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WHAT IS THE EFFECT OF A NON RESIDENT PERSON MAKING AN EQUITY INVESTMENT INTO A KENYAN RESIDENT COMPANY?

It is common for Kenyan resident companies to receive offers from non-resident persons seeking to make an equity investment into their businesses, either having sought investment from them, or the investors having expressed an interest in the potential investees.

"Should the non-resident person(s) proceed to make an investment in the Kenyan company, does this have any implication to the investees?" The answer to this question is that if the Kenyan company becomes foreign controlled as a result of the non-resident person(s) making an investment, then there are implications of such a change of status. These implications are from two key perspectives, being from a thin capitalization and deemed interest perspective as will be discussed below.

A company, according to the Income Tax Act of Kenya ("ITA"), is thinly capitalized if:

- The highest amount of all loans held at any time during the year of income exceeds three times the sum of the revenue reserves and paid up capital of all classes of shares of the company (which includes share premium); and

Note: “All Loans” means “loans, overdrafts, ordinary trade debts, overdrawn current accounts or any other form on indebtedness for which the company is paying a financial charge, interest, discount or premium.”

- The company is under the control of a non-resident person alone or together with four of fewer other persons, and where the company is not a bank or financial institution licensed under the Banking Act.

In the above context, “control” is defined to be, “the power of a person to secure, by means of the holding of shares or the possession of voting power in or in relation to that of another body corporate, or by virtue of powers conferred by the articles of association or other document regulating that or another body corporate, that the affairs of the first mentioned body corporate are conducted in accordance with the wishes of that person; and in relation to a partnership, means the right to a share of more than one-half of the assets or of more than one-half of the income of the partnership.”

The 2008 Finance Act introduced a change whereby “in the case of a body corporate, unless otherwise expressly provided for by the articles of association or other documents regulating it, control shall mean the holding of shares or voting power of *twenty-five percent or more*.”

With regards to a company therefore, unless there exists documentation reflecting that the threshold for control is greater than the 25% shareholding stipulated in the ITA, the company in question will be deemed to be foreign controlled where non-resident persons own 25% or more of the shares or voting power in the company. Consequently, the thin capitalization provisions will apply.

The effects of a Kenyan company being thinly capitalized are:

1. To disallow interest expense to the extent of the interest expense attributable to the excess loan (debt/equity ratio), and
2. To defer realized foreign exchange losses charged in the profit and loss account to the extent of the realized foreign exchange losses attributable to the excess loan (debt/equity ratio).

It is important to note that according to the wording in the ITA, the debt level is based on the highest amount of all loans held at any time during the year, and not the company's balance sheet position as at the year end. To determine the highest amount of debt, the Kenya Revenue Authority would request for the debt balances on a monthly basis. On the other hand, and from an equity perspective, the year-end equity (share capital and reserves) balance is accepted.

In addition to the thin capitalization rules, we note that foreign controlled companies are subject to the deemed interest provisions in the ITA. These provisions apply where interest free loans are advanced by (or secured by) a non-resident person in control of the company, or their associates, to a foreign controlled company. In simple terms, the provisions seek to deem an interest charge where no interest has been charged on loans granted to foreign controlled companies by the non-resident person(s) in control, or their associates.

The interest is deemed based on the amount of interest equal to the average ninety-one-day Treasury Bill Rate, as prescribed by the Commissioner on a quarterly basis.

Where interest has been deemed, this attracts withholding tax at the statutory rate of

15%, unless this rate is reduced through a double tax treaty. We also wish to point out as the interest is deemed, and thus not an actual expense, it does not form part of the tax deductible expenses of the company.

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