Finance Act 2017 amendments to S135 TCA 1997

Overview

Finance Act 2017 ("**FA 2017**") was signed into law by the Irish President on 25 December 2017. One important anti-avoidance amendment introduced by FA 2017 relates to what constitutes a distribution for Irish tax purposes. It is widely believed that the provisions of this amendment could impact adversely on the feasibility of several important categories of corporate transaction, including management buy-outs ("**MBOs**"), corporate restructurings and other means by which investors and business owners may wish to exit or otherwise restructure their businesses.

S135 Changes (Anti-Avoidance Legislation)

The main objective of the new amendments is to counter avoidance schemes whereby individuals seek to extract value from a company as capital, as opposed to income, in order to avail of the lower rates of capital gains tax. It is important to note that these provisions will affect individuals more than companies since individuals are taxable at their marginal rate of income tax (plus PRSI and USC) where value is extracted from a company as income (i.e. dividends, distributions).

MBOS and certain restructurings

The newly inserted section 135(3A) of the Taxes Consolidation Act 1997 ("**TCA**") imposes a charge to income tax rather than capital gains tax where certain conditions are met. By imposing income tax, as opposed to capital gains tax, it not only results in a higher tax liability but also removes the ability of the tax payer to avail of reliefs from capital gains tax such as retirement relief and revised entrepreneur relief.

Therefore company shareholders contemplating an MBO, a sale of shares or corporate restructuring will need to consider the impact of these new provisions carefully, as they may result in very significant tax liabilities in excess of what would previously have been the case.

The new provisions apply specifically to "close" companies i.e. companies under the control of five or fewer persons. In addition, there is no legislative reference to an exemption from these anti-avoidance provisions for bona fide commercial transactions.

Impact on Share Sales

Section 135(3A) TCA 1997 applies where the assets of the target company are used to fund the disposal of the company i.e. where the consideration for the sale is paid out of the assets of the company being sold. It applies where:

(a) a shareholder (or someone connected to the shareholder) in a company (Company A);

(b) enters into ***arrangements*** with another close company (Company B); and

(c) the arrangements involve a sale of shares in Company A in consideration for a payment for which is funded either **directly or indirectly** from the assets of Company A.

If the shareholder disposing of the shares either directly or indirectly receives a payment from Company B, then the payment in question is treated as a distribution paid to the shareholder from Company A.

Impact on MBOs

MBOs are commonly structured such that the acquirer will borrow to acquire a target entity and seek to repay the debt incurred through dividends paid from the target. In those circumstances, the sellers could be exposed to income tax treatment as a result of the new amendment.

Revenue has stated that "bona fide" MBOs will not be impacted. Revenue guidance states that they will generally apply a main purpose test in determining whether a shareholder has entered into an arrangement to secure the payment of consideration from the assets of the target. While there is no legislative basis for this assertion, the guidance **seems** to indicate that a shareholder with only a marginal involvement in the structuring of the purchaser's funding arrangements should not be impacted.

While this is to some extent a helpful clarification, commercial reality dictates that it is common for the target company and its shareholders to be involved in taking actions prior to completion to assist with the purchaser's funding arrangements. Where the transaction involves, for example, a post-sale dividend from the target, the shareholders in the target may have to pass a resolution approving the financial assistance i.e. the seller's involvement will be far from peripheral. And concern on this point can only be increased by the broad definition of the term "arrangement" provide for in Revenue guidance:

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

It is worth noting that the provisions are not limited to MBOs and apply in any case where a corporate buyer is being introduced to allow shareholders to exit, or partially exit, such as if a new holding company acquires some shares from existing shareholders as part of a liquidity exercise. If the new holding company finances itself using the assets of the target, the provisions are potentially relevant.

Personal Holding Companies and Corporate Restructuring

Many entrepreneurs and investors use personal holding companies to hold their shares in trading companies. An additional provision introduced by Finance Act 2017 (Section 135(2A)) may have major tax implications for structures which involve a shareholder transferring his shares in a company to a personal holding company. Take the following example from Revenue guidance:

> *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.*
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> *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 €500,100 of share capital to Nora.*

In this example any amount in excess of €100 received by Nora as a consequence of the reduction in capital will be taxed as a distribution. If Nora would not otherwise qualify for capital gains tax treatment in relation to the proceeds of the reduction in share capital, income tax is payable on these proceeds.

Non-Irish Investors

For most non-Irish investors, these provisions are not likely to be significant. Such investors will generally be subject to tax on the proceeds of a sale, or other corporate action, in line with their own domestic tax law. However, in a few cases, the Irish provisions could be material where:

a) the provisions deem payments to be distributions and as such attract Irish dividend withholding tax. Although Ireland offers a wide range of exemptions from this tax, this should be considered in the light of the relevant Double Tax Treaty and the legislation of the investor's home country; or

b) if an investor's domestic tax treatment takes account of Irish tax legislation in considering whether a payment is taxed as income or capital.

Conclusion

The increased uncertainty created by these provisions is unwelcome and it is very likely that further Revenue clarification and guidance will be required. Until such guidance (or further legislation) is forthcoming, purchasers and sellers will have to be particularly careful about how they implement MBOs and other reorganisations in future.

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