Disposals of Shares in Landowning Companies

By Professor John Ward, FCA and Dara Burke, ACA

Practitioners should pay careful attention to TCA 1997 Section 643 which John Ward and Dara Burke suggest represents a real trap for the unwary.

Background

TCA 1997 Section 643 charges certain gains which would not otherwise be liable to income tax and which have been obtained from either the disposal of land (including buildings) or from property deriving its value from land (PDVL) as income under Sch D Case IV. This will generally prove particularly expensive for an individual facing income tax, PRSI and levies at a potential combined top rate of 46.5%. However, where the land concerned qualifies as residential development land, a flat rate of 20% may apply if the taxpayer so elects (TCA 1997 Section 644A (2) (b)); in the writers' view, the 20% rate will potentially apply even where the taxpayer disposes of PDVL rather than the land itself. PDVL can include shares in a land-owning company and the aim of this article is to highlight some surprising scenarios where a disposal of shares in such a company could be attacked under Section 643. The section represents a real trap for the unwary since it would be highly unusual for such gains to be taxed as income on general principles (see e.g. *Guinness & Mahon Ltd v Browne* 3 ITR 373).

It should be stressed that Section 643 does not require the existence of any tax-avoidance motive nor does it provide any exemption for *bona fide* commercial transactions, as is frequently the case for similar provisions. However the then Minister for Finance, when introducing the original legislation, gave an undertaking that the Revenue Commissioners would where possible apply these provisions only where it would be 'just and reasonable' to do so, apparently in order that 'genuine commercial transactions' free of tax avoidance elements would not be jeopardised (hereafter the 'Ministerial Undertaking'). It is questionable whether in fact it falls within the Revenue Commissioners' powers of 'care and management' to abstain from implementing the full force of the law on grounds of equity as opposed to pragmatism (see *R v IRC ex parte Wilkinson* [2005] UKHL). While, naturally, taxpayers are unlikely to complain about the Revenue operating a self-denying ordinance in relation to Section 643, taxation by administrative discretion is self-evidently contrary to principle.

Section 643 is stated to apply to any person, whether resident in the State or not, if all or any part of the land is situated in the State. This wording carries a strong inference that transactions relating to land outside the State do not fall within the scope of the section, notwithstanding that they are carried out by, or are attributable to an Irish resident. Even if the wording should be said to be unclear, any doubt should presumably be resolved on the basis that the legislature has failed to impose a clear charge in respect of land outside the State (see *O' Sullivan v Revenue Commissioners* 5 ITR 570). Transactions in respect of shares in a company incorporated outside Ireland, but which derives its value from Irish land, undoubtedly fall potentially within the ambit of Section 643.

The definition of PDVL

It is crucial to appreciate the situations in which shares in a company may be treated as PDVL for the purposes of Section 643. 'PDVL' is to be regarded as including any shareholding in a company deriving its value, or the greater part of its value, directly or indirectly, from land, including any interest it may hold in a company, partnership or a trust which itself represents PDVL. For these purposes, the property held by any company, partnership or trust is to be attributed to its shareholders, partners or beneficiaries in whatever manner is considered just and reasonable (Section 643(14)). This formulation clearly leaves considerable latitude for uncertainty.

Pre-conditions for liability under s.643

There are three criteria which must be satisfied before Section 643 can bite. These may be summarised as follows:

- Either (1) land or PDVL has been acquired with the sole or main object of realising a gain from a

disposal of the land, or (2) land is held as trading stock or (3) land is developed by a company with the sole or main object of realising a gain from disposing of the land when developed.

- A gain of a capital nature must have been obtained from a disposal of the land; and
- The person realising the gain is either (1) the person who respectively acquired, held or developed the land under criterion A, or is connected to such a person; or (2) a party to, or concerned in, an arrangement or scheme which has been effected in respect of the land and which enables the gain to be realised directly or indirectly.

Section 643 (12) provides an exemption in most cases where there is a disposal of shares in a company holding land as trading stock (or a 90% holding company of such a company) so long as, broadly speaking, the land is sold under arm's length conditions. However, the exemption will not apply where the disposal forms part of any arrangement or scheme (for discussion of this aspect, see the UK case of *Chilcott v IRC* [1982] STC 1, bearing in mind however that the wording of the UK equivalent of Section 643(12) is not identical).

The term 'developed' bears the standard definition in TCA 1997 Section 639(1). A 'company' includes any body corporate; accordingly (in contrast to the corresponding UK provisions) development by an unincorporated entity falls outside the scope of criterion A. A 'capital' gain is one which is not taken into account for the purposes of computing income tax.

The 'sole or main object' tests within criteria (A) (1) and (A) (3) appear to require a subjective approach, i.e. it is necessary to determine the object or purpose behind the acquisition or development at the time it is undertaken. However, Section 643(13) expressly provides that the intentions, objects and powers of any company, partners or trustees set out in any document are not conclusive evidence of their objects). A 'connected person' is determined in accordance with the general rules of TCA 1997 Section 10 (see also the second practical illustration below).

It should be noted that under criterion C, any number of transactions may be regarded as constituting an 'arrangement or scheme' so long as a common purpose is discerned in them, or if there is other sufficient evidence of a common purpose (Section 643(6)). There is clearly no need for any formal contractual linkage to exist between such transactions. There is no requirement that the arrangement should be in any sense artificial or that the purpose in question should be one of tax avoidance (see the UK case of *Page v Lowther* [1983] STC 799, notwithstanding the presence of a specific reference to tax avoidance in the UK legislation which is not repeated in Section 643). However, as noted above, the Revenue Commissioners in practice may restrict the application of the section to perceived cases of avoidance in accordance with the terms of the Ministerial Undertaking.

Section 643(5) defines a 'disposal of the land' to include *inter alia* the 'effective disposal' of either 'the property in' or 'control over', the land in question. It would seem therefore that the transfer of a controlling interest in a company owning land will constitute an effective disposal of that land. There is however no definition as such of the phrase 'control over the land' and it does not seem possible to import the standard tax definition of control found in TCA 1997 Section 11 for these purposes, since the latter refers specifically to 'control' in relation to a company or partnership. In practice it may be that the Section 11 definition would be applied in the present context where a transfer of shares is concerned, but the matter is certainly open to debate. Section 643 (5) further provides that the effective disposal may be made by means of either one or more transactions or by any arrangement or scheme (as defined above) carried out in relation to the land or PDVL.

The section is so vague and convoluted that it is really only feasible to appreciate its ramifications by appreciating how it might apply to real-world situations and we have accordingly set out two practical illustrations involving property investment companies below.

Practical Scenarios

Sale of shares in property investment company with no development undertaken

Mr X acquired all the shares in Y Ltd, which owns Irish commercial properties acquired as investments. He acquired them with the main purpose of realising a gain and subsequently disposed of the shares at a substantial profit; neither the purchase nor sale formed part of any wider scheme or arrangement. It is necessary to consider whether all three preconditions of liability under the section have been satisfied. Criterion A above is met since PDVL (the shareholding) has been acquired with the object of effectively disposing of control over the company (and thus, control over the land which it owns), at a gain. Criterion B is satisfied since effective control over the land has been disposed of by the sale of the shares. In the writers' opinion, however, criterion C is not met, since Mr X, the person realising the gain, did not acquire the land nor is there anything in Section 643 to have deemed him to have done so. It is true that he is a person who is connected to Y Ltd, which did acquire the land; however, in our view, this is irrelevant since Y Ltd did not acquire the land with the requisite object of realising a gain on its disposal.

It must be conceded that the above analysis does not command universal acceptance. The Revenue Commissioners' Guidance Notes imply without any qualification that the sale of a property investment company by a controlling shareholder in these circumstances would fall within Section 643, as opposed to what they term 'a genuine investment'. Of course, in practice, it would prove difficult in the absence of unusual background facts to demonstrate that an investor had indeed acquired shares with the sole or main object of realising a gain as opposed to merely harbouring a hope that he might realise a gain in due course.

Sale of shares in property investment company: development undertaken

Ms A, Ms B, Mr C and Mr D (the 'Promoters'), four unrelated individuals who have expertise in the construction industry, come together to acquire all of the shares in E Ltd which already owns a site which it had acquired as an investment. E Ltd then constructs commercial property on the site which it will continue to hold as an investment. The Promoters each acquired 25% of the issued share capital of E Ltd and their intention from the outset was to realise a gain by selling all of their shares as part of a single transaction as soon as possible after the building work had been completed. The sale of the shares takes place shortly after completion; neither the purchase nor sale formed part of any wider schemes or arrangements.

In this case, all three preconditions of liability under Section 643 do appear to have been satisfied. Criterion A is met, since the land was developed with the object of a gain being realised by the Promoters through the disposal of effective control over the land when developed. Criterion B is satisfied since the capital gain arises on a disposal of control over the land by virtue of a transaction or arrangement. Criterion C also appears to be met since the gain is obtained by persons who are connected to the company. This is on the basis that TCA 1997 Section 10 provides that two or more persons acting together to acquire a holding in a company are to be treated as connected with each other in relation to that company. As a consequence, each promoter will have all the shares held by his fellow-promoters imputed to him, giving him deemed control over the company and thus rendering him connected with it.

It is arguable that if the intention of the Promoters had been to hold their shares for an indefinite period until market conditions were favourable, Criterion A would not have been met; this is because Criterion A refers to 'realising a gain from disposing of the land when developed' implying perhaps that the disposal must be intended to follow immediately or very shortly after completion of the development.

It is clear that if the Promoters only formed a definite intention to realise a gain after completion of the building work, then Section 643 could not apply. Furthermore, if the individual shareholders had each intended from the outset to sell their shares independently of each other, it is highly arguable that the object of disposing of control over the land would have been absent (as no individual holding would confer control in its own right), with the result that criterion A would not have been satisfied.

Conclusion

In a short article it is only possible to give a flavour of some of the technicalities and subtleties of Section 643. With the Revenue Commissioners taking an increasingly aggressive stance towards tax avoidance, it behoves practitioners to pay this dangerous and abstruse enactment the respect it deserves.

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