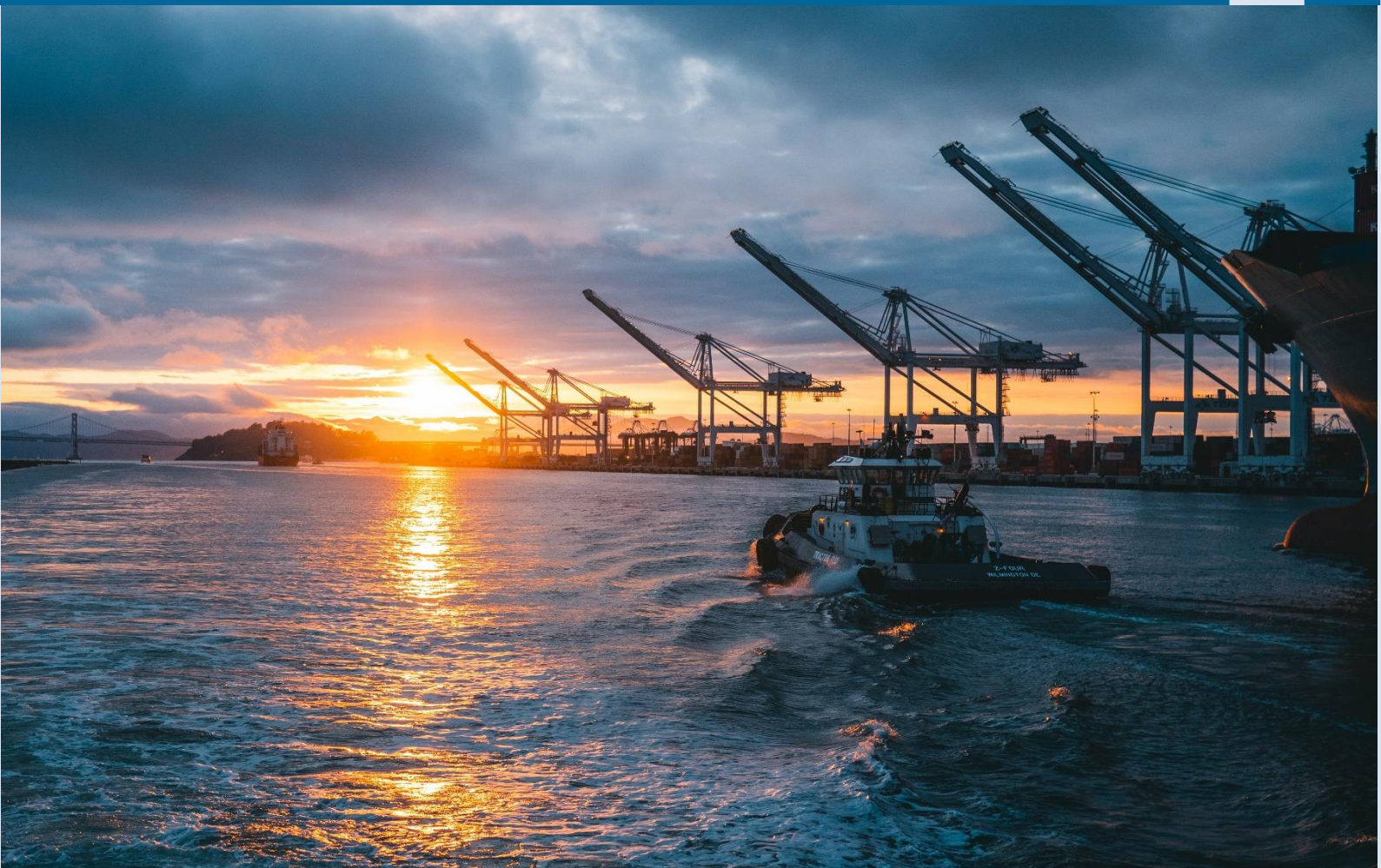


# Sagamore Hill.

# TAX NEWSLETTER.



Navigating Withholding Tax on Deemed Interest - Your Guide to Compliance and Optimization

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This publication is provided for general information and is intended to furnish users with general guidance on the tax matters discussed only. This information is therefore not intended to address the specific circumstances of any individual or entity nor is it intended to replace or serve as substitute for any advisory, tax or other professional advice, consultation or service. Readers should consult professional tax advisors to determine if any information contained herein remains applicable to their facts and circumstances. Part of this publication has been quoted from other online publications.

Every month, we do an analysis of the most downloaded tax case law from our [database](#), where we have classified court case decision according to the class of tax that they fall in for ease of your perusal.

In this month's issue, we share into one of the issues that is becoming very thorny, as the effects of the tax changes as introduced by the finance act 2023 continue to be felt across the board.

The case was between **aquavita kenya limited vs commissioner of domestic taxes** and revolved around two issues the we are going to look at, that of Value added tax and that of Withholding Tax. For the sake of this issue, we are going to have a look at the discussion around Withholding Tax. Kenya revenue authority conducted an audit and issued an assessment on Value Added Tax and Withholding Tax. Consequently, the appellant lodged a Notice of Objection where the respondent followed and issued an Objection decision. The grounds of appeal were as follows.

1. The respondent errs in law and fact by holding that the redeemable preference shares issued by appellant from its parent company constitute interest free loans and are subject to the deemed interest provisions under the Income Tax Act on the deemed interest.
2. The respondent errs in law and fact by holding that the non-refundable shareholder funds held by the appellant tha awaiting capitalisation were interest free loans and therefore subjected to WHT provision under the Income Tax Act.
3. The respondent errs in law and fact by subjecting to VAT supplies that are not subject to VAT contrary to the provision of VAT Act 2013.

The appellant case was as follows.

The appellant pointed out that the difference between the income tax return filled and the VAT returns was a result of non-vatable sales, that is export sales which are zero rated and supplies to VAT exempt entities.

On the treatment of Preference shares as a debt instead of equity, the appellant argued that, the firm was owned by it's parent at 99% of the shareholding and the parent had been financing the subsidiary by way of shares since it's incorporation in 2014

The appellant further argued that, according to the companies Act 50(1) issuance of redeemable of preference shares was a common share injection mechanism as it allows the shareholder to redeem the share when the company becomes profitable and the share capital is in excess of what the company needs as share capital. The appellant further stated that the companies act expressly states that redeemable preference shares constitutes equity in a company irrespective of whether they are redeemable at the option of the company or the shareholder.

The fact that the preference shares were redeemable at the option of the shareholder did not necessitate their change in form from equity to debt. Further, the interpretation of the income Tax which in it's definition of terms defines deemed interest as " *...an amount of interest equal to the average ninety one day Treasury Bill rate, deemed to be payable by a resident person in respect of*

*any outstanding loan provided or secured by the non-resident, where such loan is provided free of interest; further, the act does not define the term loan but defines "all loans" that has the meaning of "means loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which the company is paying a financial charge, interest, discount or premium"*



On whether the shareholders' funds received by the appellant pending allotment constitute a loan, the appellant argued that the moneys received and indicated in the books as "long term investment" were meant to be capitalised, which happened after four years. Further, the funds were not refundable to the foreign lender as the lender did not reserve the right to a refund of the shares if the shares were not issued after a stipulated time. The appellant buttressed his stand by quoting a report by Institute of Chartered Accountant of India in 2013, ***that share given to a subsidiary after the balance sheet date with the intention to allot the same for share, should be, considering substance over form, be considered as a long-term investment.***

On whether the respondent erred in failing to apply the doctrine of strict interpretation of taxes statutes in assessing the appellant for WHT, the appellant submitted that as it was decided

in Cape Brandy Syndicate Vs Inland Revenue Commissioner, that ***"In interpreting a taxing Act, one has to look merely at what is clearly said. There is no room for intendment as to a tax. There is no equity about tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied (emphasis added). One can only look fairly at the language used"*** As per the appellant argument, there is no reference to or reliance on specific provisions of law.

The respondent case was as follows;

Upon the examination of the particular instruments and the circumstances surrounding the issuance of the shares, the same should be treated as loans to the appellant and interest was deemed to apply.

On whether the appellant had treated this as loan in their books, the respondent established that no interest was paid in connection with the funds, neither was interest provided for in the appellant financial statements and thus no WHT on interest had been remitted to the respondent.

As regards the issuance of Redeemable Preference Shares, for purposes of Income Tax, notwithstanding the compliance to Companies Act, that in it's self was not a conclusive demonstration that the same was used for capital purposes. Rather, the overall intrinsic economic nature of the transaction must be considered before concluding whether the redeemable preference shares issued was meant to be equity or debt purposes. The substance over form stance here dictated that the name given to the instrument construed it's form, and that was to the contrary of it's substance.

Further, the IAS 32 states that for an instrument to amount to a debt, ***the instrument contains no contractual***

*obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.*

The IAS further requires that Redeemable Preference shares, redeemable at a future date or at the option of the holder, be classified as a financial liability as there's expected future cash outflow.

In 1980, the US court compiled a list of 13 determinants that may help in conducting such an analysis that may help determine the nature of an instrument as determined in *Dixie Diaries Vs Commissioner of internal Revenue*. These include;

1. Names given to the instrument.
2. Presence of a fixed maturity date.
3. Sources of payment.
4. Right to enforce payment.
5. Participation in management as a result of the advances.
6. Status of the advances in relation to regular corporate creditors.
7. Intent of the parties.
8. Identity of interest between creditor and stockholder.
9. Thinness of capital structure in relation to debt.
10. Ability of the corporation to obtain credit from outside.
11. Use to which the advances were put.
12. Failure of the debtor to repay.
13. Risk involved in making advances.

The respondent further stated that, such a similar case had already been decided by the supreme court of Canada in the case of *Sukloff VS A H Rushforth and Co 1964* where it was held that issuance of Redeemable Preference Shares are not

themselves equity, the surrounding circumstances and the terms of the instruments have to be considered. In the aforementioned case, the preference shares were to be surrendered upon payment of some money advanced to them, and the funding to surrender the shares, was to be derived from the profits of the company. In light of the foregoing, the respondent required some questions to be considered. Among the questions are;



- a. Was there a contractual obligation to deliver the cash. This should create a debtor-creditor relationship.
- b. Was the amount to be paid fixed or determined. If fixed, this would imply a debtor-creditor relationship.
- c. Is there a participation in the management as a result of the advancement?
- d. Is there a presence of fixed maturity date? A fixed maturity date means the existence of debt
- e. What were the consequences for failure to repay?

The respondent was of the stand that the issuance of the Redeemable Preference Shares created and revealed a creditor – debtor relationship and not a shareholder

– company relationship as demonstrated by such facts such as;

The contractual obligation to deliver cash, the amount of which would be repaid in future. In determining whether there was an obligation in future, one can look at the following,

1. Whether the shares are redeemable at a future date.
2. Whether the shares are redeemable at the option of the holder.
3. Whether the receiver is obliged to make payments in the form on interest or dividend.
4. Whether the terms and conditions oblige the issuer to distribute a specific percentage of profits.



The interrogation of the appellants' books, there were several indication of factors that were unfavourable to the issuer, and this created a debtor and creditor relationship. Such included,

1. There existed a specific maturity date and value. In a notice of

increase of nominal capital, the appellant had indicated that the preference share holder shall excise it's redemption option on a specific date, after issuing a seven (7) days' notice.

2. Subordinate to the rights of other creditor. It had been stated that failure to repay the shares at the specific date after issuance of the notice, would convert the amounts to a loan. This was advance was therefore superior to the rights of other shareholders as there was no provision for invitation to vote for the conversion of the preference shares to a loan.
3. Voting right. Shareholders did not have any voting rights arising on the shares and this shows that the advances were a loan and not equity.

In closing to the respondent's submissions, the respondent submitted that the appellant assertion, that issuance of preference shares amounts to equity, is in itself misleading when viewed from the accounting and tax perspective. Whereas it may be correct from the commercial perspective, for income tax purposes, the transaction can however be deemed to be debt instrument. The respondent is empowered to do so under sec 23 of the Income Tax Act.

- (1) *Where the Commissioner is of the opinion that the main purpose or one of the main purposes for which a transaction was effected (whether before or after the passing of this Act) was the avoidance or reduction of liability to tax for any year of income, or*

*that the main benefit which might have been expected to accrue from the transaction in the three years immediately following the completion thereof was the avoidance or reduction of liability to tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which could otherwise be effected by the transaction.*

*(2) Without prejudice to the generality of the powers conferred by subsection (1) of this section, those powers shall extend—*

*(a) to the charging to tax of persons who, but for the adjustments, would not be charged to the same extent;*  
*(b) to the charging of a greater amount of tax than would be charged but for the adjustments.*

*(3) Any direction of the Commissioner under this section shall specify the transaction or transactions giving rise to the direction and the adjustments as respects liability to tax which the Commissioner considers appropriate.*

### **The courts analysis and findings.**

On whether the respondent erred on holding that the redeemable shares received from the UK parent constituted interest free loans and therefore subjected to deemed interest provisions.

The tribunal noted that the imposition of tax on deemed interest is provided in section 10 (c), section 16(3) and section

35(1)(e) of the Income Tax Act state that;  
 Section 10(c)

*For the purposes of this Act, where a resident person or a person having a permanent establishment in Kenya makes a payment to any other person in respect of—*

*(c) interest and deemed interest;*

Section 35(1)(e)

*Every person shall, upon payment of any amount to any non-resident person not having a permanent establishment in Kenya in respect of—*

*(e) Interest and deemed interest;*

*...deduct Tax thereof at the appropriate rate.*

The income tax Act further provides guidance on what amounts to be deemed interest.

Sec 2 of the Income Tax Act states,

***"deemed interest" means an amount of interest equal to the average ninetyone day Treasury Bill rate, deemed to be payable by a resident person in respect of any outstanding loan provided or secured by the non-resident, where such loan is provided free of interest;***



The above provision shows that deemed interest is to be payable and it's therefore important to look at the definition of interest in the income Tax Act.

*"interest" (other than interest charged on tax) means interest payable in any manner in respect of a loan, deposit, debt, claim or other right or obligation, and includes any premium or discount by way of interest and any commitment or service fee paid in respect of any loan or credit or an Islamic finance return.*

The above highlighted definition then means that deemed interest would be applicable and it is therefore of no doubt that withholding tax is applicable on deemed interest.



On whether redeemed preference shares amount to a loan or a debt, it was emphasised that the **shares were redeemable at the option of the shareholder and that there was no option of the amount to not be repaid.**

Further, the IAS 32;18 clarifies that the substance of a financial instrument governs its classification. **If an entity issues preference (preferred) shares that pay a fixed rate of dividend and that have a mandatory redemption feature at a future date, the substance is that they are a contractual obligation to deliver cash and, therefore, should be recognised as a**

**liability. [IAS 32.18(a)]**

**In contrast, preference shares that do not have a fixed maturity, and where the issuer does not have a contractual obligation to make any payment are equity. In this example even though both instruments are legally termed preference shares they have different contractual terms and one is a financial liability while the other is equity.**

The tribunal noted that the appellant redeemable preference shares gave the holder the option to redeem the shares at a future date upon issuance of a seven days notice. It therefore meant that a debt obligation arises by virtue of the fact that the holder of the preference shares expects to be paid or repaid at some point in future.

In light of the foregoing, the matter was determined that since there existed an obligation or debt, and no interest was charged on it, deemed interest was applicable and WHT due. The redeemable preference shares were treated as a debt and therefore taxed appropriately. The tax assessment on WHT was therefore found to be due and payable.

Further to the discussion above, we will delve into a discussion on withholding tax.

#### **Deemed interest and Withholding Tax.**

The concept of deemed interest was first introduced by the finance Act 2010 and according to the Income Tax Act, the interest in this case is charged on income accrued in Kenya by a foreign holding or parent company of a company in Kenya.

To put this into perspective, many companies in the mining and exploration sectors require a huge capital outlay while they start their operations. For the next several years they will be in operation,

these companies will not have earned any income leave alone break even. This make the local financial institutions to avoid such companies since their finances would be held for a long time with no return, presuming that such institutions would be required to reasonably extend prolonged grace periods to such companies. Avoiding them all together and advancing such loans to other institutions in the country and in other industries, their would be tied advances would be earning interest without necessarily having to offer interest holidays or grace periods.

This, therefore, forces the parent company in a different tax jurisdiction to pump in large amount of money during the exploration phases in a mixture of debt or loans and equity. The loans extended to these mining and exploration companies are interest free as it would not make any sense to charge interest to an institution that is not earning any income yet. This certainly does not make any commercial reason to do so.

If the lender, or the parent company **decides not to charge interest, the deemed interest provision in the incomes statement immediately applies.** This unfairly pushes up the cost of doing business in the country especially where such companies have not earned any income yet.

The rate of deemed interest is published periodically by the commissioner. The prescribed rate is usually equal to the average 91-day Treasury Bill rate.

How then the withholding tax works, is that the party who makes a payment in mandated to charge withholding tax at the appropriate rate and therefore, in this case, the local company that has accrued income in the country and financed by the parent company is required to withhold tax on the deemed interest that it would be

paying the parent company. It is important to note that the withholding tax affects only the tax computation in the financial adjustments and does not affect the financial statements.

In the analysis of our case above, we noted that the parent company hoped to circumvent the definition of a loan and opted to provide finances to it's subsidiary as preference shares. A key consideration to take note of when structuring such transactions, is the definition of the term loan as per the income tax act, that,

*"all loans" means loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form of indebtedness for which the company is paying a financial charge, interest, discount or premium;*

The prevailing withholding tax rate of deemed interest is 15%.

As regards the general rules surrounding withholding tax, it is important to remember that withholding tax in premised in the income tax act, that considers income on accrual concept, therefore, as it was decided in *China Jiangsu International Economic Technical Cooperation Corporation Vs Commissioner of domestic taxes* in the year 2019, withholding tax when the income is accrued, or when the actual consideration in paid up, all this coming down to the definition of the phrase "Upon Payment". The background of this case was on the definition of the term "Upon Payment" and the court concluded that upon payment doesn't only necessarily mean when a consideration is actually paid, but also when income is accrued and a payment will be paid on it.

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