KPMG Tax Chat

Restructure At Your Own Peril

For those who have recently undertaken a corporate restructure, or are about to embark on one, a key consideration nowadays is whether the restructure could be viewed as a dividend stripping arrangement.

Dividend stripping, a form of tax avoidance, occurs when what should have been a taxable dividend is converted into a capital sum in the hands of a shareholder. This typically happens by way of a sale of shares to a related party and the ultimate economic ownership or control of the company remaining unchanged. There is commonly a lack of genuine commercial motivation for the restructure and the key aim of the restructure is to release funds free of tax to shareholders, usually by way of debt repayment or a return of capital.

In the past, the dividend stripping provisions were rarely enforced by Inland Revenue but this is changing with the release of Risk Alert 18/01. Inland Revenue believes there are an increasing number of dividend stripping arrangements in place and, as a result, have commenced investigations into taxpayers.

Risk Alert 18/01 was released earlier this year and sets out three scenarios where the Inland Revenue believe dividend stripping arrangements may exist. The common features of these examples are:

- The vendor's ownership interest in a company remains substantially the same both pre and post the transfer of the company shares;
- There is a lack of genuine commercial reasons for the transaction (and evidence available to support the commercial rationale); and
- Shareholder loans or share capital are introduced into the arrangement to allow funds to be extracted as the repayment of loan principal instead of the repayment of taxable dividends.

Practical Application

The writers agree in principle with the positions set out by Inland Revenue in Risk Alert 18/01. However, as always, there are often differences between the specific examples set out in an Inland Revenue Risk Alert and the many different commercial factors that contribute to the need for corporations to restructure. For example, Risk Alert 18/01 does not give any real consideration to the quantum of retained earnings a company may have and this has a significant impact on whether a company would choose to borrow funds to make a dividend payment. Further, the need to introduce new investors in the future is often a key commercial driver of restructures but it can be a challenge for taxpayers to demonstrate how important this is when opportunities fall through or taxpayers have not documented in detail the potential investment opportunities.

In the writers' view, there can be no dividend stripping arrangement where there are no shareholder loans and no increase in the available subscribed capital of the company. However, Inland Revenue are taking a very hard line on restructures and investigations can be very costly and time consuming for taxpayers. This is particularly challenging when the Operations and Policy divisions of the Inland Revenue may be taking different views on the same matter. Consequently, we strongly recommend tax advice is sought before undertaking any corporate restructures to ensure no risk of dividend stripping exits.

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