Section 135 TCA – Anti-avoidance

Part 06-02-05

This document should be read in conjunction with section 135 of the Taxes Consolidation Act 1997

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Revenue
Cáin agus Custaim na hÉireann
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1 Introduction

Section 135 of the Taxes Consolidation Act 1997 (TCA) provides for a number of additional rules of interpretation in relation to the meaning of the term 'distribution'. In addition, the section also contains anti-avoidance measures to counter collusive arrangements made between companies. Finance Act 2017 further amended section 135 TCA by inserting two new subsections, (2A) and (3A). The provisions represent anti-avoidance measures designed to counter avoidance schemes whereby individuals sought to extract value from a company as capital, as opposed to income, in order to avail of the lower rates of capital gains tax. In some instances CGT was completely avoided by a claim to retirement relief. The purpose of this manual is to provide guidance on these new measures.

2 Consideration derived from share capital (or securities) of a close company

Subsection (2A) provides a restriction in certain circumstances on the amount of consideration which may be treated as 'new consideration' where it is derived from share capital or securities of a close company. Where, on a share for share exchange, a close company ('company A') receives shares or securities of another close company ('company B'), the consideration derived from the shares or securities in company B which may be regarded, for distribution purposes, as 'new consideration' received by company A is restricted. The amount which may be recognised as 'new' consideration received by company A will be limited to the new consideration originally given for the company B shares or securities. In effect, the new consideration for the 'new' is limited to the new consideration for the 'old'. The effect of the provision is therefore to recognise, as new consideration, shares or securities received by a company to the extent that they originated as new consideration received by the other company.

The underlying principle of the legislation is that the use of shares or securities as consideration as part of a reconstruction between two close companies should not give rise to opportunities to create new capital in a company.

2.1 Example

Nora is a hairdresser and the sole shareholder of Nora Salon Limited (NSL). NSL has 100 ordinary shares in issue which were originally subscribed for at par and the company is now valued at €500,000. Nora is advised to set up a holding company. She incorporates Nora Salon Holding Limited (NSHL) and exchanges her shares in NSL for 500,100 €1 ordinary shares in NSHL. A dividend of €500,000 is paid by NSL to NSHL. For commercial and corporate governance reasons, Nora subsequently decides to reduce the capital of NSHL. NHSL repays €500,010 of share capital to Nora.

Section 135(2A) TCA limits the amount to be treated as ‘new consideration’ received by NSHL on the share for share exchange such that only the amount originally subscribed by Nora in NSL, i.e. €100, may be treated as such. Therefore, the €500,000 is treated as a distribution made by NSHL to Nora which is subject to income tax. The remaining €10 represents new consideration received by NSHL and therefore is treated as the receipt of a capital payment by Nora.

3 Certain share disposals involving close companies

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 distributable reserves of the company on the disposal of their shares, and where the company receives no compensating consideration for the depletion of its assets, then distribution treatment should apply.

Subsection (3A) provides that a payment to a member of a close company, on a disposal of shares or securities in the company, shall be treated as a distribution, where arrangements are entered into by a member whereby the consideration for the acquisition of the shares or securities is funded, or to be funded, directly or indirectly out of the assets of the company.

It is understood that there may be a range of commercial transactions between close companies whereby the resources of an acquired company may be used to fund payments of consideration related to the acquisition of shares. However, 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 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, 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).

3.1 Arrangements

As stated above, the provisions of subsection (3A) only apply where a member enters into certain ‘arrangements’ directly or indirectly with another close company. The term ‘arrangements’ is to be given its ordinary meaning and includes any agreement, understanding, scheme, transaction or series of transactions. Therefore, where in connection with the disposal by a member of shares, an arrangement is entered into by a member under which the member arranges for the consideration for the disposal to be met out of the assets of the company, then the provisions will apply. This is the position regardless of the financial position of the company when the arrangements are entered into. For example, 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. Revenue will generally 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.[1]

3.2 Example

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 buy-out 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.

3.3 Management Buy-Outs

A management buy-out (MBO) involves the management team of a company purchasing the company from the existing shareholders. Typically a new company is created to acquire the shares of the company, the 'target'. Financing may generally provided to the new company by way of a mixture of equity finance i.e. from venture capitalists and debt finance i.e. bank loans. Many MBOs may also involve the provision of financial assistance by the target company to secure and repay the loans used to acquire the shares of the target.

As stated above, subsection (3A) only has application where a member enters into the relevant arrangements and does not apply to bona-fide financing arrangements entered into by a purchaser. Therefore, whereas a bona fide MBO may involve the provision of financing out of the assets of the target company, the provisions of section 135(3A) TCA will not apply unless the member has engaged in an arrangement to ensure that the consideration is met from the assets of the company.

[1] TDM 33.01.01 – Tax Avoidance "Main Purpose" tests refers.

Similarly, 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. Therefore, in such circumstances, a bona fide MBO may involve 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, however they would not be regarded as arrangements entered into by the member to secure the payment of consideration from the assets of the company. Accordingly, section 135(3A) TCA does not apply in such circumstances.

3.3.1 Example – Bona fide MBO

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.

3.3.2 Example – Arrangements to extract income as capital

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.

3.4 Earn-outs/deferred consideration

An 'earn-out' typically refers to a transaction whereby shares in a company are sold and part of the consideration is payable at some point in the future and is calculated by reference to the future performance of the business. In the case of a purchase of a closely held company from the existing shareholders, the parties may agree to defer payment of part of the consideration under an earn-out arrangement. 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).

3.4.1 Example

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.

4 Commencement

Subsection (2A) applies in relation to share for share exchanges occurring on or after 2 November 2017. Subsection (3A) applies in relation to relevant arrangements entered into on or after 2 November 2017.