Irish Tax Institute Submission on Section 135 TCA 1997

Confirmations sought in Revenue Guidance in relation to the operation of section 135(3A)

1. Confirmation that the provisions of subsection (3A) are not intended to apply to the sale and purchase of shares in a closely held company by another closely held company where the sale and purchase occur in the course of a bona fide commercial transaction and do not form part of any arrangement or scheme of which the main purpose or one of the main purposes is the avoidance of liability to tax.

2. The payment of liquidation proceeds to a close company upon a bona fide liquidation of an acquired company should not be regarded as within the scope of payments which are contemplated by subsection (3A).

3. Clarification and some guiding principles on the meaning of "arrangement." For example, if the Target Co has no reserves as at the date of sale, does this mean that the provision does not apply. Similarly, if the funding mechanism for the payments is out of the future reserves of the Target Co, does this mean that the provision does not apply?

4. The wording in the legislation is that the shareholder in the first company "enters into arrangements directly or indirectly" with the second company as a result of which the consideration for the acquisition of the shares in the first company is paid or to be paid directly or indirectly out of the assets of the first company. Confirmation that that this wording requires deliberate and planned extraction by the two parties effectively acting in concert.

5. Clarity on the phrase which refers to the "consideration … is paid or to be paid directly or indirectly out of the assets" of the first company would also be very helpful. The consideration will be stated in the SPA and it will usually be clear when it is paid or to be paid. In most cases, it will not be paid directly out of the assets of the first company so clarity as to what nexus is required for the "indirectly" rule to apply would be useful.

6. Clarification would be welcome on whether there is a distinction between cash-laden companies and cash-strapped (but asset rich) companies.

7. There are a range of commonly occurring commercial transactions between close companies where it can be foreseen that the resources of an acquired company could be expected to fund future payments of consideration related to a share sale.
   It would be welcome to receive confirmation that it is not intended that the provisions of subsection (3A) would be applied in the context of bona fide commercial transactions which involve commonly occurring commercial arrangements such as those which are described below.

   (a) *Earn out consideration paid in the course of third party sale and purchases of close companies*

In the case of the purchase of a closely held company from the existing shareholders, the parties may agree to defer payment of part of the consideration on sale of the shares in the original company.

The purchasing company may have raised capital and/or debt funding to acquire the shares in the acquired company and may, in addition, seek to defer paying part of the consideration to the vendor for its acquisition of the shares based on the future performance of the business of the acquired company. In making the future payments to the vendor, the acquiring company will use resources available to it in future which may well include the assets of the original acquired company. The assets of the acquired company could be used by the acquirer to put in place arrangements which directly or indirectly fund future payments of consideration for the acquired shares. This could include using the assets of the acquired company to support additional capital raising, to raise proceeds from borrowings, to refinance existing debt or simply to generate cash flow from the conduct of the business and realisation of assets of the acquired company.

It is not expected that the provisions of subsection (3A) would be applied so as to change the capital nature of the disposal proceeds related to the future earn out payments into distributions received by the vendor from the share sale.

(b) Arrangements to sell and purchase shares in the context of MBO transactions

In a Management Buy Out scenario, management will typically incorporate a company (MBO Co) which purchases some or all of the shares of a trading company or group (TradeCo) from one or more of its existing owners. It is assumed that both TradeCo and MBO Co are close companies.

There is often limited funding available to MBO Co and its shareholders to fund the sales consideration payable to the existing TradeCo shareholder/s. Even where formal arrangements are not in place with the existing owners, it can be expected that MBO Co will need to draw upon the assets and resources of Trade Co to fund future payments of consideration to the existing owners in relation to its acquisition from them of TradeCo shares.

It is not expected that the provisions of subsection (3A) would be applied so as to change the capital nature of the disposal proceeds related to the future payments of consideration received by the existing shareholder/s on sale of their shares to MBO Co.

(c) Throughout the lifetime of MBO Co, some members of the original MBO team or employee shareholders in MBO Co may wish to realise their capital in MBO Co by the sale of their MBO Co shares. Where the remaining MBO team offer to buy out the interests of exiting MBO Co shareholders, it can be expected that part of the sales consideration could be funded (directly or indirectly) by them from future receipts from MBO Co (as their shares in MBO Co may well be the main asset of the remaining MBO shareholders). Arrangements by remaining MBO shareholders to buy out the interests of exiting shareholders should not be expected to be within scope of subsection (3A) where the sale and purchase of the shares is effected for bona fide commercial reasons.

(d) Liquidity arrangements for shares in private companies

Where a closely held private company has shares held by employees, the shareholders of the company may put in place arrangements whereby a connected company will purchase shares of exiting employees on agreed terms. The connected company used as the share acquisition vehicle is typically funded by the employer company.

The exiting employees (e.g. senior management who are required to take an 'equity stake' in their employer company) hold small shareholdings in the company and are not eligible for retirement relief or entrepreneur relief on capital gains arising on the share disposals. These arrangements provide a market (liquidity) in the shares which is not otherwise available for shares in a private company. The employees have the assurance that they will be able to sell their shares upon departure from the company (whether upon termination, leaving to take up another position or retirement). The remaining shareholders in the company do not face a dilution of their respective holdings in the company and have provided a mechanism to acquire shares from exiting employees in an orderly manner.
Arrangements by private companies to provide liquidity in their shares by putting in place buy out arrangements for exiting employees should not be expected to be within scope of subsection (3A) where the sale and purchase of the shares is effected for bona fide commercial reasons.

(e) *Arrangements to purchase shares from EII investors*

Investors who subscribe for shares in a company which is raising capital under the Employment and Investment Incentive (EII) relief generally have the expectation that their shares will be purchased from them at the end of the EII investment period. The EII provisions require that any arrangements to purchase shares from the EII investors cannot remove their risk of investment in the EII company but the provisions do not prohibit arrangements to purchase the EII shares at the end of the investment period at market value and this is commonly done and agreed with the investors at the point of investment.

Where an EII company raises capital from investors in successive years, it cannot repay capital to exiting EII investors by way of repurchase or redemption of share capital as this will trigger a clawback of relief for remaining EII shareholders who have invested in a later period.

As a result, it is not uncommon for a separate company to purchase the shares of EII shareholders. The acquisition of the EII investors' shares by the second company will often be funded by the EII company, using savings set aside during the EII investment term or debt finance to facilitate the removal of the EII shareholders from the EII company. These arrangements have historically been accepted by Revenue in the context of EII and BES investments provided there are no arrangements whereby EII investors can dispose of their shares at other than market value.
Arrangements for a company to purchase the shares of EII shareholders in another company should not be within scope of subsection (3A) where the arrangements otherwise meet the requirements of the EII relief provisions.

Examples of these common commercial transactions set out at Appendix 1.

Confirmations sought in relation to the operation of section 135(2A)

1. Detailed guidance on the new section 135(2A) would be very welcome.

2. Clarification on the assessable amount under subsection (2A) would be helpful. If the full amount of the consideration for the shares/securities were assessable as a distribution, then this would be very severe, as on a redemption, it is only the premium over the

subscription price, which would be a redemption. Take for example if a shareholder had subscribed €100 for shares and then sells those shares in a transaction caught by subsection (3A), he is fully exposed to income tax on the €100 as a distribution. The same position arises for securities (i.e. loans).

Confirmation sought in relation to commencement date of the new provisions in section 135 TCA 1997

1. Clarification on the commencement date for the provision would be useful – it provides that it will "come into operation on 2 November 2017." Confirmation that this means that it applies where the disposals take place on or after 2 November 2017 and presumably it would not apply if the disposal took place before that date and the payments within the scope of subsection (3A) arise after that date.

Appendix 1

Illustrative examples of types of commercial transactions that could be impacted by the amendment to section 135 TCA 1997

Example 1

X Ltd has been trading for many years and it is fully owned by Mr. X. Management wish to buy out Mr. X and, to facilitate this, they establish Z Ltd which subsequently acquires X Ltd from Mr. X. The consideration for the acquisition of X Ltd is cash of €10m plus the issue of loan notes of €5m to be settled 3 years later. Although distributable reserves existed in X Ltd at the date of sale, there was no significant surplus cash.

Over the course of the next three years, X Ltd. trades profitably and is in a strong cashflow position. It applies the cash to redeem the loan notes previously issued to Mr. X.

The consideration for the acquisition of the shares in X Ltd by Z Ltd was €15m and it has been fully paid. However, the fact that the loan notes issued in settlement of €5m of the consideration and those loan notes were subsequently redeemed using the profits of X Ltd raises the question as to whether the €5m of consideration for the shares in X Ltd was paid indirectly out of the assets of X Ltd.

Once the consideration has been paid, there should be no look-forward approach applied as the test in subsection (3A) is performed by reference to the payment of the consideration. Accordingly, the above example should not be impacted by subsection (3A). Clarification from Revenue on this position would be welcome.

Example 2

Villa Ltd is owned by Simon. The shares in Villa Ltd are acquired by United Limited (a close company). The consideration for the acquisition of the shares in Villa Ltd is the payment of €100m in cash.

United Limited is financed by way of bank borrowings up to the amount of €100m. Subsequent to the acquisition of Villa Ltd, United Limited takes a loan of surplus cash from Villa Ltd of €25m and it uses this cash to pay down part of the loan from the bank.

Revenue confirmation that this type of transaction is not impacted by the subsection (3A) would be welcome.

Example 3

Arsenal Ltd is owned by Jack. The shares in Arsenal Ltd are acquired by Spurs Limited (a close company). The consideration for the acquisition of the shares in Arsenal Ltd is the payment of €100m in cash.

Spurs Limited is financed by way of bank borrowings up to the amount of €100m. In the years subsequent to its acquisition, Arsenal is very profitable. It generates sufficient cash over the following years to allow it to pay dividends to Spurs Limited to enable it to fully pay off its bank borrowings.

Revenue confirmation that this type of transaction is not impacted by the subsection (3A) would be welcome.

Example 4

The majority shareholders in Tiger Limited enter into a transaction whereby their shares in that company are transferred to Rory Ltd in exchange for the issue of shares in Rory Ltd (assume share for share relief available - so no disposal arising for the majority shareholders).

At the same time, Rory Ltd acquires the shares held by the minority shareholder in Tiger Ltd for cash consideration. The acquisition of the shares from the minority shareholder is financed by way of a loan from Tiger Ltd to Rory Ltd.

As this is a bona fide commercial transaction and the minority shareholder is not in any position to influence the manner in which the transaction is undertaken, we would fully expect that subsection (3A) should not apply in this case. Revenue confirmation of the position would however be welcome.

Example 5

Golf Ltd is owned by Henry. The shares in Golf Ltd are acquired by Racing Limited (a close company). The consideration for the acquisition of the shares in Golf Ltd is the payment of €100m in cash.

Racing Limited is financed by way of bank borrowings up to the amount of €100m.

Subsequent to the acquisition of Golf Ltd and over the course of the next few years, Racing Limited takes a loan or dividend of the funds within Golf Ltd as at the date of its acquisition. The funds are used to make the interest and capital repayments on the bank borrowings.

Revenue confirmation that this type of transaction is not impacted by the subsection (3A) would be welcome.

Example 6

A sale of shares for consideration payable over a number of years. The consideration is made up of X on completion, Y circa 12 months later and Z after 24 months. The purchaser has formed a "PurchaseCo" to make the acquisition of my client's company (let's call it Company A). While a matter for the purchaser, it is possible that the PurchaseCo would need to access the cash reserves in Company A to fund the Y and Z components of the consideration (after all they are purchasing the company to make profit).

On a literal reading of Section 135 as amended in the Finance Bill, the payments of Y and Z are potentially within the scope of Section 135. Arising from this concern, it is not possible for us as taxation advisers to provide the vendors with certainty that they will secure CGT treatment on the sale proceeds. It also raises significant uncertainties from the Purchaser's perspective as the payments could be regarded as distributions and, therefore, would be within the scope of DWT upon payment.

The facts in this example would bear out that there is no "arrangement" in place between the parties such that Section 135 should not arise. However, the meaning of the term “arrangement” is open to interpretation and, while we would not regard the above example as involving any “arrangement” (as there is no pre-agreed understanding or agreement between the parties for the payments to be funded out of the reserves of Company A) clarification of Revenue’s position on this matter would be welcome.

Example 7

An individual (Mr Tom) is running a service company for 30 years. He is approaching 65 and looking to step back from the business. Two individuals in their 30s are looking to purchase the business (but have very little money). They believe that if they get involved in the business that they would be able to drive sales and develop the business from the existing client base. They need the 65-year hold to stay on board for 2 to 3 years to ensure a seamless handover. The 65 year old has built up a very good business but recognises that he doesn’t have the energy he once had and is not driving the business sales, developing the business etc.

So, the two individuals form a PurchaseCo. They borrow €200K from the Bank and use it to purchase the shares in the company from Mr Tom. They also agree to pay Mr Tom an additional consideration at the end of Year 3 of between €400K and €800K depending on how the company performs. Mr Tom is happy as it allows him to retire having realised the value of the business and he is happy that the business (and its employees) can trade successfully into the future.

The two individuals (who had very little money) will need to access the reserves of the company to assist in funding the purchase price payable to Mr Tom at the end of year 3. The movement of money (by way of dividend or loan) to PurchaseCo to assist in paying a purchase price is vulnerable to Section 135.
This is a bona fide transaction that should not result in Mr Tom paying income tax on the realisation of his shares in the business.

Example 8

A company has a good business worth €1m. A purchaser makes an offer to purchase the business and the agreement is that the price would be €1m plus the level of surplus cash on the balance sheet at completion (determined as €500K). So the purchaser agrees to buy the shares for €1.5m with the consideration payable over a 12 month period. The purchaser completes the transaction, the €500K cash is moved from the company to the purchaser to assist in paying back bank borrowings and funding the consideration.

Revenue clarification is sought that the movement of the cash to the purchaser is not vulnerable to the Section 135 change.

Example 9

Old and Young are two men involved in a business. Old was on his own but circa 10 years ago young came on board as a "junior partner" and they are working away ever since with a simple trading company where Old owns 70 shares and Young owns 30 shares. The company is worth €1m and Old wants to retire. He is happy for Young to take over but Young doesn't personally have €700k to fund same.

The traditional solution would be for Young to form Y Ltd which would buy Old's 70 shares for €700k and then share-for-share his own 30 shares into Y Ltd. Now Young owns Y Ltd which is the Parent Holding company of its 100% subsidiary Trade Co. Old has retired and sold his shares for their fair value. The key thing here is that Old has actually sold his shares and thus, there is a real transaction which means they did not have to worry about all of the old S.817 and other traditional anti-avoidance schemes. This is not an artificial transaction - Old has sold his shares and received cash for same.

Old could have sold his shares to anyone in the world and received the €700k and no questions would be asked. Old could have liquidated the company and received his €700k and no questions would be asked.

Given Y has no access to money other than the trade co, it could be at risk of being targeted as an arrangement where the proceeds are paid by the distributable reserves.