

Tax alert

Aquavita Revisited: The Decision that Clarified the Debt–Equity Distinction for Tax Purposes



Summary

While hindsight may offer greater clarity, revisiting past precedents can provide valuable perspective on contemporary tax controversies.

This alert revisits the Tax Appeals Tribunal's decision of 19 April 2022 in *Aquavita Kenya Limited v Commissioner of Domestic Taxes* (Tax Appeal No. 292 of 2021). Although the appeal also covered VAT and procedural matters, this alert focuses on the income-tax treatment of the redeemable preference shares.

The Tribunal focused on the instruments' substantive rights and obligations rather than their legal label. Because the holder could compel redemption on seven days' notice, it characterised the preference shares as debt and upheld WHT on deemed interest. It rejected WHT on deemed dividends because the same proceeds could not also be treated as equity distributions. The decision is relevant to taxpayers using redeemable preference shares and other hybrid funding arrangements in Kenya. It highlights the need to align instrument terms, transaction documents, accounting treatment and tax reporting.

Background

Aquavita Kenya Limited, a Kenyan provider of eco-friendly point-of-use water services, is a subsidiary of Aquavita II UK Limited (Aquavita UK). Aquavita UK financed the business through ordinary and redeemable preference-share capital, including funds held pending allotment.

Following tax compliance checks, KRA treated the redeemable preference shares as interest-free loans subject to deemed interest and WHT.

Aquavita UK financed the Kenyan subsidiary through several issuances of redeemable preference shares. Ten preference shares were issued in August 2014 and another ten in December 2014, each at Kshs 2,610,000; a further 606,000 Class B preference shares of Kshs 100 each were issued in February 2016. Some issued shares were initially unpaid. Funds received and held pending allotment included Kshs 71,116,218 at the end of 2019, and these were applied when 1,411,254 additional Class B preference shares of Kshs 100 each were created in October 2020.

The Appellant challenged that characterisation, maintaining that the instruments were equity under the Companies Act, 2015. It also disputed KRA's treatment of unpaid preference shares as deemed dividends.

The Appellant's Arguments

The Appellant argued that the redeemable preference shares were equity under the Companies Act, 2015 and did not become interest-free loans merely because the shareholder could elect to redeem them. It emphasised that there was no fixed redemption date, mandatory dividend or separate debt agreement.

It submitted that a debtor–creditor relationship would arise only if the shareholder exercised the redemption right. Until

then, dividends were payable only from distributable profits and on the directors' recommendation.

The Appellant also maintained that funds pending allotment were non-refundable contributions intended solely for additional preference shares. Their later capitalisation and treatment as long-term investments, it argued, supported an equity characterisation.

Finally, it argued that imposing WHT on both deemed interest and deemed dividends in respect of the same proceeds would amount to double taxation.

KRA's Arguments

KRA argued that the redeemable preference shares were, in substance, interest-free loans. In its view, classification under the Companies Act, 2015 was not conclusive for income-tax purposes; the instruments had to be assessed by reference to their terms and economic substance.

Relying on IAS 32, KRA contended that the shareholder's right to require redemption on seven days' notice created an unavoidable cash-settlement obligation once exercised. KRA therefore treated the preference shares as debt and applied the deemed-interest provisions.

KRA further argued that funds pending allotment did not constitute equity until the corresponding shares were issued. In the absence of sufficient documentation showing that the funds were irrevocably committed to share issuance, it treated them as interest-free debt.

KRA also maintained that unpaid preference shares gave rise to WHT on deemed dividends.



The Tribunal's Findings

Debt characterisation and deemed interest. The Tribunal considered sections 10(c) and 35(1)(e) of the Income Tax Act together with the statutory definitions of “interest” and “deemed interest.” It concluded that deemed interest can apply to an interest-free loan or other form of indebtedness owed to a non-resident.

The Tribunal relied on IAS 32.18(a), under which a preference share is a financial liability where the holder may require redemption for a fixed or determinable amount. It also referred to Barejo Holdings ULC v Canada on the characteristics of debt. Aquavita UK’s ability to require redemption on seven days’ notice created a repayment obligation; the instruments were therefore debt for income-tax purposes.

Accordingly, the Tribunal upheld KRA’s treatment of the preference-share proceeds as interest-free loans and held that WHT on deemed interest was due and payable.

Deemed dividends. Having characterised the preference shares as debt, the Tribunal held that the same proceeds could not simultaneously give rise to dividends.

It therefore rejected WHT on deemed dividends, which would have taxed the same proceeds as both debt and equity.

Our Opinion and Key Takeaways

The Aquavita decision confirms that the tax characterisation of a financing instrument may differ from its company-law form. The critical feature was the shareholder’s right to require redemption on seven days’ notice, which created a repayment obligation.

Taxpayers using redeemable preference shares, convertible instruments or other hybrid funding should assess the instrument as a whole. Relevant features include redemption rights, the amount payable, maturity, return, voting and management rights, ranking, participation on liquidation and the transaction’s implementation.

Legal documents, accounting treatment and tax reporting should be consistent and supported by a clear commercial rationale.

The Tribunal’s reliance on IAS 32 is notable. Accounting classification does not itself determine tax liability, but accounting principles may inform the analysis of an instrument’s substantive rights and obligations. Taxpayers should identify and document any differences among the legal, accounting and tax treatment.

Shareholder funding arrangements should be supported by clear subscription terms, board and shareholder approvals, complete accounting records and timely implementation.

Where an instrument is intended to constitute equity, its documentation and operation should consistently support that treatment.

Any disconnect between the stated equity treatment and the underlying rights or conduct may enable KRA to argue that the funding is debt in substance, with potential WHT consequences.

KPMG is happy to assist on any issues arising from this decision.

If you have any questions, do not hesitate to reach out to us on taxandregulatory@kpmg.co.ke or contact cakora@kpmg.co.ke

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