures contracts.[127] The common thread underlying these

[124] B Ellmers, *Paying for the Crisis: IMF Staff Reject the FTT (In Favour of a Financial Activities Tax),* European Network on Debt and Development, p. 1.
[125] As at September 2010.
[126] Ibid note 124
[127] See generally, Z Darvas & JV Weizsäcker, *Financial Transaction Tax: Small is Beautiful*, (2010), Bruegel Policy Contribution, p. 6-7.

transactions is that banks are involved either as financiers, brokers, advisors or even the principal buyers.

Revenues from such a tax could be impressive. In the UK, for example, in the fiscal year 2008/2009, the collection cost for all stamp duties, including on property, was 0.21 pence per pound raised (21 percent), while the average for all taxes was 1.1 pence.[128] However, the collection cost for stamp duty on share transactions is likely to be substantially lower since the amount given above includes collection costs for stamp duty on property, which is typically more expensive to collect.

At the same time, it should be noted that transaction taxes have not been equally successful in raising revenues everywhere. For example, when Sweden introduced a financial-transaction tax in the mid-1980s, revenues were disappointing, not least because the tax was easily avoided by moving financial dealings abroad. The extent to which this is possible depends crucially on the specific design of the financial-transaction tax. UK stamp duty, for example, essentially buys legal certainty – the transfer of ownership will officially be stamped once the tax is paid. Of course, in the UK case, it is still possible to sell a share to a counter party abroad so that it leaves the UK system and can thereafter change hands without being subject to UK stamp duty. However, a transaction that exits the system in that way is in effect charged at a rate of three times the normal stamp duty, thereby inoculating the system to some extent against geographic relocation of transactions.

The following international case studies have been chosen not only because of their diverse economic backgrounds but also because they have in one way or another levied a FTT in the recent past. What we seek to learn here is their experience and to see whether Kenya can adopt a hybrid system picking only the best features from them and learning from their mistakes.

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[128] HM Revenue & Customs Autumn Performance Report 2009. Available at http://www.hmrc.gov.uk/about/reports.htm. Last accessed 12/ 9/10.

4.1. International Case Studies

4.1.1. The United Kingdom

The United Kingdom imposes financial transaction taxes in the form of a stamp tax.[129] It is very limited to specific transactions. It is not levied on transactions *per se* but on the registration of securities.[130] Where transactions result in a change of ownership that needs to be registered, the stamp duty comes into effect. This tax does not apply to trades by non-residents; neither does it apply to trades in foreign securities. This stamp duty has been in effect for many decades since 1974 when it was levied at 2 percent.[131]

This is a unique tax that works very well for the system. It is mainly applied in stocks trade in which banks are largely involved.[132] It is notable that stock-trading is nowadays a largely electronic affair and so the UK, through a stamp tax, is able to tax banks for their electronic financial transactions.

The UK imposes its stamp tax, and manages to raise a substantial amount of revenue[133] meaning that the tax is indeed collectable. The UK tax applies to stock trades for firms that are incorporated in the UK, regardless of where the trades take place. While enforcement of the tax on trades that take place outside of the UK is undoubtedly poor, this law limits the extent to which firms would have incentive to list elsewhere to escape the tax.[134]

The UK stamp tax demonstrates that a modest FTT is not inconsistent with maintaining a vibrant stock exchange, as the two are not mutually exhaustive.[135] The London market remains one of the largest stock exchanges in the world, in spite of the stamp tax. The other benefits of the

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[129] See generally, D Baker *The Benefits of a Financial Transaction Tax*, Center for Economic Policy and Research, (2008)

[130] See generally F Saporta, K Kan, *The Effects of Stamp Duty on the Level and Volatility of UK Equity Prices,* Markets and Trading Systems Division, Bank of England, London, UK

[131] Supra note 129

[132] Ibid

[133] See statistics on, http://www.hmrc.gov.uk/stats/stamp_duty/menu.htm. Last accessed on 15/9/10.

[134] See generally, D Baker *The Benefits of a Financial Transaction Tax*, Center for Economic Policy and Research, (2008), p. 3-4.

[135] Ibid.

London exchange obviously outweigh the burden of the tax so that it is still an attractive venue for raising capital and trading shares. Arguments[136] against an FTT have carried the notion that levying such a tax would be tantamount to discouraging investment by the IMF and would be akin to 'Financial Suicide'. Despite this, the London FTSE moves forward.

As a successful model, the stamp tax has two important features that are worth emulating. First, the dealer is responsible for collecting the tax since he is the best able party to ensure that the tax is paid. A second important feature of the UK law is that a security cannot be legally transferred unless the tax is paid. The stamp is effectively proof of the transfer of the security, although this can be done electronically. In effect, tax evasion would imply ambiguity around the ownership of the asset. Prudent investors are willing to pay a 0.25 percent fee to ensure their proper claim to the asset is unassailable.[137]

A ready complaint against the stamp tax is that it only applies to a narrow class of assets, stock shares, and therefore it can be avoided by traders wishing to speculate on other assets, or even those wishing to speculate on stock through the purchase of futures or options. The remedy to this problem is to have a more broadly based tax that applies to transfers of all standardized financial assets. The fee structure would be scaled to the expected life of the asset so that the disincentive to trading will be roughly equal across markets.[138]

The UK however refused to accept proposals by Germany and France to introduce a broader European financial transaction tax on 7th September, 2010. This was despite former Prime Minister Gordon Brown's support for it. Shortly after taking office, UK Chancellor of the

[136] See generally, P Wahl, *FAT versus FTT: How the EU is manoeuvring*, World Economy & Development In Brief, (2010). Available at http://www.world-economy-and-development.org/wearchiv/042ae69e0b0e4e801.php. Last accessed 13/10/10.
[137] Supra note 129.
[138] Ibid.

Exchequer George Osborne expressed reservations about the idea of a Financial Transaction tax, saying the UK instead backed proposals for a global bank tax made by the IMF.[139]

4.1.2. Sweden

In January 1984, Sweden introduced a 50-basis-point[140] tax on the purchase or sale of an equity security.[141] Thus a round transaction (purchase and sale) resulted in a 100-basis-point tax. The tax applied to all trades in Sweden using local brokerage services and to stock options. It did not apply to gifts or bequests. In July 1986 the rate was doubled. The next year, a tax at half the normal rate was also applied against trades between dealers. In January 1989, a tax on fixed-income securities was introduced.[142]

The tax on fixed-income securities was considerably less than on equities, as low as 0.2 basis points for a security with a maturity of 90 days or less. On a bond with a maturity of five years or more, the tax was 3 basis points. On 15 April 1990, the tax on fixed-income securities was abolished.[143] In January 1991 the rates on the remaining taxes were cut in half and by the end of the year they were abolished completely.

There were several reasons for this change in policy.[144] In the first place, the political climate in Sweden had shifted. The taxes were initially supported because financial transactions were viewed as destabilizing to the economy and as promoting excessive wage differentials. This latter point was distasteful in a society that places so much importance on income equality. Additionally, the revenues from taxes were disappointing; for example, revenues from the tax on fixed-income securities were initially expected to amount to 1,500 million Swedish kroner per

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[139] J Strupczewski, Europe to Urge Transaction Tax, Bank Levy at G20, *The IB Times*, 18 June 2010. Available at http://www.ibtimes.com/articles/29356/20100618/europe-to-urge-transaction-tax-bank-levy-at-g20.htm. Last accessed 16/09/10.

[140] A basis point is a unit related to the *change* in an interest rate, and it is equal to 1/100th of a percentage point (0.01%)

[141] MG Wrobel, *Financial Transactions Taxes: The International Experience And The Lessons For Canada,* Canadian Depository Services Program, 1996. Available at http://dsp-psd.pwgsc.gc.ca/Collection-R/LoPBdP/BP/bp419-e.htm. Last accessed 20/09/10.

[142] Ibid

[143] Ibid

[144] Ibid

year.[145] They did not amount to more than 80 million Swedish kroner in any year and the average was closer to 50 million. As taxable trading volumes fell, so did revenues from capital gains taxes, almost entirely offsetting revenues from the equity transactions tax that had grown to 4,000 million Swedish kroner by 1988.[146]

Another reason for the reduction in capital gains taxes was the decline in share prices associated with the initial announcement of the tax and its increase. On the day that the tax was announced, share prices fell by 2.2 percent.[147] But there was leakage of information prior to the announcement, which might explain the 5.35 percent price decline in the 30 days prior to the announcement. When the tax was doubled, prices again fell by another 1 percent.[148] These declines were in line with the capitalized value of future tax payments resulting from expected trades. It was further felt[149] that the taxes on fixed-income securities only served to increase the cost of government borrowing, providing another argument against the tax.

The Swedish system of taxes also played a very profound role in causing trades to migrate to non-taxed or lower-taxed jurisdictions. With the 1986 announcement that the equity tax would double, 60 percent of the trading volume of the 11 most actively traded Swedish share classes, accounting for one-half of all Swedish equity trading, moved to London; thus 30 percent of all Swedish equity trading moved offshore.[150] By 1990, more than 50 percent of all Swedish trading had moved to London. Foreign investors reacted to the tax by moving their trading offshore while domestic investors reacted by reducing the number of their equity trades. Even though the tax on fixed-income securities was much lower than that on equities, the impact on market trading was much more dramatic. During the first week of the tax, the volume of bond trading fell by 85 percent, even though the tax rate on five-year bonds was only three basis points. The volume of futures trading fell by 98 percent and the options trading market disappeared. Trading

[145] Supra note 141
[146] Ibid
[147] Ibid
[148] Ibid
[149] Ibid
[150] Ibid

in money market securities, which faced a tax as low as 0.2 basis points, fell by 20 percent.[151] This reaction was due in large part to the existence of a wide variety of non-taxed substitutes. Once the taxes were eliminated, trading volumes returned and grew substantially in the 1990s.[152]

The Swedish results cited above are all consistent with those that economic theory would predict, *ceteris paribus*. Events and factors other than the FTT could, however, cause similar results, making it difficult to establish cause-and-effect relationships. The timing and magnitude of the financial market effects lead one to look for dramatic changes in explanatory variables.[153] No such changes were evident in economic or financial variables; however, they were evident in changing institutional (read FTT) variables. This does not mean that high FTT rates are needed to generate such results. The high rates simply make the cause-and-effect relationship clear. Low rates would likely produce similar qualitative results, albeit of smaller magnitudes, but they might be masked by other factors.[154]

In 2010, Sweden through its Finance Minister, Anders Borg, opposed the introduction of a tax on financial transactions within the European Union, but supported the imposition of a levy on banks. He is quoted as saying that a banking levy is more suitable as it will give revenues to deal with a future crisis.[155]

4.1.3. Japan

The Japanese government also levies an FTT, which, in the late 1980s, was generating revenues of about USD 12 billion per year. At the peak of its stock bubble[156] Japan was drawing 4.0 percent of federal tax revenue through this source.[157]

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[151] Supra note 141
[152] Ibid
[153] See generally, K. Habermeier, A.A Kirilenko, *Securities Transaction Taxes and Financial Markets*, Chapter 11.
[154] Ibid
[155] M Dalton, The Dow Jones Newswires. Available at http://www.dowjones.com/. Last accessed 13/9/10.
[156] This is an economic bubble experienced in the stock market when the stock market trades in inflated prices.
[157] D Baker, *The Benefits of Financial Transactions Taxes*, Statement to the Bundestag, Center for Economic and Policy Research, p. 2.

Japan, however, had to stop taxing financial transactions in 1999 when the government found that the level of tax excessive to that charged by other countries, 0 percent at the time in the United States, was likely to result in the Japanese financial markets moving away from Japan altogether.[158] The abolition of this tax in 1999 was a protectionist strategy adopted by the Japan Ministry of Finance given the experience in other states.

As at September 2010, Japan was among a group of sixty countries, which will support a proposal to the United Nations to impose a tax on international currency transactions. It is estimated that USD 35 billion could be raised. The amount to be collected will be used for aid and development.[159]

4.1.4. Taiwan

Taiwan imposed a transaction tax of 0.05 percent on the value of the commodity futures contract[160] in 1993. This affected the Taiwan Futures Exchange (TAIFEX), which lost trading volume to the Singapore Exchange (SGX). In 2000, Taiwan reduced the transaction tax to 0.025 percent, and in 2005 furthered reduced it to 0.01 percent. TAIFEX's volume then jumped from 31.87 million contracts in 2003, to 92.66 million contracts in 2005.[161] The competitive advantage enjoyed by the SGX diminished, and trading shifted back to Taiwan. Taiwan's revenue generated by the transaction tax declined immediately after the reductions, but three years later, the increase in volume had caused revenue to exceed previous levels.[162]

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[158] See, *Potential and Unintended Consequences of the Financial Transaction Tax* by Irene Aldridge December 21, 2009. Available at http://www.advancedtrading.com/regulations/showArticle.jhtml?articleID=222002855. Last accessed 14/09/10.

[159] As reported by J Irish on September 1, 2010 at http://www.alertnet.org/thenews/newsdesk/LDE68021J.htm.

[160] A standardized contract between two parties to buy or sell a specified asset of standardized quantity and quality at a specified future date at a price agreed today (the *futures price*). The contracts are traded on a futures exchange. Futures contracts are not "direct" securities like stocks, bonds, rights or warrants. They are still securities, however, though they are a type of derivative contract. The party agreeing to buy the underlying asset in the future assumes a long position, and the party agreeing to sell the asset in the future assumes a short position.

[161] Charles M. Seeger, *Transaction Taxes Harm Commodity Futures Markets,* Financial Markets International, Inc. (FMI), 2008, p. 3

[162] Ibid

The Taiwanese government has recently suspended the tax on bond transactions until the end of 2016 by revising the Securities Transaction Tax Act which exempts corporate and financial bond transactions from the securities transaction tax for seven years beginning January 2010.[163] No official reason has been given for this reason. Under the provisions of the Act, when an investor sells corporate bonds or other securities a transaction tax of 0.1 percent of the value must be paid on each transaction.[164]

Taiwan provides an excellent example of a sophisticated FTT that has a regulatory effect through a multi-tiered system of tax rates, but also raises significant revenue for the government. In 2008 it raised 5.5 percent of total tax revenue, much higher than many countries, yet it did this without disrupting its financial markets.[165]

4.1.5. Brazil

Brazil first introduced a bank debit tax in 1993.[166] However, the longest lasting bank debit tax was put in place in 1997 at an initial rate of 0.20 percent increased from 2001 to 0.38 percent. This was the CPMF[167] tax which was discontinued by the Senate in 2008. Originally, it was earmarked to finance health care programmes, to combat poverty and for social assistance. However, the Supreme Court later abolished the tax on the grounds that the Constitution ruled out the earmarking of revenue from such taxes.

Although taxes were not officially hypothecated afterwards, bank debit revenues allocated to local governments financed healthcare, particularly HIV prevention, programmes.[168] This is an example of how other developing countries can raise their own revenue to help finance public services through ring fencing. This is when a regulated public utility business financially separates itself from a parent company that engages in non-regulated business. This is done

[163] D Beitler, *Raising Revenue: A review of Financial Transaction Taxes throughout the World*, Health Poverty Action and Stamp out Poverty, 2010
[164] Ibid p.7- 8.
[165] Supra note 163
[166] Supra note 163 p. 9
[167] *Contribuição Provisória sobre Movimentação Financeira*
[168] Ibid note 163

mainly to protect consumers of essential services such as power, water and basic telecommunications from financial instability or bankruptcy in the parent company resulting from losses in their open market activities. Ring fencing also keeps customer information within the public utility business private from the for-profit efforts of the parent company's other business.[169] This process ensures that funds are strictly accounted for and protected from any undue misallocation.

In addition to bank debit taxes, Brazil introduced a tax on financial operations in 1999,[170] whereby capital inflows regarding portfolio investments and investments in local assets are subject to a 2 percent tax to be paid when the foreign currency is converted into Brazilian Reals.[171] The 2 percent financial transaction tax applies to all fixed income and equity investments by foreign investors, on the Brazilian stock and capital markets. The taxable base for calculating the IOF is the amount of foreign currency converted into Reals that will be invested in Brazil.

A subsequent return of a foreign investor's initial capital investment i.e. the conversion of Brazilian currency into foreign currency, however, is exempt from the tax. According to the government, the IOF tax is designed to slow the appreciation of the Brazilian currency and to prevent speculation in the Brazilian stock and capital markets.[172] It has also been claimed that recent increases in the tax were in response to the need to compensate for the loss of tax revenue caused by the abolition of the CPMF in 2008. The government increased the IOF rate in 2008 on several financial transactions involving foreign exchange, loans and insurance to 0.38 percent. Since 2009, the IOF has been levied at the rate of 5.38 percent on foreign loans, where the

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[169] S Karekezi, L Majoro, J Kimani & A Wambille *Ring-fencing Funds for the Electrification of the Poor: Lessons for Eastern Africa,* Sub-Regional "Energy Access" Study of East Africa, Final Report, Prepared for "Energy Access" Working Group Global Network on Energy for Sustainable Development (2005) p. 2. Available at http://www.afrepren.org/project/gnesd/Edited%20Regional%20Report_AFREPREN030406.pdf

[170] Supra note 169

[171] The tax is called *Imposto sobre Operações de Crédito, Câmbio e Seguro* (IOF). The Real is the present-day currency of Brazil.

[172] This implies a disincentive for high-frequency, short-term trading as the impact of the tax is reduced as the length of the investment increases, and vice versa.

average payment term of the loan is lower than 90 days. For loans with an average payment term higher than 90 days, the IOF rate is now 0.38 percent.[173]

4.1.6. United States of America

From 1914 to 1966, the US had a federal tax on stock sales of 0.1 per cent at issuance and 0.04 percent on transfers. Currently, although not often mentioned in literature, a security transaction tax applies to transactions in publicly traded shares and exchange traded futures and options. Known as the Section 31 fee[174], it was applied at 0.0033 percent, to the face value of shares. This raised USD 1,090 million in 2000.[175] In 2002, the tax was reduced to 0.0012 percent, of the value of the transaction in securities.[176]

The fee is collected by the Self-Regulatory Organisations (SROs) namely the New York Stock Exchange and National Association of Securities Dealers, and is used to cover the cost of the main regulator: the Securities and Exchange Commission. The public trading of futures and options is also taxed on behalf of customers; this tax was lowered in 2002 to USD 0.10 on round-trip trades in futures and USD 0.05 in options.[177] In 1990, the US government reviewed a proposal during the budget negotiations for a broad-based 0.5 percent tax on transactions in stocks, bonds and exchange traded derivatives. In 1993, the Clinton administration proposed a fixed 14 cent charge on transactions in futures contracts and options on futures, neither of which were implemented.[178]

There has been a latent support of a FTT by the Obama administration although with *provisos*. President Obama is quoted as saying "If we do have losses, I've proposed a Financial Stability Fee on the financial services industry so Wall Street foots the bill – not the American

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[173] Supra note 169.
[174] This is because it emanates from Section 31 of the US Securities Exchange Act of 1934 which requires each Self Regulatory Organisation to pay the Commission twice annually a fee based on the aggregate dollar amount of certain sales of securities (covered sales). The fee rate may change annually as part of the US Securities and Exchange Commission's budget appropriation for a given fiscal year.
[175] Supra note 163.
[176] Ibid
[177] Ibid
[178] Ibid

taxpayer."[179] This financial stability fee is similar to the FTT which is the subject matter of this thesis. The speaker of the House of Representatives is on record stating that the transaction tax has a lot of merit since although it has a minimal impact on the transaction, it has a tremendous beneficial impact on the economy.[180]

4.2. Arguments for a Financial Transaction Tax

The goals, or intended benefits, of transactions taxes include the following:

A FTT would reduce the volume of foreign exchange, and other, transactions, and thereby reducing the volatility of foreign exchange rates. It would also reduce the returns to short-term speculation; reduce the amount of speculation and the incidents of speculative attacks on currency regimes; reduce the volume of speculative flows of "hot money" and other short-term investments; reduce the volatility of international capital flows and the price volatility in markets for foreign exchange and related financial instruments; and encourage long-term relative to short-term investment.[181]

A financial transaction tax could raise substantial revenues for development and other purposes. There are few alternatives to the financial transactions tax, especially in Kenya, where tax payers are already overburdened by taxes that increase every year.[182] We have seen this tax applied in Brazil[183] to cater for public goods, a fete that can be replicated in other countries.

The tax would increase efficiency by reducing the volume of short-term trading which is not productive trading, thus freeing up resources for more productive ends. The more complex the financial sector becomes, the less efficient it is. And since computerization has caused financial

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[179] *USA Today:* http://www.usatoday.com/news/politics/election2008/2008-09-30-campaign_N.htm and full speech text: http://speeches.demconwatchblog.com/2008/10/barack-obamas-speech-in-la-crosse-wi.html
[180] N Pelosi, Speaker of the U.S. House of Representatives as quoted in Reuters: http://www.reuters.com/article/idUSTRE5B24J520091203
[181] See generally, S Schulmeister, *A General Financial Transaction Tax: A Short Cut of the Pros, the Cons and a Proposal,* WIFO Working Papers, No. 344 October 2009.
[182] Supra note 163
[183] Supra note 163 p. 7

transactions costs to drop dramatically over the last decade, the adoption of an FTT will result in vibrant capital markets.

These goals are laudable, showing why there is a strong push for the application of an international FTT.

4.3. Arguments against a Financial Transaction Tax

There are, in the very least, three arguments against such a tax.

It has been argued that a financial transaction tax would have done nothing to avert the 2007-08 financial crisis, and might even have made things worse. The two markets upon which a tax would impinge most, foreign exchange markets and stock markets, played little role in this crisis. What the tax might have done, though, was to reduce the liquidity of mortgage derivatives. But this was, for many banks, precisely the problem. Analysts attributed the problem not to so much that the "toxic assets" were devalued, but rather that they became illiquid and untradeable.[184] However, a transactions tax might have exacerbated this problem. The only way such a tax might have helped is that it might have deterred mortgage securitization in the first place.

Another argument is that a transactions tax does not necessarily stabilize markets. It might do the opposite. Such a tax doesn't so much reduce short-term trades as trades with low expected gains.[185] However, these trades are often stabilizing trades, undertaken by small-scale players in the financial market. If the tax bears more heavily upon such traders, then it might make financial bubbles more likely, not less, to the detriment of the market's stability.

The burden of a transactions tax doesn't necessarily fall upon unscrupulous bankers. If investors anticipate lower liquidity when they come to sell, they'll not pay such high prices. The effect of

[184] See generally, A Milne, *The Fall of the House of Credit: What Went Wrong in Banking and What can be Done to Repair the Damage?* Cambridge University Press, 2009
[185] See generally, A Terzi, *Is a Transaction Tax an Effective Means to Stabilise the Foreign Exchange Market?* Franklin College, Switzerland.

such a tax will then be to depress stock prices, as Bank of England research suggests.[186] In this sense, the FTT bears upon people sensitive to current share prices, such as those coming up to retirement - rather than traders.

If these objections are valid, one can draw two possible inferences. Standard libertarians might say that interventions in markets are, often, ineffective or counter-productive. Leftists, though, might show that it just shows that the financial system needs much more radical change than merely new taxes.

4.4. Advantages of a Financial Transaction Tax

In recent months, various public policy groups, economists, and politicians have advocated the imposition of a tax on financial transactions. Proponents claim that financial transaction taxes will advance the goals of raising revenue and discouraging "destabilizing speculation."[187] These have been the main advantages brought forward as concerns FTT.

Additionally, it has been argued that a FTT could be designed to discourage excessive share trading and encourage longer-term ownership of securities.[188] Although the amount of tax is low, a shrewd investor will not want to trade in his shares unless he has to since he knows there is some financial outlay involved. The FTT as such discourages non-productive activity in the financial markets. A FTT would be a trivial expense for long-term investors, but it would deter much of the churning that now takes place in our hyperactive financial markets and could generate substantial revenue, helping alleviate fears about government deficits.[189] Adding a small fee on the cost of financial transactions will reduce their frequency and encourage people to hold financial assets for longer periods of time.

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[186] See generally F Saporta & K Kan, *The Effects of Stamp Duty on the Level and Volatility of Equity Prices*, Bank of England Publications, Available at http://www.bankofengland.co.uk/publications/workingpapers/wp71.pdf. Last accessed 13/10/10.

[187] CL Culp, *Financial Transaction Taxes: Benefits and Costs*, Compass Lexecon, 2010. Available at http://www.rmcsinc.com/articles/FTTCLC.pdf. Last accessed 27/10/10

[188] Aspen Institute, *Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management,* 2009, p. 4.

[189] P Krugman, "Taxing the Speculators," *New York Times,* November 2009..

A FTT would also make speculation less profitable, keeping some of the speculators' greed in check[190] and would encourage international stock markets to invest more of their resources in the productive economy to the benefit of the citizenry. This can be done through financing of public goods as seen in Brazil. In the United States, it has been argued that a FTT is the most painless way to raise revenues, pay the bills and create jobs in America and Wall Street can easily bear this tax.[191]

4.5. Conclusion

From the foregoing, an FTT seems a delicate affair. While countries like Brazil have been successful in applying it, others like Sweden have failed. Others like the UK limit it while Taiwan has almost done away with it. A lesson to learn is that the success of a financial transaction tax is largely dependent on the transactions to which it is applied and the percentage charged. It will also depend on international relations of a country with others and the purpose for which it is intended.

As this research will discuss in chapter five, Kenya can learn from Brazil, Taiwan and the UK as to ways of ensuring a financial transaction tax is successful in taxation of e-commerce in the banking industry.

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[190] Senator Bernard Sanders (I-VT) quoted by A. Sorkin, *Transaction Tax Is Floated on Capitol Hill*, 2009. Available at http://dealbook.blogs.nytimes.com/2009/10/16/transaction-tax-is-floated-on-capitol-hill. Last accessed 27/10/10

[191] Senator Tom Harkin (D-IA) quoted in Press Release, "DeFazio Introduces Legislation Invoking Wall Street 'Transaction Tax'," *News from U.S. Representative Peter DeFazio,* 2009.

CHAPTER 5:

5.0. FINDINGS AND RECOMMENDATIONS

Background

This study was primarily aimed at considering whether a Financial Transaction Tax can be used to tax e-commerce in the banking industry. To this end, the study was geared towards assessing whether the Kenyan tax regime can benefit from some of the inroads made in other jurisdictions and whether the same can be replicated locally in as far as a Financial Transaction Tax is concerned. Its main objective was to establish the modalities of taxing e-commerce in the banking sector by application of a Financial Transaction Tax. In the previous chapters the study assessed electronic commerce in relation to the banking sector and its regulatory regime surrounding the same. Case studies were also looked into with an aim of considering whether Financial Transaction Taxes are indeed sustainable. These were the United Kingdom, Japan, Taiwan, Brazil and the United States of America.

This chapter concludes the discussion on FTT and recommends how best Kenya can apply a FTT on e-commerce in the banking industry. As the study has revealed, a number of countries have used FTT to varying levels and to different success rates. The challenge for Kenya is to pick from best practices of each of those countries and apply them to come up with a plausible regulatory structure and implementation policy that can govern the application of Financial Transaction Tax in the banking industry. Whilst market impact is clearly related to the rate, there are many other contributing factors which will affect the penetration capacity of this tax. These include the implementation policy, the regulation surrounding the FTT, evasion and avoidance of the tax, exemptions, the stability of revenue collection, vested interest and ring-fencing. Others include the philosophy and attitude of the tax payers towards the levying of a new tax, the strength with which the tax is grounded on the constitution and the tax burden.

5.1. Revenue and Impact

FTTs are a significant source of revenue for both developed and developing countries with collections that oscillate around 1 percent of GDP, though in the case of Taiwan this has risen as high as 7 percent. Generally, the lower the rate and the simpler the design, the more revenue is collected. In particular, it seems that there is a relationship between coverage and tax productivity as exemplified by the fact that simpler taxes that levy only one-way transactions have fewer exemptions and thus less evasion and higher productivity. Kenya should therefore endeavour to have a FTT policy and law that is simple in design and which ensures that e-commerce in the banking industry is well taxed. This can be encouraged by applying favourable rates to avoid the delusion that the taxpayers are being punished for transacting in their securities, or conducting any other e-commerce transactions.

It should also be noted that the size of a country's financial sector must be taken into account when assessing the potential of a FTT to raise revenue. Below a certain threshold the administrative and enforcement costs may outweigh revenue collected. Middle-income countries have the most to gain, for example, Korea stands to raise between USD 0.68 – USD 3.4 billion a year.[192] Kenya, equally being a low income country should therefore consider the administrative and enforcement costs of an FTT to tax e-commerce in the banking industry. There should be careful consideration to ensure that the returns from such a tax cover all anticipated costs. The Ministry of Finance and that of Planning ought to hold a round-table with the Revenue Authority so as to chart the way forward.

As also seen in chapter four above, the market impact of FTTs varies tremendously between countries. Sweden represents one extreme, where widespread migration caused a dissipation of the stock and derivatives markets. On the other hand the UK, despite its 0.5 percent stamp duty on share transactions, has the world's second largest stock exchange and registers a higher turnover than the New York Stock Exchange.

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[192] I Grabel, Taxation of International Private Capital Flows and Securities Transactions in Developing Countries: Do public finance considerations augment the macroeconomic dividends? *International Review of* Applied Economics, Vol.19 (4): 2005, 477-497

5.2. Implementation

A key advantage of FTTs is that their implementation does not require new administrative apparatus. They can be 'plumbed in' to existing mechanisms by which transactions are already settled. This makes implementation relatively simple and collection costs small, as evidenced by the stamp duty in the UK which costs only 0.21 pence per pound, in contrast to income tax (1.24 pence) and corporation tax (0.76 pence) per pound collected.

Kenya can use this model and introduce FTT to tax e-commerce in the banking industry by amending existing legislation such as the Income Tax Act or the Value Added Tax Act. It could also set up a Financial Transaction Tax Act which would comprehensively deal with e-commerce in the banking industry. This study advocates for the latter since such a law would identify and consolidate all transactions that can be taxed using an FTT and especially as it pertains to e-commerce in the banking industry. This is in light with the canon of certainty wherein the tax and the rate should be known and certain. Certainty further dictates that the taxpayers should not be subject to the arbitrariness and discretion of the tax officials is that breeds a corrupt tax administration.[193]

The law should also ensure that the administrative and enforcement agency is well prepared for the tax it advocates. The study therefore proposes that the Kenya Revenue Authority should create an oversight committee to specifically deal with taxation of e-commerce in the banking industry through a FTT.

5.3. Regulation

As the case studies in chapter four demonstrate, the intention of introducing some FTTs is not to raise revenue but to have a regulatory effect. For best practice we can look to Taiwan's multi-tiered tax regimes that reduce short-term speculative trading without affecting the functioning of

[193] A. Waris, *Taxation without Principles: A Historical Analysis of the Kenyan Taxation System*, Kenya Law Review p 276, Vol 1 , (2007)

their financial markets. This type of policy tool can control systemic risk by fine-tuning rates on different product markets when circumstances justify without sacrificing general growth. In finance, systemic risk is the risk inherent to the entire market or entire market segment, which cannot be avoided through diversification as they affect the entire market.

Despite the overlap in designing best practice for revenue raising and regulatory FTTs, there are some intrinsic contradictions in trying to pursue both. The clearest one is related to tax rates, as low rates tend to maximize productivity and so revenue collection whilst regulatory taxes maximize market impacts through high rates which in turn reduce volume of trade, and therefore, potential revenue. In instances where countries attempt to do both, such as Sweden, neither goal can be fully realized.

This study proposes that for a start, Kenya should use FTT as a means of raising revenue. This is because most of the electronic transactions by banks in Kenya are not geared towards the stock markets. As the economy grows towards realization of vision 2030, the laws governing FTT can then be amended or adapted to ensure regulation of markets since banks and other financial instruments will be more involved in stocks. However there ought not to be a blanket adoption of the FTT mechanisms. A feasibility study should be sanctioned by the round-table prescribed above as to its applicability.

5.4. Evasion

Because FTTs are collected at the point of settlement and rely on existing market mechanisms, evasion is more difficult compared with other taxes such as Income tax. As concerns FTTs, there are two core concerns relating to evasion: one has to do with substitution, shifting away from taxed instruments to non-taxed ones, and the other with migration, shifting activities to untaxed locations. The British and Swedish examples give a marked illustration of how well designed taxes can simply negate both of these problems. Investors in Sweden could avoid the tax by either moving transaction offshore at very low costs, or finding or creating close substitutes. The British stamp duty side-steps these problems because it is not a tax on domestic consumption of trading services but a worldwide tax on the transfer of ownership of companies incorporated in the United Kingdom, independently of where the transaction takes place. In other words, since trading offshore does not remove the need to make a transfer of ownership legally binding, it does not shrink the tax base. Furthermore, the stamp duty built in higher tax rates upon leaving the regime to discourage transactions migrating to different instruments.[194]

This study dealt specifically with e-commerce in the Kenyan banking industry and so, it contends that unlike the Swedish and British scenarios, a local FTT would be easily evaded or avoided due to the hardships involved in following electronic transactions. The study therefore proposes that through the enacted law, banks and other financial institutions should be under an obligation to keep detailed records of their financial transactions to enable scrutiny where necessary. These records ought to be maintained in a pre-approved standard format and access to such information only granted on a need-to-know basis to avoid reckless disclosure contrary to the primary duty of secrecy in the banking industry.

5.5. Exemptions

Most countries exempt certain financial transactions to protect key functions within the economy, for example those involving financial intermediaries[195] based on the assumption that they play a crucial role in providing liquidity. Those involving government securities are not usually taxed so that the government's ability to raise capital is not affected and transactions outside national boundaries in many cases are not taxed due to enforcement problems.[196] This study proposes that Kenya could create exceptions for certain e-commerce transactions in the banking industry especially those that involve or encourage innovation in ICT and those

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[194] D Hillman, S Kapoor, & S Spratt, Taking the Next Step: Implementing a Currency Transaction Development Levy, *MPRA Paper No. 4054*, 2006, Available at: http://mpra.ub.uni-muenchen.de/4054/1/MPRA_paper_4054.pdf

[195] These are Institutions which act as middlemen between investors and firms raising funds. They include banks, insurance companies, investment dealers, mutual funds, and pension funds.

[196] S Schulmeister, S Schratzenstaller, O Picek, A General Financial Transaction Tax: Motives, Revenues, Feasibility and Effects, *Austrian Institute of Economics Research WIFO Monographs,* Vienna: WIFO, 2008

involving SMEs in recognition of the fact that these sectors are primed to directing the economy towards the aspirational Vision 2030.

5.6. Stability

The stability of revenue collection is directly related to the political will to maintain these taxes. Over time, productivity may decrease, or avoidance increase, which would require the need to adjust the regulatory and legislative framework. The need to raise revenue is often a response to economic and financial crises. Therefore, tax rates have often varied and revenue productivity has been consequently unstable.

There is therefore need for continuous government intervention and follow up on laws and policies that ensure taxation of e-commerce in the banking industry through an FTT. This can be achieved through amendments and adoptions of laws and policies depending on the prevailing economic conditions to have a 'rudder-effect' on the country's fiscal environment.

5.7. Vested Interest

The successful introduction and maintenance of FTTs also depends on the government's ability to resist vested interests. This is illustrated in cases like Brazil and Japan, where both high revenue generating and market stabilizing taxes were removed or diluted as a consequence of the lobbying efforts of the finance industry.

As Kenya tries to introduce FTTs on e-commerce in the banking industry, the banks and other financial institutions will not sit back. It is anticipated that they will resist an attempt at implementing FTT as is the case internationally. It is therefore important that the government is resilient and focused on its goal without bending to vested interests of those institutions. However for the application of FTT to be successful, the banking institutions through their umbrella body, the Kenya Bankers Association and the Central Bank of Kenya have to come in and own the process as it requires their goodwill.

5.8. Ring Fencing

As some of the cases presented above illustrate, financial transaction taxes have been successfully ring-fenced to finance either local development or particular social policies like Brazil's CPMF.

This study therefore recommends that the money or revenues generated by imposing an FTT on e-commerce in the banking industry should have specified usage, specifically social policy enhancement, provided for in the law to be enacted. This ensures there is good will on the FTT as the financial institutions and players may adopt it as some form of corporate social responsibility. The enactment of the new Constitution and the establishment of new offices will have a strain on the public coffers especially after 2012. The revenue stream trickling from the levying of FTTs can also be channelled to meet these costs.

5.9. Conclusion

The case studies in this paper draw on the empirical evidence available for a variety of FTTs that have been implemented in both developed and developing countries. By drawing on the lessons learnt from these experiences, both positive and negative, a key set of criteria have been established that underlie the successful implementation of FTTs. In 2005 Grabel estimated prospective aggregate revenues for FTTs in developing countries to be in the range of $2.9 billion – USD 14.5 billion. Whilst some caution ought to be exercised over these projections, particularly in regard to countries that do not have developed financial sectors, for Kenya there is clearly potential to build on the success of FTTs. Additional revenue can be raised from its own financial sector which can make a significant contribution both to safeguarding and extending public spending on, for instance, health, education and other public goods.

The main finding in this research is that Kenya indeed needs an apt and adequate way of taxing e-commerce in any form. However, and to answer the research question alluded to in chapter one, a Financial Transaction Tax can and should be used to capture e-commerce in the Kenyan banking industry. This is as opposed to amending pre-existing legislation on taxation because they themselves are in need for review. Parliament ought to take charge over the ongoing international discourse on the matter and land a voice. This is because the challenges facing the taxation of e-commerce and FTT more specifically are enormous and require international cooperation and consensus. The consensus is essential as it will achieve a stable international tax environment that will enable e-commerce develop and contribute to our economies. To this end, Kenya should be the first country in Africa to levy a FTT and not to fund the largesse that is our bloated government but to finance social activities and undertakings. This will ensure that the "pinch" felt by taxpayers is numbed since the money so raised is redistributed to serve friendlier interests.

I also recommend that further studies and research be conducted on Financial Transaction Tax, particularly by scholars from sub-Saharan Africa, so that the arguments in this field have a truly global outlook. The Kenya Revenue Authority should also invite papers and proposals on the best way forward as concerns taxing e-commerce generally but more specifically, financial transaction tax in the banking industry. KRA should move from the position of saving administrative costs and realise that other canons of taxation such as effectiveness also apply.

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