

This technical query paper was submitted to Revenue via the TALC Direct/Capital Taxes sub-committee in advance of the December 2021 TALC Direct/Capital Taxes sub-committee meeting following queries raised by practitioners at the June and September 2021 meetings. This technical query paper was discussed at the December 2021 TALC Direct/Capital Taxes sub-committee meeting and the discussion is reflected in the Minutes.



ITI submission to Revenue regarding whether an anti-dilution clause in a constitution could render a shareholder a connected person under section 500 Taxes Consolidation Act 1997

18 October 2021

At the June meeting of the Direct / Capital Taxes TALC sub-committee, practitioners requested clarification from Revenue on whether anti-dilution clauses in a constitution could render a shareholder a connected person under section 500 Taxes Consolidation Act 1997. Following a discussion at the September meeting of the Direct / Capital Taxes TALC sub-committee, practitioners agreed to submit a sample clause to Revenue so that they could consider the matter further. A sample anti-dilution clause is set out in the Appendix to this submission.

The purpose of an anti-dilution clause is not to provide investor protection or de-risking. It is to prevent the company from raising future funds at a price per share less than what earlier investors paid for their shares. It is possible that an investor could be a connected party to a company or otherwise have some side agreement with a company to participate on much better terms than other investors. For example, if A pays €5 per share and B pays €1 per share, B will get 5 times more shares than A and therefore, significantly more proceeds on a future disposal or liquidation even though B paid much less for the shares.

Having an anti-dilution clause in an agreement keeps the company “honest” and prevents the company from disadvantaging early stage investors who typically take on higher levels of risk. Early stage companies are much riskier than established ones, thus, early stage investors take on more risk. As the existence of an anti-dilution clause is a preventative measure, it means that it is rarely invoked in practice as the company knows if it raises funds at a lower price in future the clause will become effective. A sample anti-dilution clause is set out in the Appendix.

An anti-dilution clause would more commonly feature where there is a larger funding round comprised of several investors and investor groups, typically only a small proportion of whom are EIS investors who would not be in a position to dictate the terms of the investment. Venture capitalists and seed investors will determine the rights attaching to the shares and EIS investors have to accept the terms. An anti-dilution clause is not something that is typical of a standard EIS fundraising round. Rather, it is typically part of a larger investment round, some of which may qualify for EIS if the investors are individuals.

APPENDIX

Sample Anti-Dilution Clause

Anti-Dilution of Preference Shares

10.1. In order to prevent dilution of the rights of the holders of the Preference Shares, the number of Preference Shares shall also be subject to adjustment from time to time pursuant to this Regulation 10. This adjustment will, where practicable, be by way of bonus issue (with all other Shareholders being deemed to have waived their rights to participate in such bonus issue of Shares) or if not practicable or only partly practicable, [the holders of the Preference Shares will have the option (with no right of pre-emption for any other Shareholder) exercisable within one month of the issue or sale giving rise to this right to subscribe for such additional Shares (or portion thereof where partly practicable) at nominal value and in any event for no less than €250 in a calendar year:

10.1.1. if the Company issues or sells (or is deemed to have issued or sold) any Shares or Options or Convertible Securities other than or pursuant to:

- (a) any Shares or New Securities issued pursuant to the terms of the Loan Note Instrument;
- (b) Shares which form part of the Employee Share Option Plan;
- (c) the issuing of CCRPS to Enterprise Ireland;
- (d) the conversion of CCRPS; or
- (e) the operation of this Regulation,

for a consideration (in the case of Options on an as-exercised basis and in the case of Convertible Securities on an As-Converted Fully Diluted Basis) per Share less than the Preference Share Subscription Price (adjusted appropriately to reflect any previous anti-dilution adjustment pursuant to this Regulation), then forthwith upon such issue or sale, the number of Shares held by the Investors shall be adjusted as to increase the number of Shares held by the Investors and to be such number as is derived from the formula (ignoring any fraction resulting from application of the formula):

$$\frac{X \vee Z}{Y} - Z$$

where:

X = the Preference Share Subscription Price adjusted appropriately to reflect any previous anti-dilute adjustments made pursuant to Regulation 0;

Y= the weighted average price of (a) in relation to the Shares, the Preference Share Subscription Price, adjusted appropriately to reflect any previous anti-dilute adjustment made pursuant to this Regulation 0 and (b) in relation to the Shares to be issued by the Company (the number thereof being "V"), the price ((in the case of Options on an as-exercised basis and in the case of Convertible Securities on an As-Converted Fully Diluted Basis) at which such Shares, Options or Convertible Securities are to be issued by the Company ("W"), and for this purpose "weighted average price shall mean:

$$\frac{Y = (X \times Z) + (W \times V)}{Z + V}$$

Z = the number of Shares held (or deemed held) by the Investors prior to the relevant issue.

10.1.2. If there is any doubt or dispute arising in respect of the adjustment to be made pursuant to this Regulation 0, the matter will be referred to the Auditors who, acting as experts and not as arbitrators, will certify the appropriate adjustment (or if they consider themselves unable to do so, appoint an appropriate party so to do) and the certificate of the Auditors (or other appointed party) shall (in the absence of manifest error) be conclusive and binding on all concerned.