Tax & Exchange Control

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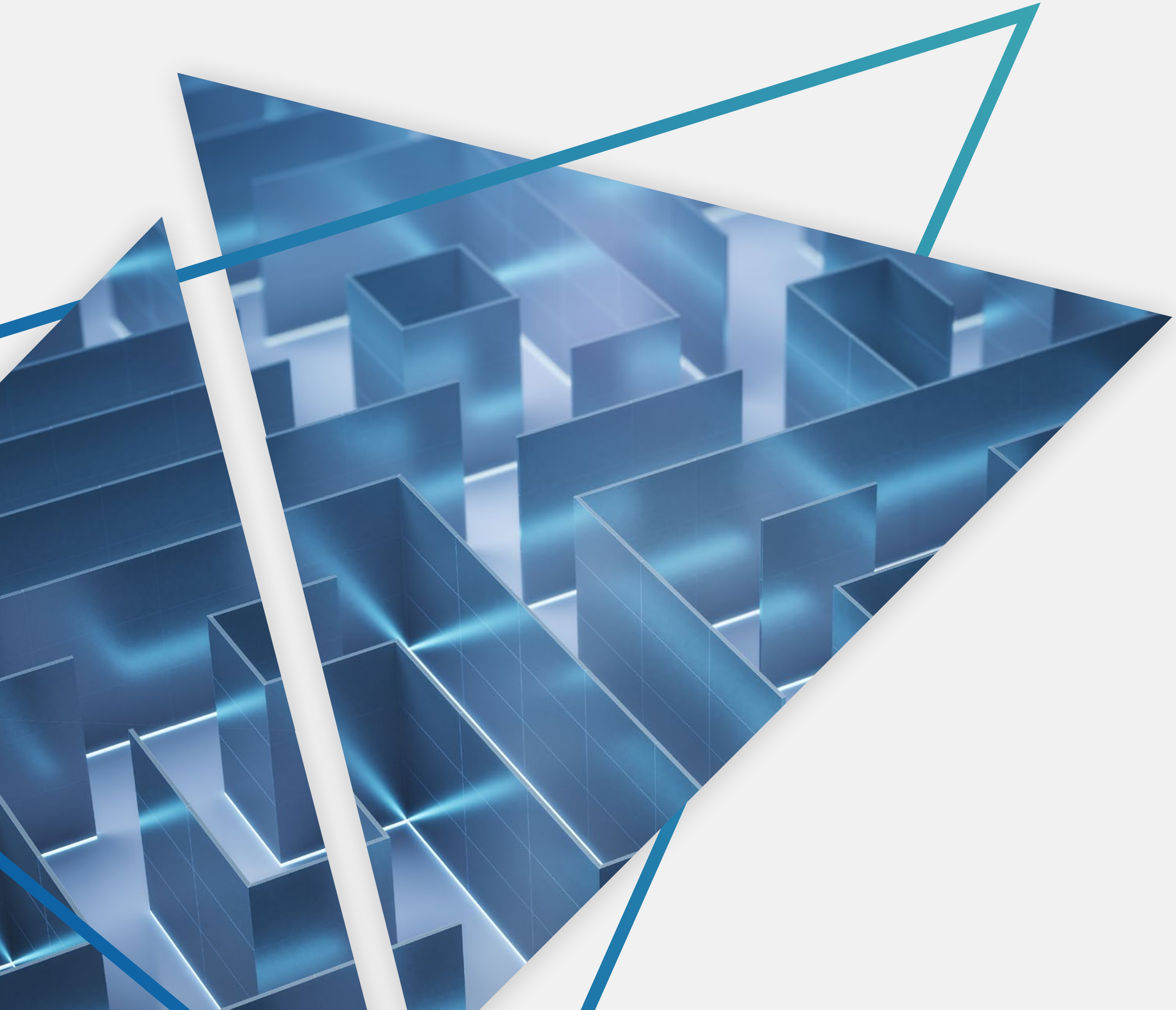

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KENYA

The fine line between debt and equity: An analysis of the Aquavita case and its impact on structuring redeemable preference shares

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The fine line between debt and equity: An analysis of the Aquavita case and its impact on structuring redeemable preference shares

Redeemable preference shares are often used by companies during fundraising and have certain tax advantages, depending on how they are structured.

In *Aquavita Kenya Limited v Commissioner of Domestic Taxes* (Tax Appeals No. 292 of 2021), the Tax Appeals Tribunal (Tribunal) determined that redeemable preference shares issued by Aquavita to its parent company in the UK constituted interest free loans and were subject to the deemed interest provisions under the Income Tax Act, and on this basis assessed withholding tax (WHT) on the deemed interest. This decision raises the pertinent question of what would make redeemable preference shares an interest free loan and not equity?

In this alert we analyse the issue of redeemable preference shares as determined by the Tribunal and look at what this decision means for businesses.

Brief facts

The Kenya Revenue Authority (KRA) conducted a compliance check of Aquavita and issued an assessment for WHT and valued-added tax (VAT), which formed the basis of the appeal at the Tribunal. Aquavita's ground of appeal was that the KRA erred in law and fact by holding that redeemable preference shares issued to Aquavita's parent company constituted interest free loans, and were thus subject to WHT. The position taken by Aquavita was that the issued redeemable preference shares constituted equity as provided for in section 520(1) of the Companies Act. However, the KRA argued that for the purposes of the Income Tax Act, issuance of redeemable preference shares, notwithstanding compliance with the Companies Act, is not in itself a conclusive demonstration of proof that the same is meant for equity purposes. The overall circumstances and the intrinsic economic nature of the instrument must be interrogated before arriving at a decision on whether redeemable preference shares are meant for equity or debt purposes.

Findings of the Tribunal

The Tribunal noted that Aquavita UK had financed Aquavita since its incorporation and that Aquavita issued additional share capital in the company by way of redeemable preference shares to Aquavita UK with the terms that:

- upon being issued, the preference shares were redeemable at the option of the shareholder, with seven days' notice;
- the preference shares did not confer any voting rights;
- the preference shareholders were entitled to a dividend only when Aquavita had distributable profits and upon recommendation by the directors; and
- the preference shareholders were entitled to participate in the capital of the company upon liquidation.

The Tribunal, after reviewing both parties' submissions, examined the relevant provisions of the Income Tax Act concerning deemed interest. The Tribunal noted that interest is applicable not only to loans but also to debts, claims, or any other form of financial obligation. This includes situations where the law treats certain financial arrangements as involving an obligation to pay interest, even if no explicit interest is charged.

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Furthermore, the Tribunal observed that both parties were in agreement that WHT applies to deemed interest. Based on this consensus, the central issue for the Tribunal's determination was whether the redeemable preference shares issued by Aquavita constituted a loan or debt, thereby triggering the application of deemed interest provisions and making the shares subject to WHT.

The Tribunal highlighted that, as per the terms of the redeemable preference shares, the shares were redeemable at the option of the shareholder, and there was no provision for the amount to remain unpaid. This indicated that the shares were akin to a debt, with a clear repayment obligation, rather than an equity instrument. As a result, the Tribunal concluded that Aquavita was indeed indebted to the shareholder, making the redeemable preference shares subject WHT.

The Tribunal noted the provisions of the International Accounting Standards, which provide that:

> *"[A] preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability."*

Moreover, the Tribunal was guided by the decision of the Supreme Court of Canada in the case of Barejo Holdings ULC v Canada 2020 FCA 47 which held that:

> *"A debt arises for purposes of this provision when an amount or credit is advanced by one party to another party; an amount is to be paid or repaid by that other party at some point in the future in satisfaction of the advance and this amount is fixed or determinable or will be ascertained when payment is due."*

In respect of the above, it was the Tribunal's holding that Aquavita's redeemable preference shares were more like debt instruments than equity. Consequently, the KRA was correct in treating proceeds arising from the issuance of these instruments as interest free loans and raising WHT on the basis of deemed interest provisions of the Income Tax Act.

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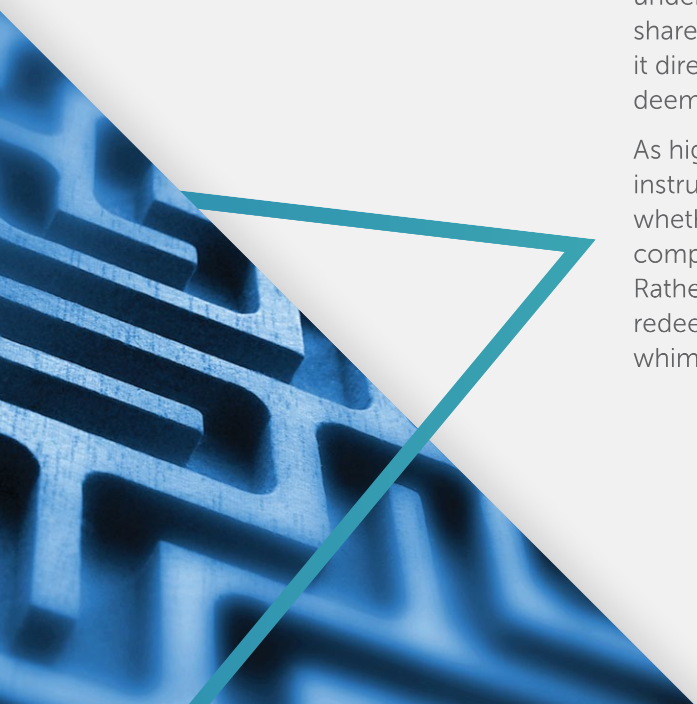
Analysis and recommendation

Traditionally, preferential shares have been classified as equity instruments for companies because of their ownership characteristics and preferential rights. However, preference shares may be classified as debt instruments in certain circumstances. Specifically, if the shares have mandatory redemption features with a fixed maturity date, as in this case, they are treated as liabilities rather than equity. The crux of the Aquavita case was the question of who had the right of redemption and what effect that had in the treatment or classification of the preference shares from a tax perspective. Classification of preference shares as debt instruments may trigger deemed interest provisions under the Income Tax Act that apply to interest free loans, making them subject WHT. On the other hand, if they are classified as equity, they would be subject to dividend taxation, which is also subject to WHT. Therefore, it's important to understand that the classification of redeemable preference shares depends on their specific terms and conditions, and it directly impacts the tax treatment, either through WHT on deemed interest or dividends.

As highlighted by the KRA in its submissions, the instrument's sole purpose must be examined to confirm whether the terms between a shareholder and the company do not give rise to any form of indebtedness. Rather, the redeemable preference shares should be redeemed at the option of the company, as opposed to the whim of the shareholder.



In light of this, it is advisable for companies to consider having the right of redemption of preference shares to be at the level of the company and not at the shareholder level. If a company resident in Kenya has non-resident shareholders advancing loans to the resident entity, it may be useful to check if the resident company can benefit from structuring the loans as redeemable preference shares so that they are classified as equity. Key points to note for the redeemable preference shares to be classified as equity and not loans include:

- the redeemable preference shares should have a 0% coupon rate;
- the redemption should be at a date or dates to be fixed by the company (not the shareholder or investor);
- the redemptions should only be at the option of the company (not the shareholder or investor);
- the company should not be obliged to make payments in the form of interest or dividends to the shareholder or investor; and
- the company should not be obliged to distribute a specific percentage of its profits to the shareholder or investor.

A loan conversation agreement as well as careful structuring of the redeemable preference shares goes a long way. Obtaining the appropriate legal and tax advice will ensure that such risks in respect of new and existing funding models are mitigated.

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