THAKRAR FINANCIAL CONSULTANTS

TFC

Redeemable Preference Shares

Optimal Tax Structuring

Audit * Taxation * Advisory

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GENERAL TAX IMPLICATIONS

DEFINITION OF REDEEMABLE PREFERENCE SHARES

- **What are Redeemable Preference Shares?**

  "a preference share in a body corporate that is, or at the body's option is to be, liable to be redeemed."

  It is generally considered that Redeemable Preference Shares (**REDP**) are hybrid securities because they have characteristics akin to both debt and equity. REDP are also known as Convertible Preference Shares.

  What is important to understand is that the rights and entitlements associated with those shares are not generic, but can be defined by the members passing a special resolution of the Company or by amending the Constitution to include the rights and obligations associated with those shares. Therefore the codes may be standard, but the rights and obligations may not be.

- **Power to Issue**

  "Redeemable preference shares are preference shares that are issued on the terms that they are liable to be redeemed. They may be redeemable:

- *at a fixed time or on the happening of a particular event; or*
- *at the company's option; or*
- *at the shareholders option.*

ADVANTAGES AND DISADVANTAGES OF REDEEMABLE PREFERENCE SHARES

Preference shares carry a number of benefits for both companies and investors. The chief benefit for shareholders is that preference shares have a **fixed dividend** that must be paid before any dividends can be paid to common shareholders.

While dividends are only paid if the company turns a profit, some types of preference shares (called cumulative shares) allow for the accumulation of unpaid dividends. Once the business is back in the black, all unpaid dividends must be remitted to preferred shareholders before any dividends can be paid to common shareholders.

In addition, in the event of bankruptcy and liquidation, **preferred shareholders have a higher claim on company assets than common shareholders**. This makes preference shares, also called preferred shares, particularly enticing to investors with low risk tolerance. The company guarantees a dividend each year, but if it fails to turn a profit and must shut down, preference shareholders are compensated for their investments sooner.

Other types of preference shares carry additional benefits. Convertible shares allow the shareholder to trade in preference shares for a fixed number of common shares. This can be a lucrative option if the value of common shares begins to climb. Participating shares offer the shareholder the opportunity to enjoy additional dividends above the fixed rate if the company meets certain predetermined profit targets. The variety of preference shares available and their attendant benefits means that this type of investment can be a **relatively low-risk way to generate long-term income**.

From the investor's perspective, the main disadvantage of preference shares is that preferred shareholders do not have the same ownership rights in the company as common shareholders. The **lack of voting rights** means the company is not beholden to preferred shareholders the way it is to equity shareholders, but the guaranteed return on investment largely makes up for this shortcoming. However, if interest rates rise, the fixed dividend that seemed so lucrative can quickly look like less of a bargain as other fixed-income securities emerge with higher rates.

Preference shares also have a number of advantages for the issuing company. The lack of shareholder voting rights that may seem like a drawback to investors is beneficial to the business because it means ownership is not diluted by selling preference shares the way it is when ordinary shares are issued. The lower risk to investors also means the cost of raising capital for issuing preference shares is lower than that of issuing common shares. Issuing preference shares carries many of the benefits of both debt and equity capital and is considered to be a hybrid security.

Companies can also issue **redeemable preference shares**, which afford them the right to repurchase shares at their discretion. This means that if callable shares are issued with a 6% dividend but interest rates fall to 4%, the **company can purchase any outstanding shares** at the market price and then reissue shares with a lower dividend rate at any time at will, thereby reducing the cost of capital. Shareholders, however, would consider this a disadvantage.

The chief disadvantage to companies is the higher cost of this type of equity capital relative to debt. However, financing through shareholder equity, either common or preferred, lowers a company's debt to equity ratio, which is considered by both investors and lenders to be a sign of a well-managed business.

MANAGING THIN CAPITALIZATION

- In order to manage thin capitalization, companies opt to issue redeemable preference shares.

The question arises, will KRA deem these as Equity or Debt. Justification for KRA to treat this as Equity:

(a) Who has a right to seek redemption of the shares?

The Articles of Association of the company provide **that the company** (and not the shareholder) has the right to redeem the shares.

(b) What would need to be done to ensure that the KRA treats redeemable preference shares as equity?

The thin capitalisation rules require that the debt to equity ratio of a company controlled by foreigners should not exceed 3:1. The definition of "equity" for thin capitalisation purposes is defined to include "*the sum of the revenue reserves and the issued and paid up capital of all classes of shares of the company*".

In Kenya, a company is said to be thinly capitalized when it is foreign controlled, and its loans and debt exceed three times the sum of the revenue reserves (which includes accumulated losses) and the issued and paid up capital. Thus the ideal safety margin is a 25% equity financing or a 3:1 debt equity ratio.

• any foreign exchange losses realized from foreign loans advanced by the controlling shareholder will be deferred until the state of thin capitalization diminishes.
• In addition to this, there will be a restriction of interest deductible as an allowable expense.

Meaning of foreign control
The Income Tax Act defines the meaning of control for purposes of thin capitalization rules. Control normally occurs when a nonresident person alone or together with 4 or fewer other persons, holds more than 50% of the issued and paid up capital of all classes of a company's (except banks and financial institutions) shares. It also occurs when such a person or group of persons own more than 25% shares and the voting power.

It will be noted from the above that preference shares constitute a "class of shares" of a company.

It will also be noted that the share premium account is considered as part of the capital of a company by the Companies Act. However care should be taken as section 16(2)(j) of the ITA, only refers to "*revenue reserves and the issued and paid up capital of all classes of shares of the company*" and not broadly to "all forms of capital". It is however our understanding that the KRA as a matter of practice treats the share premium account as part of the "*revenue reserves and the issued and paid up capital of all classes of shares of the company*" and has not sought to treat the share premium account as debt.

TAX LEGISLATION ON REDEEMABLE PREFERENCE SHARES: EXCERPTS FROM THE INCOME TAX ACT

Income from Dividends

- **7**(1) For the purposes of section 3(2)(b) -

(a) Deleted by 8 of 1978. s. 9);

(b) a dividend paid by a resident company shall be deemed to be income of the year of income in which it was payable;

(c) when, in relation to a company that is being wound up voluntarily, profits (including profits realized on the disposition of assets of the company) whether earned before or during the winding up are distributed (whether in cash or otherwise), the distribution shall be deemed to be payment of a dividend;

(d) where a company issues debentures or **redeemable preference shares** to any of its shareholders and receives therefrom no payment, the issue of those debentures or **redeemable preference shares** shall be deemed to be a payment of a dividend on the shares held by the shareholders of an amount equal to the nominal value or redeemable value, whichever is the greater, of the debentures or redeemable preference shares;

(e) where a company issues debentures or **redeemable preference shares** to any of its shareholders for a sum less than their nominal value or redeemable value whichever is the greater, the issue of those debentures or redeemable preference shares shall be deemed to include a payment of a dividend on the shares held by the shareholders of an amount equal to the excess:

Provided that this paragraph shall not apply if the sum paid for the debentures or redeemable preference shares is ninety-five per cent or more of their nominal value or redeemable value, whichever is the greater;

Should you require further clarification on any of the above, please let us know.

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TFC GROUP PROFILE

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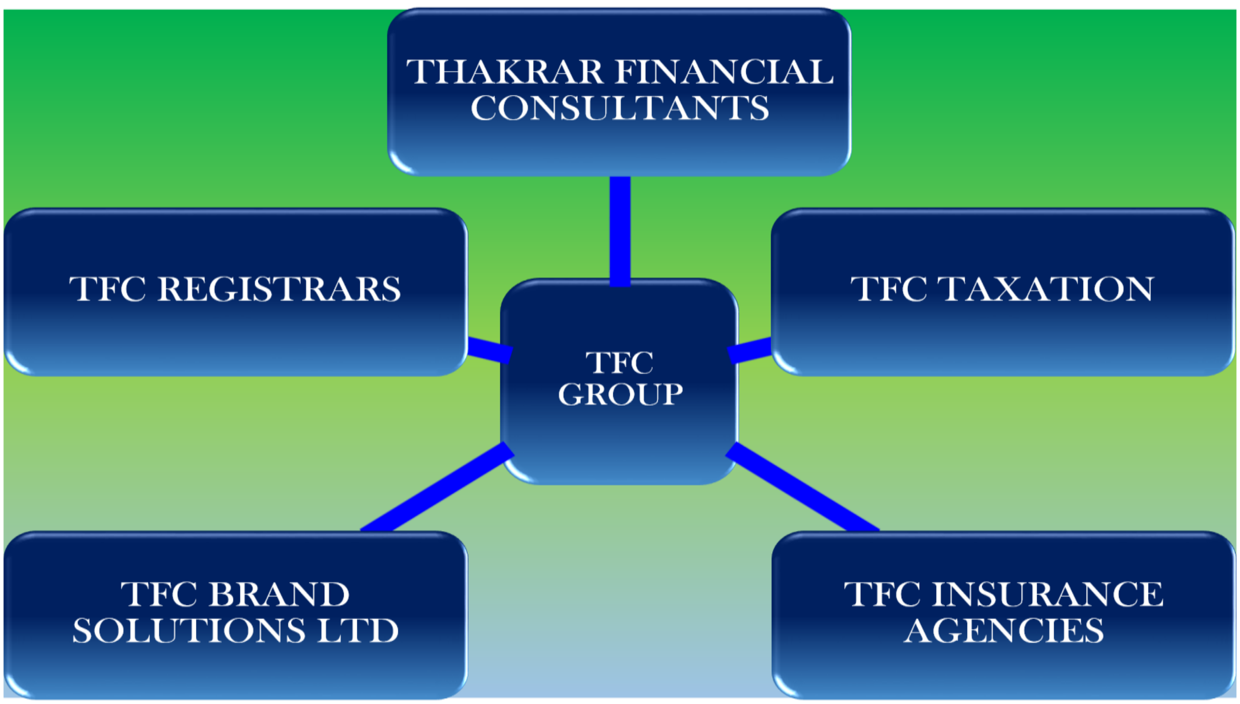

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