THE OFFSHORE ENVELOPE TRICK: A PROBLEM

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In his article *The Offshore Envelope Trick* at page 101 of Issue 2 of Volume 3 of this *Review*, Kevin Prosser set out an ingenious scheme whereby gains could be realised in reality within an offshore trust structure without realising a chargeable gain for the purposes of the Offshore Settlor Provisions or the Offshore Beneficiary Provisions. I quote:

> "It is well known that if a chargeable gain accrues, not to the trustees but to a non-resident company whose shares are owned by the trustees, that gain will be subject to capital gains tax if and only if s.13 of the [TCGA 1992] applies to attribute the company's gain to the trustees. It is also known that s.13(5)(a) provides that in certain circumstances the company's gain is *not* to be attributed to the trustees."

Kevin Prosser then considers the strategy, which is dependent upon the asset to be disposed of being owned by an offshore company which is itself owned by trustees. One of the limitations of the strategy is that this is the place from which it starts. If, for example, trustees own an asset directly, then it may or may not be possible to transfer the asset to a wholly owned offshore company without realising a chargeable gain at that stage. Kevin Prosser explains the strategy as follows:

> "Suppose that, instead of the company selling the asset in the open market, it sells the asset to a non-resident subsidiary company for a market value price left outstanding. The subsidiary then sells the asset in the market, and within two years is put into liquidation, and in the course of the liquidation the amount owing to the parent company is paid off. What is the analysis then?
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> "First of all, the transfer to the subsidiary will not crystallise the gain. Instead, the transfer is treated as being for a no-gain, no-loss consideration so that the subsidiary inherits the parent's gain. Thus, the gain is triggered when the asset is sold in the market by the subsidiary. If the subsidiary is liquidated within two years,

> and an amount at least equal to the gain is paid up to the parent as creditor in respect of the outstanding proceeds of sale, then once again s.13(5)(a) applies, this time to prevent the subsidiary's gain being attributed to the parent and on to the trustees. Moreover, the liquidation will not trigger any gain in respect of the shares in the subsidiary unless the price at which the subsidiary sells the asset exceeds the price payable to the parent to acquire it. If there is no excess then there will be no surplus on the liquidation, so that the gain on the asset is locked in the subsidiary and cannot be attributed up to the trustees."[1]

Admirably concise as this account is, we do need to examine the mechanics in rather greater detail in order to see whether it really does work.

First of all, of course, the onward sale of the subsidiary must not be so predestined that the Revenue could successfully invoke *Furniss v Dawson*. Otherwise, the whole transaction could be collapsed and treated as a sale of the asset by the company directly to the third party.

Secondly, where it is said that the transfer to the subsidiary will not crystallise the gain, that is not, strictly speaking, altogether correct. TCGA s.14 provides, in effect, that transfers within a "group" of non-resident companies are to have the same consequences as transfers within a "group" of UK resident companies, that is that transfers are deemed to be for such a consideration as to give rise to neither a gain nor a loss: see TCGA s.171. Strictly speaking, s.14 is applicable only for the purpose of s.13. However, in the present context section 13 is our only concern. For present purposes, therefore, Kevin Prosser's statement is not misleading.

The possible weakness in the strategy comes on the application of s.13(5)(a). This provides:

> "(5) This section shall not apply in relation to -
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> (a) any amount in respect of the chargeable gain which is distributed, whether by way of dividend or distribution of capital or on the dissolution of the company, to persons

[1] I found this sentence a little difficult to understand, as the essence of the scheme is that the gain in not locked in the subsidiary but it distributed from it. Possibly, "subsidiary" is a mistake for "company". Alternatively, Mr Prosser may mean simply that the gain cannot be attributed to any other person or persons.

> holding shares in the company, or creditors of the company, within 2 years from the time when the chargeable gain accrued to the company ..."

In order to come within the protection of s.13(5)(a), what is it which must be distributed within the two year period? It is "any amount in respect of the chargeable gain". Is it not at least arguable that what is being distributed to the parent company, *qua* creditor, is simply the purchase price of the asset? While that is no doubt the case, I cannot see that that it is necessarily fatal. S.13(5)(a) contemplates that part of a chargeable gain may be paid out to creditors. They could be creditors for all sorts of reasons. There is no reason why they should not be creditors in respect of the purchase price of the asset the sale of which gave rise to the chargeable gain.

There is, however, to my mind, a much more serious objection. Is what has been distributed to the parent company, *qua* creditor, the chargeable gain at all? It might be said, with some plausibility, that in reality the subsidiary has not realised a chargeable gain. The chargeable gain which it realises is a wholly fictitious gain and a wholly fictitious gain cannot be distributed, so that s.13(5)(a) can never operate to prevent s.13 applying to such a gain.

One might compare the case of a gift by a UK resident but non-UK domiciled individual of an asset situate outside the UK to a non-UK resident trust. The donor is deemed to receive a market value consideration and is liable to capital gains tax only to the extent to which such consideration is remitted to the UK. It appears to be universally accepted that as the gain is not a real gain, there is no question of it being remitted. Even if, for example, the trustees were in due course to appoint to him absolutely capital of the trust which historically represented the asset gifted, this would not be a remittance of the notional gain. So too, in this case, it could be argued that the same principle works against the taxpayer and in favour of the Revenue.