FLIP-FLOP OUT OF SECTION 13?

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The purpose of this article is to consider some of the options available to those who find themselves trapped in a s.13 guarantee company structure.

After the Finance Act 1991 changes to offshore trusts, there was much deliberation about what to do next for clients who had *not* set up trusts, but nevertheless anticipated a gain in the future. Those who acted on advice to set up offshore trusts, but had not yet made a disposal, could relax in the knowledge that they had escaped the clutches of FA 1991, as long as their trust remained untainted. Almost before the ink was dry, the race was on for the discovery of the successor to the "freezer trust", and very soon s.13 schemes were born. The simplest, and therefore most widely used, s.13 scheme was the Isle of Man guarantee company, which like freezer trusts was also capable of warehousing shares from a start-up with a view to sheltering the gain in the longer term. Guarantee companies soon became widespread and hence, perhaps inevitably, in the Finance Act 1996 were made redundant. In contrast to pre-FA 1991 trusts which continued as a tax shelter, such status is not afforded to pre-FA 1996 guarantee companies!

Consequential Changes

As a result of the new s.13, those who have placed shares in a guarantee company may have a gain attributed to them and may have lost valuable statutory reliefs in the process. Spare a thought for those who set up a guarantee company structure, were trapped (by s.174 FA 1996) before a sale and had just celebrated their 50th birthday! Having read s.174 their advisor must have felt decidedly uncomfortable when he got to s.176 and realised that if *nothing* had been done, retirement relief would have become available to his client. That relief is not available on a gain attributed from a guarantee company structure.

How is the gain attributed? Some guarantee companies were formed without any other structure around them. The simplicity of such an arrangement, being cheap

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and easy to arrange, made it attractive to some on a "what have you got to lose" basis. However, in most cases an extra step was taken of inserting an offshore trust above the guarantee company. This usually comprised a life interest trust in which the settlor retained an interest. The principal reason was to ensure that the company was not managed and controlled by a UK resident. The amended s.13 (at s.13(10) and s.13(14)) operates so that the Isle of Man trustees (if the trust is a participator, or would be so if taken together with the beneficiary) will be attributed any future capital gain realised by the guarantee company. Consequently, the beneficiary will have a gain attributed to him under s.86 TCGA 1992.

The way the capital gain is attributed raises other issues, for example re-investment relief: in order to qualify for that relief, s.164A(1)(a) requires a chargeable gain to accrue to an individual on a disposal *by him* of any asset. If nothing is done, it would appear that the person locked into the guarantee company structure will have a capital gain attributed to him without retirement relief or re-investment relief available.

There are three main alternatives to mitigate the potential s.13 capital gain which are considered in detail below.

Double Enhanced Stock Dividend

Some lower risk pre-sale planning options do not appear to be available whilst the shares are held by the guarantee company structure: for example an enhanced stock dividend, because s.249(4) ICTA 1988 only provides the income tax treatment where the scrip issue shares are distributed to an individual beneficially entitled to the share capital attracting the scrip issue.

One way of potentially effecting a stock dividend is to import the trust, and then convert the guarantee company into a share capital company.

The conversion would appear to crystallise a capital gain at the point when the membership is exchanged for share capital as no roll-over of the gain is possible. This is because the conversion would not fall within the reorganization provisions of s.126 TCGA 1992. There is an argument that it is not possible to dispose and reacquire the same asset to and from the same individual and have a disposal for CGT. However, if that were the case there would be no need for s.126 on the exchange of one type of share for another. It appears to be possible to convert an Isle of Man guarantee company by re-registering the company under s.16(1) CA 1931 (Isle of Man). The mechanism would probably involve the member giving up his guarantee in exchange for a new issue of shares (of a similar value). Consequently, the risk of the conversion amounting to a disposal for CGT seems high. Although if a disposal arises, the trustees acquire the shares in the converted guarantee company at market value.

If the gain is realised by the trustees at a time when the trust is UK resident, the gain is imputed to the beneficiary under s.77 TCGA 1992. If the shares are then appointed to the beneficiary, he will acquire the shares in the now converted guarantee company at market value and therefore the beneficiary has a high base cost. If the share value has not gone up since the conversion, the trustees would not have a capital gain. If the trustees do have a gain (under s.71 TCGA 1992), that gain may be held over under s.165 TCGA 1992.

The overall base cost can then be further enhanced through a stock dividend under s.249 ICTA 1988 (s.141 TCGA 1992). When the shares in the converted guarantee company are sold by the beneficiary, a capital loss may be crystallised which should be available for offset against the s.77 gain.

However, this amounts to no more than a hypothesis so far. Even if it works, the commercial risk is that the settlor/beneficiary would incur the s.77 gain even if a subsequent sale did not take place and would therefore need to be confident that the disposal will take place and be aware of the potential tax charge if it does not.

Offshore Flip-Flop

Readers of this *Review* may recall the article by Kevin Prosser QC 'Reducing the Revenue's Interest in a Settlement' a few years ago *(PTPR Volume 1, 1991/92, Issue 3)*, which first put forward the idea of using parallel trusts to avoid the charge to CGT under s.77 TCGA 1992. This idea has been successfully put into practice where loan finance can be obtained (a colleague came up with the name *flip-flop* despite the thought that anything with "flop" in the name is not the best way to describe tax planning!). An offshore variant of this planning may hold the key to the s.13 trap. In simple terms the steps might be as follows:

1. A new offshore trust (Trust 2) is set up for the benefit of the settlor;

2. The existing offshore trust above the guarantee company (Trust 1) borrows as much as it can from a bank (or possibly the potential purchaser) against its assets;

3. Trust 1 appoints the borrowed funds to Trust 2;

4. The settlor, his spouse and their children and spouses, are excluded from benefiting from Trust 1;

5. In a subsequent tax year the guarantee company of which Trust 1 has membership, sells the shares in the UK company it holds (which might be 49% of a Newco).

6. Trust 2 appoints cash back to the UK resident settlor.

The wider exclusion of beneficiaries at point 4 is necessary to avoid a settlor interest as widely defined in para 2 Schedule 5 TCGA 1992.

The new Trust 2 will be a settlor interested settlement, and hence the settlor/beneficiaries will be subject to s.86 and s.87 TCGA 1992. The trustees of Trust 1 under a deed of appointment transfer the cash borrowed from the bank (or the purchaser) to Trust 2. The transfer between settlements will be subject to s.90 TCGA 1992 so that the stock-piled capital gains in Trust 1 will be apportioned to Trust 2 to the extent of the appointment. However, at the time of the appointment, Trust 1 has not realised any capital gains, so no gains fall into Trust 2.

If fully successful, the offshore flip-flop has the significant benefit of avoiding tax on the capital gain rather than obtaining just a deferral. The guarantee company structure aimed at a CGT deferral (except in those cases where the settlor decided to go non-resident). To achieve more than just a deferral, Trust 1 and Trust 2 must not be a single settlement. In this respect, the definition of a non-resident settlement is wider than is the case for a UK resident settlement for CGT purposes due to s.97(7) TCGA 1992 which refers to s.660G ICTA 1988: "settlement" includes any disposition, trust, covenant, agreement or transfer of assets. It is therefore important that Trust 2 can demonstrate independence for example, it may have a different initial settlor as well as different trustees and trust terms. Even then, the risk remains that the Revenue will attack the arrangement as a single settlement. If the two trusts are considered as one settlement then there will be a charge to tax under s.87 TCGA 1992 when funds are taken out of Trust 2, therefore a deferral is still obtained even if the Revenue succeed on the single settlement point under s.97.

The capital gain attributed to Trust 1 from the guarantee company will be a gain attributable to the settlor under s.86 TCGA 1992 if the settlor retains an interest (para 2 Schedule 5 TCGA 1992) in the trust at any time in the tax year in which the underlying disposal is made (s.86(1)(d)). This gives rise to a major practical difficulty as company disposals seldom fall neatly around the end of a tax year. One way of delaying the chargeable CGT disposal without delaying completion of the deal is to roll over into shares or debentures. Even where shares or debentures are offered for bona fide commercial reasons there is a far greater risk that clearance under s.138 TCGA 1992 will be denied where an offshore flip-flop is planned. Section 138 clearance has been granted in the context of an onshore flip-flop where the clearance letter explained the various transactions involved.

However, whilst the Revenue may have tolerated an arrangement which could reduce tax to 24%, it seems much less likely they will grant clearance where the arrangement has the effect of avoiding tax altogether. Any clearance obtained where the application did *not* make clear the anticipated transactions between the trusts would not be worth the paper it is written on.

Obtaining loan finance secured on unquoted shares is also a major practical problem. Banks are seldom prepared to lend at all and, where they do, they lend (at best) just over 50% of share value. Even then banks seek cross-guarantees from Trust 2 (where the cash is) and/or the settlor. Any such guarantee would make the arrangement vulnerable: the settlor or Trust 2 is likely to have retained an interest in those circumstances under para 2 Schedule 5 TCGA 1992. One way to give the bank comfort might be to grant a put option over the shares to the purchaser.

As with all pre-sale tax planning, if there is practical certainty that the disposal will take place there is the prospect of an attack from the Revenue under anti-avoidance case law. An important defence is to demonstrate that both Trust 1 and Trust 2 have an independent life after the transaction, perhaps as part of the general family inheritance tax planning.

The practical problems surrounding the offshore flip-flop seem to mount up. Nevertheless, in the right circumstances and with enough forward planning it is capable of unlocking the guarantee company structure with a better end result than that structure could have achieved: for example, why not ask the purchaser to lend the money to Trust 1? - a very willing buyer may consider it.

Treaty Protected Company

This idea has generated much interest recently and whilst at first it appeared to involve fewer practical problems, on closer examination there are issues emerging which alter that view.

In broad outline the arrangement would involve interposing a new offshore resident company between Trust 1 and the guarantee company. The interposed company would be one which is resident in a country with which the UK has a double tax treaty containing an appropriate Article (prescribing that any capital gain realised by the new company should only be taxed in the state in which that new company resides). Belgium is one such state, as article 13(4) states "gains from the alienation of any property...shall be taxable only in the Contracting State of which the alienator is resident".

The guarantee company would incorporate a new offshore company (Belgco) as its subsidiary. The guarantee company would then transfer its shares in the target company to Belgco (which comprise a group of companies). In theory, the transfer is a no gain/loss disposal under s.171 TCGA 1992 (s.14 TCGA 1992).

The consideration will not be paid by Belgco upfront as it will not have the cash. Therefore, Belgco will issue a combination of debt and equity to the guarantee company in exchange for its shares in the target.

The amount of the consideration (value) would need to be decided, probably at a time when the deal is still being negotiated. If the value is too low and as a consequence Belgco realises a (trading) profit this may lead to an argument that it should be attributed to the settlor under s.739 ICTA 1988. If the value is too high it may call into question the commercial legitimacy of Belgco. Belgco must be able to demonstrate non-UK residence and that it has a real commercial purpose. To this end it should have independent Belgian resident directors who understand the business of the target, at least well enough to make a reasoned decision to invest in the target at the right price.

Before the sale of the target by Belgco, Trust 1 may need to be imported, i.e., the existing non-resident trustees retire and a new trustee resident in the UK appointed. Otherwise the Revenue could argue that the only capital gains sheltered by the double tax treaty are "real world" gains as opposed to a "deemed gain" accruing to the trustees under s.13(2) TCGA 1992. Some support for this reasoning can be found in the Special Commissioners decisions in *IRC v Willoughby* [1995] STC 143 and *Bricom* [1996] STC/SCD 771. However, importing the trust, whilst overcoming that potential problem, increases the risk of the Revenue arguing that the guarantee company and Belgco are UK resident.

In most cases the guarantee company will own at least 49% of the target (assuming the target is itself a Newco in a 49%/51% arrangement to facilitate s.165 TCGA relief on entry to the structure) and in many cases involving start-ups will be higher. Where more than 25% of the target shares are held by the guarantee company, and are being transferred to a single Belgco, there is a danger (if Belgco issues a debenture for the shares in the target) that s.135 TCGA will apply (s.135(1)(a)) to treat the transaction as a reorganisation. Also, the debenture from Belgco would be deemed to be a security (as defined in s.132 TCGA 1992) as a consequence of s.135 applying (s.251(6) TCGA 1992). In those circumstances, the guarantee company would acquire securities in Belgco at a low base cost which would give rise to a capital gain when the debt is repaid to the guarantee company. However, provided the debt owed by Belgco is a simple debt and not a debenture, this problem should not arise.

Another practical issue to address is how to unwind the structure. An interest-free loan from the guarantee company to the settlor is uncommercial and therefore might bring into question the residence status of the company. ICTA 1988 section 703 (section 704 D) may also apply to the loan. Therefore, preferably the loan should be interest bearing at a commercial rate for at least one year.

The treaty protected company, by its very nature, is subject in addition to the UK considerations outlined above, to tax considerations in its own jurisdiction (which have not been explored above).

These are just some of the practical problems encountered so far and I am sure more will emerge as more clients locked into s.13 guarantee company schemes are involved in a sale. In conclusion, neither the offshore flip-flop or the treaty protected company route have a comfortable risk rating. Although, on balance the flip-flop appears less vulnerable technically if the practical problems can be overcome. The double enhanced stock dividend results in tax payable at an effective rate of 25% which is less provocative and as a result, providing the client accepts the commercial risk, is in my opinion more likely to be used in practice.