The Dividend Merry-Go-Round

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Introduction

One might be forgiven for assuming that the tax treatment applying to dividend income is quite uncomplicated: it is liable to income tax or corporation tax or is exempted from corporation tax as franked investment income. The area is, however, rather more complicated and, to use an analogy, there are occasions when the taxation of dividends moves off the motorway and onto the secondary roads.

I will focus on two such secondary-road excursions, s591A and s817 TCA 1997. These sections work in an opposite way, showing the chameleon nature of Irish tax law that practitioners often have to navigate through. Section 591A applies to companies, and s817 applies to individuals.

Section 591A recharacterises an income dividend/distribution as a capital gain, whereas s817 recharacterises a capital gain as an income dividend. The merry-go round!

Section 591A: "Abnormal Dividends"

Section 51 of Finance Act 2008 introduced this rule. The Explanatory Memorandum that accompanied the 2008 Finance

Bill states that the section "prevents a scheme involving the avoidance of capital gains on certain disposals of shares in a company. The avoidance can arise where, instead of a payment being made for the disposal of shares, an abnormal dividend is paid to a company."

The section applies in the following situations:

› A person disposes of shares or securities in a company.

› There exists a scheme, arrangement or understanding connected to the disposal where an "abnormal dividend" or "abnormal distribution" is paid/made.

› Where the person is a company, to that person or a company connected with that person.

› Where the person is not a company, to any company connected with that person.

Then, for the purposes of the capital gains tax provisions, the "abnormal dividend" or "abnormal distribution" paid to the person (or the connected person) is recharacterised as consideration received for the disposal of shares or securities and is liable to CGT. The section applies to all companies (whereas s817 is limited in application to close companies).

Very often before a disposal of shares in a company (or indeed a simplification of a group structure that may include too many companies), dividends are paid in order to expedite sales or liquidations of companies. Care must be taken to determine whether s591A may apply.

It is worth bearing in mind that these rules have no application unless a dividend/distribution is connected with a disposal of shares/securities; if there is no disposal, these rules do not apply.

Has an abnormal dividend/distribution been paid?

Section 591A(1) tells us when a dividend or distribution is to be regarded as being "abnormal". We are told that a dividend or distribution made in connection with a disposal of shares in a company "shall be treated as being abnormal if the amount or value of the dividend, or as the case may be the distribution, exceeds the amount that could reasonably have been expected to be paid, or as the case may be made, in respect of shares or securities of the company if there was no such disposal of the shares or securities".

The word "abnormal" is an unusual term and is not used elsewhere in TCA 1997. Whether something is "abnormal" is certainly a subjective matter.

It is often the case that a subsidiary does not pay dividends to its parent, or if it does, they are irregular in timing and certainly would not represent a distribution of all (or a large portion) of the profits of the subsidiary.

If the parent then goes to sell the subsidiary and as a pre-sale step (as a purchaser may be unwilling to fund the cost of buying cash in a company) a dividend is paid of surplus cash in the subsidiary to the parent, it is possible that one might be within these "abnormal dividend" rules.

This is because:

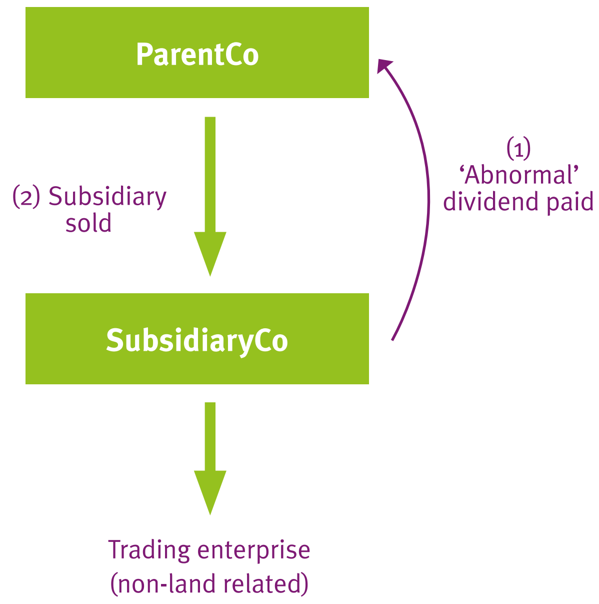
› The parent is disposing of shares in the subsidiary.

› The subsidiary does not have a history of paying regular large dividends to its parent.

› The subsidiary makes a large dividend payment to its parent before the sale of shares that is regarded as "abnormal".

The impact can be best explained using examples.

Example 1: Section 591A – participation exemption

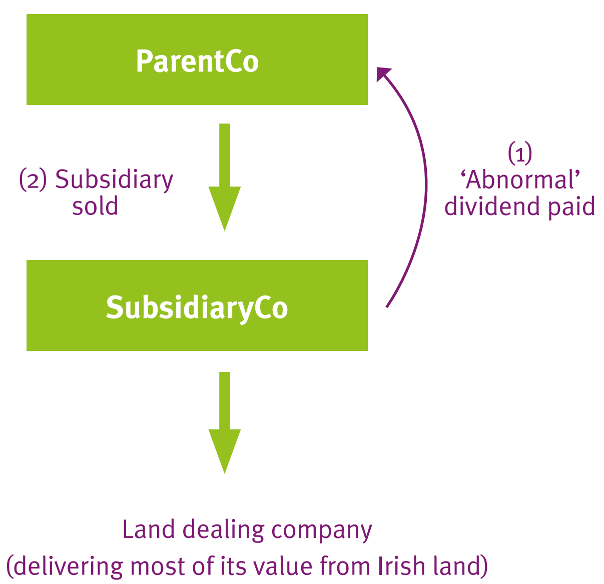


In this example a parent is disposing of a subsidiary and the sale is one to which the participation exemption (s626B) applies. However, for commercial reasons the subsidiary pays a dividend of surplus cash to the parent before sale. There is no history of significant regular dividend payments.

Section 591A can work to recharacterise the dividend as being a capital receipt, and the dividend is extra consideration for the sale of the shares.

Of course, in this instance the matter is not one of worry as there is no taxable chargeable gain on the sale of the shares in any event (s626B applies).

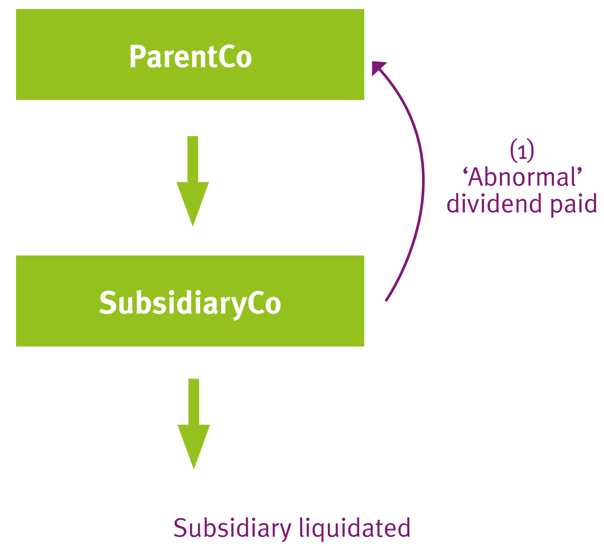
Example 2: Section 591A – land dealing subsidary



In this example the subsidiary is a land-holding company and a sale of the shares will not qualify for the Irish participation exemption.

A large dividend is paid before the disposal, which will reduce the value of the subsidiary on sale and thus the consideration for the sale of shares. The recharacterisation of that (otherwise exempt) dividend as consideration for the share sale results in (more) CGT arising on sale. Section 591A may certainly apply. The bona fide exclusion in s591A(3) needs to be examined.

Example 3: Section 591A – subsidiary liquidated



In this example a subsidiary has served its purpose and is being liquidated (the liquidation will not qualify for s626B treatment in this instance). There is legacy cash from prior trading operations (on which corporation tax has been applied to profits) matched by reserves. It is decided to pay a once-off dividend so that the subsidiary can be liquidated. Let us assume that there is no history of regular large dividends.

Again, the rules may apply: (1) there is a dividend that is potentially "abnormal" and (2) the shares are being disposed of. The dividend could potentially be rebranded as consideration for the disposal of the shares on liquidation.

However, the circumstances of the dividend are key. Is it abnormal for a subsidiary to pay a dividend of cash no longer required to its parent? In my view, no matter the size of the dividend (and regardless of whether the company has a history of paying regular dividends), where a subsidiary has served its purpose, paying out all surplus cash by dividend is not more than "could reasonably have been expected to be paid" and is not therefore an "abnormal" dividend. For this reason, in my view, the real test to be applied under s591A is what is reasonable and normal for the company to pay given the circumstances at the time that it pays the dividend.

If we assume (for illustrative purposes) that the dividend is "abnormal", then the bona fide exclusion in s591A(3) is in hand.

Bona fide exclusion

The law states that

"subsection (2) does not apply if it is shown that the scheme, arrangement or understanding is effected for bona fide commercial reasons and is not, or does not form part of, any scheme, arrangement or understanding of which the main purpose or one of the main purposes is avoidance of liability to tax".

If we return to our examples, we can see that Example 1 does not need to rely on this exclusion (because s626B applies).

In Example 2 it may be difficult to argue that the bona fide exclusion may apply where the sale of shares is liable to CGT. However, it depends on the circumstances of the dividend paid (e.g. if there was a large cash balance that a purchaser steadfastly refused to buy, the only practical way to remove it is via dividend).

In Example 3 the dividend is not in my view abnormal, but let us assume that it is. Although the parent could have liquidated the subsidiary (rather than pay a dividend), it would not make commercial sense to "hand over the keys" to a liquidator and ask them to distribute cash when one could control this and pay a dividend.

Where the subsidiary has paid tax on its profits and has served its purpose, a dividend paid (in the context of eliminating the subsidiary), even if "abnormal", should benefit from the bona fide exclusion.

Section 817: Schemes to Avoid Liability to Tax under Schedule F

This piece of tax law works to do the precise opposite to s591A. It was originally introduced in Finance Act 1989, the same Act that introduced s811. There was a view that s817 was ineffective up until the passing of s29 Finance Act 2011, where s817 was only then added to the definition of distribution as set out in s20.

When s817 applies, it converts what is otherwise a capital gain on a disposal of shares to an income dividend. It applies only in the case of close companies.

Clearly, it can be attractive to obtain cash out of companies that is liable to CGT (at rates of 33% or possibly even 20%, with the benefit of entrepreneurs' relief) as opposed to marginal rate income tax (USC and PRSI).

Section 817 is a long and tortuous section of tax law.

- It is set out that the law shall apply (s817(2)):
- to counteract a scheme or arrangement (undefined for the purposes of s817)
- undertaken or arranged by a close company
- or to which the close company is a party
- being a scheme or arrangement of which the purpose or one of the purposes
- is to make sure that a shareholder in the close company
- avoids or reduces a charge to income tax under Schedule F
- by extracting (directly or indirectly) money or money's worth
- from the close company.

Then s817(3) states

"this section shall apply to a disposal of shares in a close company by a shareholder if, following the disposal or the carrying out of a scheme or arrangement of which the disposal is a part, the interest of the shareholder in any trade or business...is not significantly reduced".

The purpose of this article is not to examine in detail the drafting of s817 itself (I would refer readers to John Ward and Dara Burke, "Extracting Corporate Cash: The Impact of TCA 1997 s817", *Irish Tax Review*, 20/1 (2007)). Rather, it is to look at some examples of where these rules may apply.

Before we look at specific examples, the following is a brief summary of the main provisions:

1. There must be a scheme or arrangement, terms that are not defined in the section. If, for example, a shareholder in a close company sells some shares (but not enough to have had a "significant reduction"), is that a scheme or arrangement undertaken by a close company or to which the close company is a party? It would certainly appear that there needs to be something further other than a sale that stands on its own for s817 to apply
2. The concept of "significant reduction" is complex (s817(1)(c)), and the law is written in the negative. Indeed, there is no percentage test of signification reduction prescribed in the law, although

Example 4: Section 817 – building trade, liquidation

generally a 25% reduction is regarded as enough (to have had a significant reduction, and once you have had this, s817 cannot apply).

Also, s817 at sub-section (ca) ensures that one must include interests of connected parties in determining whether a shareholding has been significantly reduced.

Finally, one must look at the interest of the shareholder in the trade of thebusiness through any close company before and after in determining whether a significant reduction applies. Although there is no time limit on this, Revenue states in its Guidance Notes to s817 that "it is to prevent temporary reductions of interests being arranged in order to get around the section". Of course, Guidance Notes are not the law.

3. If a shareholder has not had a significant reduction in his/her shareholding in the close company (bearing in mind the amalgamation of connected parties and the trade or business continuing in a new close company), any capital payment that the shareholder has obtained relating to a disposal of shares in the close company is recategorised as a dividend liable to tax under Schedule F (and the capital payment is ignored for CGT purposes).

4. Bona fide exclusion – s817(7) provides that "[t]his section shall not apply as respects a disposal of shares in a close company by a shareholder where it is shown to the satisfaction of the inspector or, on the hearing or the rehearing of an appeal, to the satisfaction of the Appeal Commissioners or a judge of the Circuit Court, as the case may be, that the disposal was made for bona fide commercial reasons and not as part of a scheme or arrangement the purpose or one of the purposes of which was the avoidance of tax".

Some examples may illustrate when the section may apply.

Example 4: Section 817 – building trade, liquidation (above)

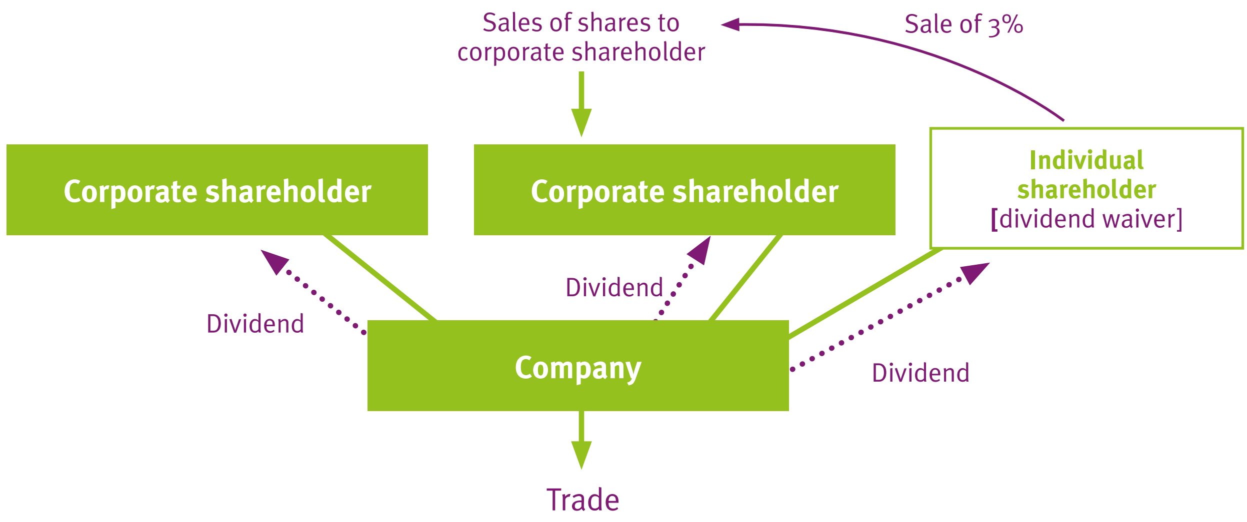
It is common in the building industry to use special-purpose vehicles on a project-by-project basis for commercial reasons. It is also very common that those companies conducting the businesses are "close".

In this example let us assume that there has been a development of residential property. All of the property has been sold, and corporation tax has been paid by the building company. The company is owned 50% by Mr A and 50% by Mr B.

Soon after the last sale, the company is liquidated, and Mr A and Mr B pay CGT as appropriate on the retained profits of the company (rather than first paying a dividend and then liquidating the company). Then (say) one year later Mr A and Mr B find a site on which to develop more property and decide to go into business again, and the same process is completed (development, corporation tax paid on profits, liquidation and CGT paid).

In this scenario s817 needs to be considered. It is clear that (1) both companies are close, (2) the trade is the same, (3) a capital payment is obtained on liquidation and (4) as the "significant reduction" test is open-ended, Mr A and Mr B could be said not to have had a significant

Example 5: Section 817 – corporate and individual shareholders



reduction in their shareholding as the same trade is being carried on by another close company.

There is a risk that the liquidation proceeds may be treated as a dividend liable to tax under Schedule F. However, in my view they should not in these circumstances, as the bona fide exclusion should apply. This is on the basis that separate special-purpose companies are needed for commercial reasons, but relying on a bona fide exclusion is often the last place that someone wants to be.

It is also arguable that there is no scheme or arrangement that a close company can be a party to where the shareholders of that company decide on a course of liquidation. The close company has done nothing.

Perhaps in this example Mr A and Mr B should use a holding company with subsidiary companies. Only when they have decided to hang up their boots entirely would they liquidate the holding company. After each subsidiary company completes its project, it may dividend after-tax proceeds to its holding company, which can reinvest them in new projects. The subsidiary company may then be eliminated. Bizarrely, s591A is then in hand, although for reasons outlined above, it may not apply.

Example 5: Section 817 – corporate and individual shareholders.

In example 5 a company is owned one-third each by two companies (each owned 100% by a single shareholder) and an individual. The company is therefore "close".

The company is a trading company and is going to pay a dividend. The two corporate recipients will not be liable to corporation tax on the receipt of the dividend (ignoring close company surcharge implications). However, the individual will suffer marginal rate income tax on his/her portion of the dividend.

The individual sells (say) 3% of his/her shares in the close company (to one of the one-third holding companies) and decides to waive a dividend entitlement. The close company uses dividend proceeds to buy the shares from the individual. Here one may be squarely within the remit of s817. The individual might buy shares back in a year's time to restore the prior shareholding equilibrium.

It could certainly be said that there is an arrangement here to which s817 will apply.

Conclusion

The aim of this article was to give some examples of when s591A and s817 can apply to transactions in shares. John D. Rockefeller stated "Do you know the only thing that gives me pleasure? It's to see my dividends coming in". It is debatable whether he would have felt the same way having had a spin on the s591A and s817 merry-go-round.

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