Revenue Alert RA 18/01

Dividend stripping – some share sales where proceeds are at a high risk of being treated as a dividend for income tax purposes

A Revenue Alert is issued by the Commissioner of Inland Revenue, and provides information about a significant and/or emerging tax planning issue that is of concern to Inland Revenue. At the time an alert is issued risk assessments will already be underway to determine the level of risk and to consider appropriate responses.

A Revenue Alert will identify:

- *the issue (which may be a scheme, arrangement, or particular transaction) which the Commissioner believes may be contrary to the law or is inconsistent with policy;*
- *the common features of the issue;*
- *our current view; and*
- *our current approach.*

An alert should not be interpreted as being Inland Revenue's final position. Rather, an alert outlines the Commissioner's current view on how the law should be applied. For any alert we issue it is likely that some investigatory work has already been carried out.

If people have entered into an arrangement similar to the one described or are thinking about it, they should talk to their tax advisor and/or to Inland Revenue for advice about tax implications.

Many people sell shares in companies each year and pay no tax on the proceeds, either because they do not exceed their cost, or because any gain is on capital account. However, increasingly Inland Revenue is seeing sales of shares to related entities in situations where Inland Revenue considers the sale proceeds are a dividend under the general tax avoidance rule in section BG 1 and also sometimes the dividend stripping rule in section GB 1.

In essence, a dividend is a transfer of value by a company to a shareholder or related person and the transfer is caused by that shareholding. Dividend stripping refers to the sale of shares where some or all of the amount received is in substitution for a dividend likely to have been derived by the seller but for the sale of the shares. The related party scenarios described in this Alert are a subset of arrangements of various kinds known generically as "dividend stripping", but Inland Revenue wants shareholders to be more aware of these situations, and of the department's concerns.

Background

When a person sells shares in a company (the *target)* to an unrelated purchaser, it is generally appropriate for the transaction to be taxed as a sale of the shares rather than a dividend (though this is not always the case, for example if the target company is cashed up, and the sale is for the purpose of avoiding tax on a liquidating distribution). The sale may be on revenue or capital account.

However, if the sale is to a related entity, such as a company in which the seller or sellers have a significant shareholding, the economic effect of the transaction may be that the seller indirectly continues to substantially own the target company. The greater the similarity between the seller's pre and post-sale ownership of the target company, the greater the risk that the transaction should be treated as a tax avoidance transaction. This risk exists regardless of whether or not the target company has liquid assets or retained earnings at the time of sale. For example, the target company may have appreciated assets, or goodwill that has emerged over time.

A recent example of this kind of dividend stripping transaction is *Beacham v CIR* (2014) 26 NZTC 21-111. In *Beacham*, the shareholders in Beacham Holdings Ltd were a husband and wife (the Beachams). They had borrowed approximately $1.1M from the company over a period of years. The borrowing was problematic in that if interest was not charged on it, it would give rise to a taxable dividend to the shareholders. Beacham Holdings had retained earnings of approximately $1.8M. The shareholders sold Beacham Holdings to Beacham Group Ltd, which they also wholly owned, in exchange for a debt obligation of $1.84M. The debt obligation was partly satisfied by various journal entries that operated to set off the shareholders' obligations to repay the amounts borrowed from Beacham Holdings against the obligations owed to them by Beacham Group for the purchase of the Beacham Holdings shares. The remainder of the purchase price was left as a debt outstanding to the Beachams.

The shareholders treated the transaction for tax purposes as a sale of the shares in Beacham Holdings to Beacham Group. However, the court held that it was a dividend stripping transaction, and the shareholders were taxable on the sale proceeds as if they were a dividend. The court did not distinguish between the amounts used to pay the shareholders' overdrawn current account and the amounts left owing to the shareholders.

Inland Revenue has been considering some practices and in some cases investigating sales of shares to related companies. It has come to the view that sometimes the transactions are likely subject to the anti-avoidance rules. This requires consideration of the objective purposes of the arrangements and the test of parliamentary contemplation, as set out in the leading court case in this area.

Current view on dividend stripping in restructuring transactions

The Commissioner's view is that where a person or persons sell shares in a company (the target) to another company (the acquirer) in which the person or persons also has (or have) a significant ownership interest, section BG 1 or section GB 1 can apply in a wider range of circumstances than those in the *Beacham* case. For example, a sale can be subject to section BG 1 where the target has no retained earnings at the time of sale, and where the purchase price is simply left owing to the vendors.

A tax avoidance arrangement may also arise where a holding company structure is used to facilitate the exit of a shareholder, or the merger of two companies.

The Commissioner would also have tax avoidance concerns where an arrangement inappropriately creates available subscribed capital (ASC) for a company in situations where a shareholder in reality has not provided anything for the issue of shares by the company.

Examples

The following examples highlight the Commissioner's concerns. They are not intended to be a comprehensive guide to when sales of shares, either to related or unrelated parties, give rise to a dividend stripping concern.

Example 1: sale of company with no retained earnings, no real ownership change

Target Ltd was 100% owned by a discretionary family trust. It owned and operated a successful medium sized business. Most of the directors were also beneficiaries of the family trust. Target distributed most of its retained earnings as fully imputed dividends each year.

Over a four year period, these dividends averaged $500,000 per annum. Although fully imputed, some of these dividends were subject to additional tax, as the income of the trustee, top marginal rate beneficiaries, or minor beneficiaries subject to the minor beneficiary rule. Others gave rise to tax refunds or reductions, as they were beneficiary income of lower marginal rate beneficiaries.

The family trust sold Target to HoldCo Ltd, for $3.5M, which was $3M above the net equity. The price was supported by a valuation from a registered valuer. The family trust lent HoldCo $3.5M in exchange for a debt obligation. Before the sale, HoldCo was a shell company owned 100% by the family trust. The gain arose from the fact that Target's business was well established, and was generating significant annual profits. There was also a small element of asset appreciation.

After the sale, Target's business continued as before. However, rather than distributing its earnings as dividends over the next three years, it loaned an equivalent amount to HoldCo. HoldCo used the money to repay the debt owed to the family trust. The loan repayments were either retained by the trust or used to make distributions to beneficiaries. They were not returned as taxable income.

The Commissioner asked the trustees of the family trust and their advisors why the shares in Target had been sold. They responded that, consideration was being given to the possibility of going into a new line of business, and that for this purpose it was desirable to have a holding company structure. The new business was going to be operated by a new company, which would be owned by the holding company. No new business had in fact eventuated.

Commissioner's view on Example 1

Looked at objectively, the transaction resulted in no material change in the family trust's commercial position. The family trust continued to own the same business as before, albeit now indirectly through its ownership of HoldCo. The sale proceeds (the $3.5m debt owed to the family trust) are a transfer of value to the family trust for which the trust has not really given up anything from the restructure and the sale of its shares in Target. The loan also means that future loan repayments are not dividends.

It seems unlikely to the Commissioner that Parliament would have contemplated that outcome within the rules in the legislation and therefore the transaction is probably a tax avoidance arrangement. It may also likely be subject to section GB 1 so that the proceeds received by the family trust (the $3.5M debt it is owed) from the sale are treated as being a dividend. This is despite the fact that Target had no retained earnings at the time of the sale, and that there is no immediate transfer of cash to Target at the time of the sale to HoldCo.

The Commissioner's view would be the same if HoldCo were an established company with its own business.

IN CONFIDENCE

Example 2: sale to holding company: target company assets used to fund shareholder exit

OpCo Ltd was a successful trading company owned 50:50 by two discretionary family trusts, Trust A and Trust B. OpCo had two executive directors, Mr A and Mr B, both of whom worked in and were the founders of the company, and each of whom was the settlor of one of the trusts. OpCo had grown significantly, funded mostly by fully taxed retained earnings, totalling $8M at the time of the transaction. OpCo had very little available ASC, having been funded mostly by shareholder loans which had been repaid. OpCo had only occasionally paid dividends.

Mr B wished to exit the business, and Mr A was keen for his trust (Trust A) to acquire Trust B's shares. The parties agreed on a valuation of $10m for the business.

The sale was structured as follows. All transactions occurred on the same day.

- Trust A set up a new holding company (HoldCo Ltd), with nominal share capital;
- HoldCo acquired all of Trust B's OpCo shares for $5M, issuing an IOU in exchange;
- HoldCo acquired all of Trust A's OpCo shares on the same basis;
- HoldCo borrowed $5M from OpCo's existing bank, secured over OpCo's assets. The provision of security by OpCo was properly dealt with in terms of Companies Act 1993 compliance.
- HoldCo paid the $5M to Trust B in satisfaction of the IOU.

The result of the transaction was that:

- Trust B received $5M cash and gave up its OpCo shares;
- The OpCo /HoldCo group (which was economically identical to OpCo, since HoldCo's only asset was its shares in OpCo) had provided that $5M cash, by HoldCo borrowing from the bank and then providing it to Trust B as the purchase price for Trust B's shares in OpCo.
- Trust A had 100% of a group worth 50% of what it was previously worth, and was owed $5M by the group.

Commissioner's view on Example 2

The Commissioner considers it probable that the transaction is a tax avoidance arrangement. The results seem again to be beyond what Parliament would have contemplated arising.

Firstly, as a result of the transaction, Trust A is owed $5M and now holds its original OpCo shares indirectly, while the OpCo/HoldCo group is able to make payments to Trust A of up to $5M free of tax (by way of debt repayment).

It is also relevant that Trust A has acquired economic ownership of $5m worth of OpCo shares from Trust B, without suffering any economic consequences as it effectively used OpCo's assets. The payment of the purchase price to Trust B has been funded by way of a borrowing by the OpCo/HoldCo group, for which that group is liable, rather than by a borrowing by Trust A, yet the transaction has not been taxed as a distribution;

The tax advantage of the transaction can be counteracted by treating Trust A as receiving a dividend at the time of the transaction.

Example 3: merger using a holding company

A Ltd and B Ltd were medium size trading companies. A Ltd was owned 100% by Mr A, and B Ltd was owned 25% by Mr A and 75% by Mr B. Both companies had very little ASC, having been funded mostly by previous shareholder loans (now repaid). Mr A and Mr B were relatives, and on good personal and business terms. They decided it would be a good idea to merge their companies, which were each valued at $5M, though their tangible assets were valued at only $2M each.

The merger was achieved by forming a new HoldCo owned 62.5% by Mr A and 37.5% by Mr B. Mr A and Mr B provided only nominal amounts for the HoldCo shares and so HoldCo had very little ASC. HoldCo acquired the shares in A Ltd and B Ltd, with $10M of finance provided by the vendors.

Before the merger, Mr A and Mr B would have been taxable on any amounts distributed to them by their companies, subject to the possibility of returning the relatively small amount of ASC by way of a share repurchase. Leaving aside sections BG 1 and GB 1, immediately after the merger, they would have been able to be paid $10M by HoldCo as a repayment of the purchase price debt.

Within a few months of the sale:

- $5M of the loans were converted into fully paid shares in HoldCo;
- HoldCo, A Ltd and B Ltd were amalgamated in a short form amalgamation, with HoldCo as the continuing company.

These steps were already contemplated at the time that the sale of the shares to HoldCo took place. Accordingly, the ASC of the HoldCo shares issued on conversion of the debt was not the $5M debt discharged by issue of those shares. It was limited by section CD 43(9) and section CD 43(10) to half the ASC of the A Ltd and B Ltd shares on issue before the sale of the A Ltd and B Ltd to HoldCo. Section CD 43(9) and section CD 43(10) limit the ASC of shares issued by a company (in this case HoldCo) where the company receives consideration for those shares, directly or indirectly, in the form of shares in another company (in this case A Ltd and B Ltd), and immediately after the issue, there are 1 or more persons (in this case Mr A and Mr B) whose common voting interests in the company and the other company total 10% or greater.

Commissioner's view on Example 3

Again applying the Parliamentary contemplation test, the Commissioner's view is that these transactions are likely to be a tax avoidance arrangement. Although there is a commercial purpose (the merger of the two businesses), given the facts and circumstances, that purpose has been achieved in a way that means the transaction has a more than merely incidental purpose of tax avoidance. Relevant facts and circumstances include in particular the fact that the ownership of HoldCo reflects the ownership of the two existing companies.

The transaction is likely to be a tax avoidance arrangement subject to section BG 1. The transactions give rise to a dividend of $5M. The Commissioner considers that sections CD 43(9) and CD 43(10) limit the ASC so that the $5M of loan converted to shares does not give rise to any ASC. Even if these sections don't apply to limit the ASC, section BG 1 if applied would affect the ASC created from the arrangement. This is because the effect of the arrangement is that the shareholders have not contributed anything in commercial reality in exchange for the shares issued to them upon conversion.

Current status

Inland Revenue has been considering arrangements of the type outlined above and has commenced investigations into a number of taxpayers who have entered into restructuring arrangements like those described.

Where Inland Revenue considers that sale proceeds, debt repayments or other value transferred are in substance a dividend, the Commissioner will assess the shareholder on the amount of the dividend. The Commissioner may also assess the company for resident or non-resident withholding tax, except where the dividend arises as a result of a reconstruction under section GB 1(3) (see sections RE 2(5)(j) and RF 3(2)).

Late payment penalties and use of money interest may be applied to taxpayers entering into the types of arrangement described in this Revenue Alert.

Shortfall penalties may also apply, although these may be reduced where a voluntary disclosure is made.

If you consider that our concerns may apply to your situation, we recommend you discuss the matter with your tax advisor or with us, and consider making a voluntary disclosure.

Guidelines for making a voluntary disclosure are contained in our booklet *Putting your tax returns right (IR280)* and *Standard Practice Statement 09/02 Voluntary disclosures (May 2009)*.

Legislative references:	Sections BG 1, CD 43, GA 1, GB 1, RE 2(5)(j) and RF 3(2)) of the ITA 2007;
Case Law	*Beacham v CIR* (2014) 26 NZTC 21-111
Statement on tax avoidance:	IS 13/01 - Tax Avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007
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