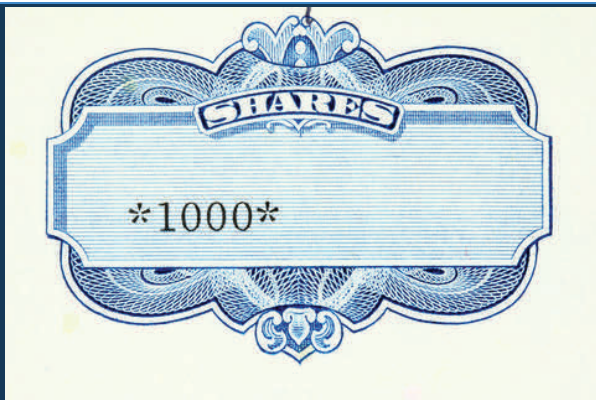


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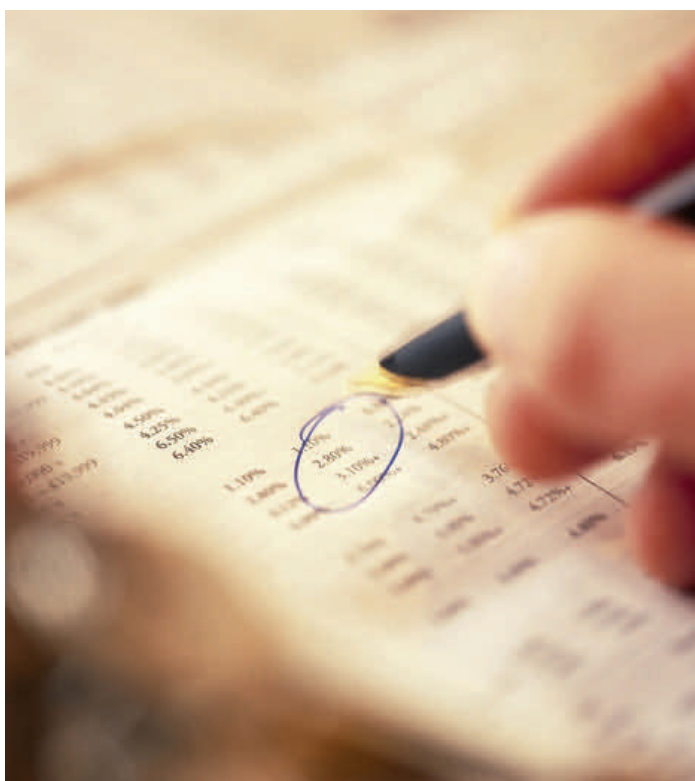
Anti-avoidance Legislation – Share Disposals



Share Disposals

Section 135 of the Taxes Consolidation Act 1997 (TCA 97) includes anti-avoidance measures to counter arrangements whereby companies could make distributions which allow a person to extract value from a company as capital as opposed to income.

The legislation (which is contained in subsection 3A) is very widely drafted and where the section applies, the sale of shares will be subject to income tax rather than CGT, if the sale is funded by the company. It is essentially an anti-avoidance provision enacted to stop shareholders paying CGT on funds in a company which should be subject to income tax.



Legislation

The operation of the subsection can be summarised as follows:-

Where

- a member of a close company (the first company) enters into arrangements directly or indirectly with another close company (the second company),
- whereby a member of the first company disposes of an interest in that company and
- the consideration is, directly or indirectly, funded out of the assets of the first company,
- then any amount received by the disposing member from the second company shall be treated as a distribution subject to income tax.

The term 'arrangements' is to be given its ordinary meaning and includes any agreement, understanding, scheme, transaction or series of transactions.

Based on the wording of the legislation, it appears that the shareholder that enters into the arrangement does not have to be the same shareholder that disposes of the shares.

Subsection (3A) applies in relation to relevant arrangements entered into on or after 02 November 2017.



Revenue Manual

Practitioners had been looking for clarification from Revenue and the Revenue Manual was updated on 05 January 2018 and it narrows the overall application of the section.

The Revenue Manual states that the underlying principle of subsection (3A) is that where a company indirectly acquires its own shares from a member whereby the member arranges to receive the consideration for the sale out of the assets of the target company on the disposal of his shares, and where the company receives no compensating consideration for the depletion of its assets, then distribution treatment should apply.

Revenue have also stated that they will apply a 'main purpose, or one of the main purposes' test in determining whether a member has entered into an arrangement to secure the payment of consideration from the assets of the company. There is no basis for such a test in the legislation.

There are a number of statements in the Revenue Manual which aim to narrow or limit the application of the new subsection:-

- Subsection (3A) only has application where the member enters into arrangements to sell their shares and secures that the consideration is funded out of the assets of the company.
- The provision only has application where a member is a party as to how the payment is to be made and the payment is made directly or indirectly from the assets of the acquired company.
- The provision therefore does not apply in relation to bona fide financing arrangements entered into by a purchaser in relation to the acquisition of shares.
- The provisions of Chapter 9, Part 6 TCA 97,

which permit capital gains tax treatment where a company acquires its own shares when certain conditions are met, continue to be available notwithstanding subsection (3A).

Chapter 9, Part 6 TCA 97 of the tax legislation deals with share buybacks where a company purchasing its own shares back. CGT treatment can apply in such a case, provided that there is a benefit to the trade.

- A member could enter into arrangements to fund the payment of consideration out of future reserves of the company. However, where a payment representing future earnings is paid as part of a bona fide earn-out agreement, that payment will not be treated as a distribution if the agreement does not specify that the earn-out must be met from the reserves of the acquired company.

Example – IT Treatment

Barry and Bob run a bakery and own 100% of the shares of BB Bakery Limited ('BBBL') equally. The company has built up cash reserves over the years and has retained profits of €1,400,000. Bob wishes to exit the business and have BBBL buyout his shares. However, rather than have BBBL purchase his shares directly, where the buy-back would trigger an income tax charge for Bob, Barry arranges to set up a new company ('NewCo') to purchase the shares. NewCo purchases Bob's shares for €700,000. The consideration in respect of the acquisition is left outstanding. BBBL subsequently pays a dividend of €700,000 to NewCo which NewCo uses to pay the deferred consideration to Bob.

The provisions of section 135(3A) TCA apply to treat the payment of €700,000 to Bob as a distribution made by BBBL to Bob on which Bob is subject to income tax. Barry has entered into an arrangement to secure the payment of consideration to Bob from the assets of BBBL and the assets of BBBL have been depleted by €700,000. Previously Bob may also have sought to claim retirement relief in relation to the €700,000 payment received. It should be noted that had Barry sourced the payment from his own resources then Bob would have been subject to CGT on the disposal of his shares.

Management Buy-Outs

A management buy-out (MBO) involves the management team of a company purchasing the company from the existing owner or owners. Many MBOs involve the target company in securing and repaying loans to fund the buy-out. Such transactions are within the new wording of subsection (3A), however, the Revenue Manual provides the following clarifications on the point:-

- The new subsection will only have application where a member enters into the relevant arrangements and does not apply to bona-fide financing arrangements entered into by a purchaser.
- The provisions will not apply unless the member has engaged in an arrangement to ensure that the consideration is met from the assets of the company.
- Any actions of the purchaser subsequent to the disposal, for example, a bona fide refinancing using the assets of the company, are outside the scope of the provision.
- The member being aware of the financing arrangements entered into by the purchaser to fund the buy-out and entering into an agreement to sell on the basis of such financing arrangements, would not be regarded as arrangements entered into by the member to secure the payment of consideration from the assets of the company. Accordingly S. 135(3A) TCA 97 does not apply in such circumstances.

Revenue provide two examples and it appears that Revenue will allow CGT treatment where the MBO is funded from borrowings by the NewCo which is then paid back from future profits made by the trade after the MBO. However, where reserves of the target are used to partially fund the MBO, the portion which is funded from the reserves will be subject to income tax and not CGT.

Example – Bona fide MBO – CGT Treatment

Target Company Limited ('Target Co') has been successfully trading for many years and is 100% owned by Mr T. Target Co is valued at €5 million. The management of Target Co wish to buy out Mr T and to facilitate this they incorporate MBO Company Limited ('MBO Co'). The shares in Target Co are subsequently acquired by MBO Co. The consideration for the acquisition of Target Co

is the payment of €5 million cash to Mr T. In order to fund the acquisition of the shares, MBO Co secures bank borrowings of €5 million. Target Co trades successfully subsequent to the acquisition and pays dividends totalling €5 million to MBO Co, which MBO Co uses to fully pay off its bank borrowings. The above transaction is not impacted by the provisions of subsection (3A).

The bona fide financing arrangements entered into by MBO Co are outside the scope of the provisions. Mr T has not engaged in any arrangements to secure the payment of the consideration out of the assets of Target Co.



Example – MBO - Partial IT Treatment

Say Mr T, in contemplation of the sale to the management team, retains profits in Target Co in excess of the company's commercial needs, rather than taking a dividend. The company has a valuation of €9 million, including cash on hand of €4 million. Mr T agrees to consideration on sale of €9 million, on the basis that €4 million will be paid from the reserves of Target Co. In order to fund the remainder of the consideration, MBO Co secures bank borrowings of €5 million.

The shares in Target Co are subsequently acquired by MBO Co. Target Co makes a distribution of €4 million to MBO Co which is used to pay the consideration to Mr T. Target Co trades successfully subsequent to the acquisition and pays dividends totalling €5 million to MBO Co, which MBO Co uses to fully pay off its bank borrowings.

The provisions of section 135(3A) TCA apply to treat the payment of €4 million to Mr T as a distribution made by Target Co to Mr T. Mr T has entered into an arrangement to secure the payment of consideration from the assets of Target Co.

Section 135(3A) does not apply to the balance of the €5 million consideration. Bona fide financing arrangements entered into by MBO Co are outside the scope of the provisions.

Earn-outs & Deferred Consideration

An 'earn-out' is a transaction where shares are sold and part of the consideration is payable in the future and based on the future performance of the business.

The Revenue Manual states that bona fide financing arrangements entered into by a purchaser to fund the earn-out element of the consideration are outside the scope of the provisions of subsection (3A).

Conclusion

Technically this section could apply to any transaction where the company whose shares are being transferred is involved in the funding and it is not possible to guarantee that it would not apply to a share sale transaction.

However, depending on the transaction, the Revenue Manual may be helpful in establishing that subsection 3A will not apply to a transaction.

Example – Earn-out – CGT treatment

JB Limited is owned Jane Bloggs. The shares in JB Limited are acquired by Joe Limited. The parties agree that Jane will receive additional consideration contingent upon the financial performance of JB Limited during the three year period subsequent to completion. The consideration is made up of the sum of €1 million, payable immediately, plus a payment of €400k if certain financial targets are achieved over the next three years. Joe Limited borrows €1 million from the bank to fund the upfront consideration. JB Limited trades successfully over the next three years and exceeds the targets agreed under the earn-out arrangement. JB Limited loans €400k to Joe Limited which is used to pay the deferred consideration to Jane Bloggs.

The above transaction is not affected by the provisions of subsection (3A). The bona fide financing arrangements entered into by Joe Limited in respect of the earn-out payment are outside the scope of the provisions. Jane Bloggs has not engaged in any arrangements to secure the payment of the consideration out of the assets of JB Limited.



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Caveat: *These notes are intended as a general guide to the anti-avoidance legislation regarding share disposals. OHT has endeavoured to provide an accurate commentary but the notes cannot cover all circumstances so OHT strongly recommends that formal tax advice be obtained before any steps are taken that may have a tax effect.*