

EXIT- Liquidation- Investor Corner

Part VI of the Insolvency Act, 2015 outlines the procedures for the liquidation of companies in Kenya, under which companies can be liquidated either voluntarily or through a court order.

The Insolvency Act differentiates between two types of voluntary liquidation, depending on the financial state of the company:

A. Solvent Companies (Members' Voluntary Liquidation - MVL): In cases where the company is solvent, the liquidation is carried out through Members' Voluntary Liquidation (MVL). Under this method, the company's directors must make a statutory declaration stating that they have made a full inquiry into the company's affairs; and that, having done so, they have formed the opinion that the company will be able to pay its debts in full, together with interest at the official rate, within such period (not exceeding twelve months from the commencement of the liquidation) as may be specified in the declaration.). Voluntary liquidation may also be sought in the following situations:

- a) When the company's articles of association specify that the company will be dissolved upon the occurrence of a particular event, and such an event has occurred.
- b) When the company has reached the expiration date set by its articles of association for its existence.
- c) When the company passes a special resolution in a general meeting to voluntarily liquidate.

B. Insolvent Companies (Creditors' Voluntary Liquidation - CVL): If no such declaration is made, the liquidation is considered a Creditors' Voluntary Liquidation (CVL), typically initiated when the company is unable to pay its debts in full.

In both cases, a liquidator must be appointed. The management of the company's affairs is transferred from the company's directors to the appointed liquidator. The liquidator's responsibilities include realizing the company's assets and distributing the proceeds to pay off the company's debts.

During the liquidation process, the debts of a company are paid out in order of priority. The purpose of prioritization is to ensure that essential debts are settled before other claims are addressed.

After preferential creditors have been paid, any remaining assets are used to settle the claims of secured creditors (those with collateral) and then the claims of unsecured creditors (those without collateral). **Shareholders and equity holders are usually**

at the bottom of the priority list and are often the last to receive any remaining funds, if there are any left after satisfying higher-ranking claims.

To wind up a solvent company, there are two possible methods, deregistration and Members' Voluntary Liquidation (MVL). Both processes apply to companies that are solvent, but they differ in their procedure and requirements.

Deregistration is a relatively quick and easy, cost-effective method of wind up a company and once deregistered, there are no further annual compliance costs. Making it the preferred method for a company without liabilities and that is non trading.

On the other hand, an application to 'strike off' can only be made if the company has not traded or carried on business, changed its name, or sold business assets, rights or business property in the previous three months.

Liquidation can be instituted immediately on cessation of trade. However, the liquidation process is often longer and more costly (a liquidator has to be appointed). Therefore, solvent companies may prefer to apply for strike-off/deregistration rather than proceeding with liquidation due to the simpler and more cost-effective nature of the former process.

Distributions/Dividends

- 1.1. Part XVII of the Companies Act provides the Rules on how the assets of a company ought to be distributed. It defines a "distribution" as *"every description of distribution of the assets of a company to its members (whether in cash or otherwise) subject to the exceptions in subsection (2)."*
- 1.2. Under Subsection 2(d) the *distribution of assets to members of the company on its liquidation* does not qualify as a distribution.
- 1.3. Section 486 of the Company's Act provides that a company may make a distribution only out of profits available for the purpose and provides that the profits of a company available for distribution are—
 - (a) its accumulated, realised profits (so far as not previously utilised by distribution or capitalisation), less—
 - (b) its accumulated, realised losses (so far as not previously written off in a lawfully made reduction or reorganisation of capital).
- 1.4. The Income Tax Act Cap 470 Laws of Kenya ("the ITA") defines a dividend distribution to mean, any distribution **(whether in cash or property, and whether made before or during a winding up)** by a company to its shareholders with respect to their equity interest in the company, **other than distributions made in complete liquidation of the company of capital which was originally paid directly into the company in connection with the issuance of equity interests;**

1.5. **The Two Acts are therefore consistent on the fact that distributions made in complete liquidation of the company do not qualify as dividend distributions**

1.6. The profits/ gains have to be distributed from taxed profits. The ITA provides that *“where a dividend is distributed out of gains or profits on which no tax is paid, the company distributing the dividend shall be charged to tax in the year of income in which the dividends are distributed at the resident corporate rate of tax on the gains or profits from which such dividends are distributed”*^[1]

1.7. Therefore, prior to distribution of any profits as dividends, the profits are subjected to tax at the corporate tax rate which is currently 30% for both resident and nonresident companies.^[2] Prior to distribution of the dividend, the distributing company is required to withhold 5% of the income to the shareholder in case of a resident and 15% in the case of a non- resident which is then remitted to the Kenya Revenue Authority and is a final tax.

1.8. Further, the Act frowns on non-distribution of dividends and provides that ***“Where the Commissioner is of the opinion that a private company has not distributed to its shareholders as dividends within a reasonable period, not exceeding twelve months, after the end of its accounting period such part of its income for that period which could be so distributed without prejudice to the requirements of the company’s business, he may direct that that part of the income of the company shall be treated for the purposes of this Act as having been distributed as a dividend to the shareholders in accordance with their respective interests and shall be deemed to have been paid on a date twelve months after the end of that accounting period.”***

2. Liquidation/Capital Gains Tax (CGT)

2.1. Capital Gains Tax (“CGT”) was reintroduced in Kenya by way of amendments to the Eighth Schedule to the ITA and is chargeable at the rate of 15% on the excess of the property’s transfer value over its adjusted cost. Adjusted cost consists of the following:

- a. cost of acquisition of the property;
- b. expenditure incurred at acquisition to either enhance or preserve the value of the property at the time of transfer;
- c. expenditure incurred after acquisition in establishing, preserving or defending the title to or right over the property; and
- d. the incidental costs to the transferor of the property.

2.2. *“Property”* is defined to mean land situated in Kenya and any right or interest in or over that land; and a marketable security situated in Kenya, other than an investment share.

2.3. A 'transfer' is defined in the ITA as:

*"where property is sold, exchanged, conveyed or otherwise disposed of in any manner whatever (including by way of gift), whether or not for consideration...or on the abandonment, **surrender, cancellation or forfeiture of, or the expiration of substantially all rights to, property, including the surrender of shares or debentures on the dissolution of a company**".*

2.4. The transfer value of property is computed by reference to such of the following amounts (if any) as are appropriate having regard to the manner of the transfer, namely–

a) the amount of or the value of the consideration for the transfer of the property;

b) sums received in return for the abandonment, forfeiture or surrender of the property;

2.5. It is the transferor's tax obligation to account for the CGT due on the transfer of property. This is concluded through filling out the prescribed tax return and settling the CGT due with the KRA by the due date which is the earlier of the date when the transfer is registered or receipt of the full purchase price.[3]

3. Analysis-Tax compliance requirements for a company in Kenya prior to deregistration and whether a dividend distribution represents a return of capital

3.1. One of the central elements of the Kenyan tax framework governing dividends is that distributions must be from profits on which tax has already been paid. Under Section 7A of the Income Tax Act, if a company distributes dividends from gains or profits on which no tax has been paid, the company distributing the dividend is charged to tax at 30% in the year the dividend is paid.

3.2. The amount of any distribution relating to these retained earnings or after-tax profits is considered an ordinary dividend.

3.3. When a company enters into a members' voluntary liquidation, the liquidator is tasked with distributing any remaining assets to the shareholders. (If the company has surplus assets after satisfying its liabilities)

3.4. These distributions are not ordinary dividends, instead, they are classified as capital distributions, subject to CGT at a rate of 15% applied to the difference between: the amount the shareholder receives during liquidation (the return of share capital) and the amount the shareholder originally paid for the shares (the purchase price)

3.5. Therefore, once a liquidator is appointed, all distributions made are treated as capital distributions subject to CGT.

- 3.6. Similarly, in the case of deregistration, any surplus assets distributed to shareholders in proportion to their shareholding or as specified in the company's Articles of Association, is considered a return of capital and is subject to CGT at the rate of 15%.
- 3.7. In conclusion, when a company undergoes deregistration or liquidation and there are no surplus assets to distribute to the shareholders, effectively, there is no gain to be realized by the shareholders.

[1] Section 7A of the Income Tax Act Cap 470 Laws of Kenya

[2] Paragraph 2 of Head B of the Third Schedule to the Income Tax Act

[3] Paragraph 11A of the Eighth Schedule to the Income Tax Act.

EXIT- Liquidation- Investor Corner

Part VI of the Insolvency Act, 2015 outlines the procedures for the liquidation of companies in Kenya, under which companies can be liquidated either voluntarily or through a court order.

The Insolvency Act differentiates between two types of voluntary liquidation, depending on the financial state of the company:

A. Solvent Companies (Members' Voluntary Liquidation - MVL): In cases where the company is solvent, the liquidation is carried out through Members' Voluntary Liquidation (MVL). Under this method, the company's directors must make a statutory declaration stating that they have made a full inquiry into the company's affairs; and that, having done so, they have formed the opinion that the company will be able to pay its debts in full, together with interest at the official rate, within such period (not exceeding twelve months from the commencement of the liquidation) as may be specified in the declaration.). Voluntary liquidation may also be sought in the following situations:

- a) When the company's articles of association specify that the company will be dissolved upon the occurrence of a particular event, and such an event has occurred.
- b) When the company has reached the expiration date set by its articles of association for its existence.

- c) When the company passes a special resolution in a general meeting to voluntarily liquidate.

B. Insolvent Companies (Creditors' Voluntary Liquidation - CVL): If no such declaration is made, the liquidation is considered a Creditors' Voluntary Liquidation (CVL), typically initiated when the company is unable to pay its debts in full.

In both cases, a liquidator must be appointed. The management of the company's affairs is transferred from the company's directors to the appointed liquidator. The liquidator's responsibilities include realizing the company's assets and distributing the proceeds to pay off the company's debts.

During the liquidation process, the debts of a company are paid out in order of priority. The purpose of prioritization is to ensure that essential debts are settled before other claims are addressed.

After preferential creditors have been paid, any remaining assets are used to settle the claims of secured creditors (those with collateral) and then the claims of unsecured creditors (those without collateral). **Shareholders and equity holders are usually at the bottom of the priority list and are often the last to receive any remaining funds, if there are any left after satisfying higher-ranking claims.**

To wind up a solvent company, there are two possible methods, deregistration and Members' Voluntary Liquidation (MVL). Both processes apply to companies that are solvent, but they differ in their procedure and requirements.

Deregistration is a relatively quick and easy, cost-effective method of wind up a company and once deregistered, there are no further annual compliance costs. Making it the preferred method for a company without liabilities and that is non trading.

On the other hand, an application to 'strike off' can only be made if the company has not traded or carried on business, changed its name, or sold business assets, rights or business property in the previous three months.

Liquidation can be instituted immediately on cessation of trade. However, the liquidation process is often longer and more costly (a liquidator has to be appointed). Therefore, solvent companies may prefer to apply for strike-off/deregistration rather than proceeding with liquidation due to the simpler and more cost-effective nature of the former process.

Distributions/Dividends

- 1.1. Part XVII of the Companies Act provides the Rules on how the assets of a company ought to be distributed. It defines a "distribution" as *"every description of distribution of the assets of a company to its members (whether in cash or otherwise) subject to the exceptions in subsection (2)."*

- 1.2. Under Subsection 2(d) the *distribution of assets to members of the company on its liquidation* does not qualify as a distribution.
- 1.3. Section 486 of the Company's Act provides that a company may make a distribution only out of profits available for the purpose and provides that the profits of a company available for distribution are—
- (a) its accumulated, realised profits (so far as not previously utilised by distribution or capitalisation), less—
 - (b) its accumulated, realised losses (so far as not previously written off in a lawfully made reduction or reorganisation of capital).
- 1.4. The Income Tax Act Cap 470 Laws of Kenya (“the ITA”) defines a dividend distribution to mean, any distribution **(whether in cash or property, and whether made before or during a winding up)** by a company to its shareholders with respect to their equity interest in the company, **other than distributions made in complete liquidation of the company of capital which was originally paid directly into the company in connection with the issuance of equity interests;**
- 1.5. **The Two Acts are therefore consistent on the fact that distributions made in complete liquidation of the company do not qualify as dividend distributions**
- 1.6. The profits/ gains have to be distributed from taxed profits. The ITA provides that *“where a dividend is distributed out of gains or profits on which no tax is paid, the company distributing the dividend shall be charged to tax in the year of income in which the dividends are distributed at the resident corporate rate of tax on the gains or profits from which such dividends are distributed”[1]*
- 1.7. Therefore, prior to distribution of any profits as dividends, the profits are subjected to tax at the corporate tax rate which is currently 30% for both resident and nonresident companies.[2] Prior to distribution of the dividend, the distributing company is required to withhold 5% of the income to the shareholder in case of a resident and 15% in the case of a non- resident which is then remitted to the Kenya Revenue Authority and is a final tax.
- 1.8. Further, the Act frowns on non-distribution of dividends and provides that **“Where the Commissioner is of the opinion that a private company has not distributed to its shareholders as dividends within a reasonable period, not exceeding twelve months, after the end of its accounting period such part of its income for that period which could be so distributed without prejudice to the requirements of the company's business, he may direct that that part of the income of the company shall be treated for the purposes of this Act as having been distributed as a dividend to the shareholders in accordance with their respective interests and shall be deemed to have been paid on a date twelve months after the end of that accounting period.**

2. Liquidation/Capital Gains Tax (CGT)

2.1. Capital Gains Tax (“CGT”) was reintroduced in Kenya by way of amendments to the Eighth Schedule to the ITA and is chargeable at the rate of 15% on the excess of the property’s transfer value over its adjusted cost. Adjusted cost consists of the following:

- a. cost of acquisition of the property;
- b. expenditure incurred at acquisition to either enhance or preserve the value of the property at the time of transfer;
- c. expenditure incurred after acquisition in establishing, preserving or defending the title to or right over the property; and
- d. the incidental costs to the transferor of the property.

2.2. “Property” is defined to mean land situated in Kenya and any right or interest in or over that land; and a marketable security situated in Kenya, other than an investment share.

2.3. A ‘transfer’ is defined in the ITA as:

*“where property is sold, exchanged, conveyed or otherwise disposed of in any manner whatever (including by way of gift), whether or not for consideration...or on the abandonment, **surrender, cancellation or forfeiture of, or the expiration of substantially all rights to, property, including the surrender of shares or debentures on the dissolution of a company**”.*

2.4. The transfer value of property is computed by reference to such of the following amounts (if any) as are appropriate having regard to the manner of the transfer, namely–

- a) the amount of or the value of the consideration for the transfer of the property;
- b) sums received in return for the abandonment, forfeiture or surrender of the property;**

2.5. It is the transferor’s tax obligation to account for the CGT due on the transfer of property. This is concluded through filling out the prescribed tax return and settling the CGT due with the KRA by the due date which is the earlier of the date when the transfer is registered or receipt of the full purchase price.[3]

3. Analysis-Tax compliance requirements for a company in Kenya prior to deregistration and whether a dividend distribution represents a return of capital

3.1. One of the central elements of the Kenyan tax framework governing dividends is that distributions must be from profits on which tax has already been paid. Under Section 7A of the Income Tax Act, if a company distributes dividends from gains or profits on which

no tax has been paid, the company distributing the dividend is charged to tax at 30% in the year the dividend is paid.

- 3.2. **The amount of any distribution relating to these retained earnings or after-tax profits is considered an ordinary dividend.**
- 3.3. When a company enters into a members' voluntary liquidation, the liquidator is tasked with distributing any remaining assets to the shareholders. (If the company has surplus assets after satisfying its liabilities)
- 3.4. **These distributions are not ordinary dividends, instead, they are classified as capital distributions, subject to CGT at a rate of 15% applied to the difference between: the amount the shareholder receives during liquidation (the return of share capital) and the amount the shareholder originally paid for the shares (the purchase price)**
- 3.5. Therefore, once a liquidator is appointed, all distributions made are treated as capital distributions subject to CGT.
- 3.6. Similarly, in the case of deregistration, any surplus assets distributed to shareholders in proportion to their shareholding or as specified in the company's Articles of Association, is considered a return of capital and is subject to CGT at the rate of 15%.
- 3.7. In conclusion, when a company undergoes deregistration or liquidation and there are no surplus assets to distribute to the shareholders, effectively, there is no gain to be realized by the shareholders.

[1] Section 7A of the Income Tax Act Cap 470 Laws of Kenya

[2] Paragraph 2 of Head B of the Third Schedule to the Income Tax Act

[3] Paragraph 11A of the Eighth Schedule to the Income Tax Act.