



# FINANCIAL CONSIDERATIONS WHEN SETTING UP A FOREIGN ENTITY IN KENYA

## INTRODUCTION

**W**hen a business is being established or scaled, one of the most critical strategic considerations is the choice between equity financing and debt financing. While both methods provide the capital necessary for growth, they differ significantly in their tax implications and cash flow impact. From a tax-law perspective, it is essential that foreigners assess these factors at the earliest stage of structuring, as the chosen financing model will not only determine the company's overall tax efficiency but also shape the manner and timing of profit extraction.

### *A. Equity Funding*

Equity financing, involves raising capital through the issuance of shares in exchange for ownership interest in the company. Shareholders are entitled to participate in the profits of the company and may exercise voting rights depending on the class of shares held.

The distribution of dividends from a Kenyan company to its shareholders is subject to withholding tax at a rate of 5% for resident shareholders and 15% for non-resident shareholders. Special rates apply where a **Double Tax Agreement (DTA)** is in place.

A critical area of tax risk is redeemable preference shares, especially those redeemable at the option of the holder. Although such instruments may be drafted as equity under company law, from a tax / accounting perspective they can be recharacterized as debt.

**In *Aquavita Kenya Limited v Commissioner of Domestic Taxes (TAT No. 292 of 2021)***, the Tribunal held that redeemable preference shares issued to a non-resident parent company, which were redeemable at the shareholder's option and lacked voting rights, constituted an "interest-free loan" and fell within the deemed interest provisions under the Income Tax Act.

The Tribunal invoked IAS 32 (which classifies redeemable shares as financial liabilities if there's an obligation to redeem) and stressed that the economic substance rather than the legal form should guide classification.

### *B. Debt Funding*

#### **Interest payments on loans advanced**

Debt financing refers to the process by which a company raises funds by borrowing, typically

through Shareholder loans, third party loans, or other credit instruments.

Under **Section 15(2)(a) of the Income Tax Act (Cap. 470) (“the ITA”)**, interest on debt that is wholly and exclusively incurred in the production of income is deductible for tax purposes.

For non-resident loans whether from related parties or third parties, the **Finance Act, 2021** adopted the OECD (Organization for Economic Cooperation and Development) guidelines and specifically Base Erosion on Profit Shifting (BEPS) Action 4 introducing a fixed ratio rule to replace the previous thin cap rules.

Allowable interest expense is capped at 30% of Earnings before Tax, Interest, Depreciation and Amortization (EBITDA). The immediate impact of this rule is significant tax liabilities for companies with a significant debt financing component because interest expense exceeding 30% of EBITDA will be disallowed.

Interest not deductible in a given year may be carried forward for up to **three years**, subject to the 30% cap constraint.

## Deemed Interest

*“Deemed interest”* refers to the amount of interest that is deemed or considered to be payable by a resident person (e.g., a local company) in connection with an outstanding loan provided or secured by a non-resident person (e.g., a foreign affiliate) where such loan has been provided free of interest.

In simpler terms, a Kenyan company borrowing from a non-resident may be deemed to pay interest even if none is explicitly charged. The local company is deemed to be paying interest at the prevailing ninety-one-day treasury bill rate. As a result, the local company must withhold tax on this deemed interest amount and remit it to the government failure to do so on time may result in penalties.

Currently, the withholding tax rate for deemed interest is 8%. It is important to note that the interest rate and withholding tax rate are prescribed by the commissioner every quarter.

## HOW WE CAN ASSIST

We work closely with businesses to navigate complex tax and regulatory considerations around financing decisions. Our approach goes beyond compliance; we take time to understand your commercial objectives and craft financing structures that balance operational flexibility with long-term tax efficiency. Whether you are raising new capital or restructuring existing funding, we provide practical guidance on cross-border transactions, interest deductibility, and withholding tax implications. Where necessary, we engage directly with the Kenya Revenue Authority, review financing documentation, and ensure that your capital structure is consistent with both domestic legislation and international best practice. Our goal is to empower you to make informed financing decisions that are sustainable and defensible.

## **Contact Persons & Contributors**



### **Tabitha Muchiri**

Tax Associate

***tmuchiri@cmadvocates.com***

Tabitha is a committed advocate specialising in delivering strategic tax solutions that address both domestic and international tax matters. At CM Advocates LLP, Tabitha leverages her diverse skill set to deliver comprehensive tax advisory services across multiple domains, including Income Tax, Withholding Tax, Value Added Tax (VAT), Domestic Tax, and International Tax. Her ability to integrate legal acumen with practical insights enables her to provide tailored, forward-thinking tax strategies that effectively mitigate risk and optimize tax outcomes.

**For tailored advice on financial considerations when establishing or scaling a business, contact our Tax & International Business Advisory Unit:**

 ***taxadvisory@cmadvocates.com***

**For more information please visit:**

**[www.cmadvocates.com](http://www.cmadvocates.com)**

Head Office - Nairobi, Kenya  
I&M Bank House, 7th Floor, 2nd Ngong Avenue  
T: +254 20 2210978 / +254 716 209673  
P.O. Box 22588 – 00505, Nairobi Kenya  
E: law@cmadvocates.com

Mombasa Office - Kenya  
Links Plaza, 3rd Floor, Links Road, Nyali  
T: +254 41 447 0758 / +254 41 447 0548  
P.O. Box 90056 – 80100, Mombasa Kenya  
E: mombasaoffice@cmadvocates.com

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