PROVISION OF BOUNTY TO PRE-MARCH 1991 OFFSHORE TRUSTS

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Inland Revenue Claims Branch from time to time raise unusual arguments in connection with the provision of bounty to offshore trusts. In one recent case they were concerned to show a UK resident individual provided bounty to an offshore trust, so as to become a "settlor" in order to fix liability to CGT on distributions to UK resident beneficiaries. In the absence of a UK resident and domiciled settlor, anomalously, the rules of s.87 TCGA 1992 (previously s.80 FA 1981) do not apply, so that realised gains can effectively be remitted to UK resident beneficiaries without liability to CGT.

The Facts

1. In 1984 a genuine (not dummy) non-domiciled settlor created a small discretionary trust outside the United Kingdom for the benefit of the family of a named UK resident.

2. Subsequently one of the UK resident beneficiaries (X), who happened to be a non-controlling director of a UK quoted plc, became aware that his company might be the target of a predator. X was therefore technically in possession of insider knowledge as far as the UK Companies Acts were concerned.

3. On taking advice, X was informed that notwithstanding the provisions of the Companies Acts, he could, if he so chose, dispose of shares in the UK plc to trustees of family trusts (widely defined) without infringing insider dealing rules, and despite the fact that X was otherwise prevented by Stock Exchange Rules and the Companies Acts from dealing in his shares on the market.

4. To avoid X becoming a "settlor" of the trust, the disposal of shares in UK plc took place by way of sale at quoted market value. A special purpose investment company (Y Ltd), wholly owned by the trustees, borrowed at arm's length from a non-UK subsidiary of a major clearing bank in order to finance the share purchase. The purchased shares were charged to the bank as security for the loan. There were no back-to-back or guarantee arrangements.

5. After several months the take-over came to fruition and Y Ltd realised a substantial profit on the sale of the shares in the UK plc.

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Pre-Implementation Analysis

The offshore trust was established for reasons concerned principally with inheritance tax. It was hoped (and the hope was subsequently fulfilled) that the shares in the UK quoted company would increase significantly in value. By capturing the value increase within an excluded property settlement, IHT at the then effective rate (60%) would not become chargeable on the value increase. The relevant statutory provision is s.48(3) IHTA 1984 which provides that non-UK property owned by a trust established by an individual domiciled outside the United Kingdom will be "excluded property". The conditions were satisfied because the original settlor was not domiciled in the United Kingdom, and the only assets owned directly by the trustees were shares in Y Ltd, the special purpose non-resident investment company.

Secondary considerations were the (remote) possibility of saving income tax in respect of income arising on trust/Y Ltd investments and the capital gains tax savings, provided that the rigours of what is now s.87(1) TCGA 1992 were avoided. Section 87 applies to a non-resident trust in any year of assessment only "if the settlor or one of the settlors is at any time during that year, or was when he made his settlement, domiciled and either resident or ordinarily resident in the United Kingdom". The original settlor was not domiciled in the United Kingdom when the settlement was created, has never changed his domicile status, and has never been either resident or ordinarily resident in the United Kingdom. On the face of it, therefore, s.87 does not apply. One of the unusual effects of this is that there is no other charging mechanism to tax chargeable gains if gains realised by offshore trustees to whom s.87 does not apply are received in the United Kingdom.

Inland Revenue Arguments

When the Inland Revenue became aware of the non-resident settlement, they raised a number of arguments designed to establish that the arrangements were not effective to avoid any UK taxes. The arguments followed fairly well-established and expected lines. As an entirely factual matter, it was not too difficult to demonstrate that the named settlor was not domiciled in the United Kingdom.

The next level of attack was s.739 Taxes Act 1988 (transfer of assets abroad - prevention of avoidance of income tax). Realistically the only possible way of wriggling out of the operation of this section was by reference to s.741 - that the avoidance of liability to taxation was not one of the main purposes of the arrangements; or that all the transactions were bona fide commercial transactions not designed to avoid taxation.

The Revenue arguments here were, of course, difficult to refute even by reference to s.740 rather than s.739. It was decided as long ago as 1943 (*Sassoon v CIR* 25 TC 154) that even if the avoidance of income tax was only incidental to some other motive (such as the avoidance of estate duty) reliance could not be placed on the first exclusion given by s.741 - i.e., that the avoidance of taxation was not one of the purposes of the transaction. Similarly, it is now trite law that the transfer of assets by a non-resident (in this case the non-domiciled settlor) can bring liability under s.740, even if (arguably) not under s.739 (*Philippi v CIR* 47 TC 75). Indeed X himself had clearly transferred assets to a non-resident entity (Y Ltd), albeit at an arm's length commercial price.

Trying to persuade the Inland Revenue to accept that the transfer of shares was undertaken for bona fide commercial purposes (to produce cash from the sale which

could be used to repay X's overdraft) was a fairly uphill (and probably impossible) task. If a clearing bank's subsidiary was prepared to lend against the security of shares held by Y Ltd, it is not an unreasonable assumption that any pressure exerted by a local bank manager in respect of an overdraft could perhaps have been otherwise overcome. Arguments about s.739 liability were a useful negotiating tool only as far as the taxpayer was concerned. Avoidance of income tax would have been a pleasant, but unexpected bonus.

The main Inland Revenue argument focused on whether, for the purposes of s.87 TCGA 1992 (and doubtless also for IHT purposes in due course) any "bounty" has been provided to the off-shore trustees by X. If X did indeed provide "bounty", he could be treated as a settlor within s.681(4) Taxes Act 1988 as required by section 97(7) TCGA 1992 (formerly s.83(7) FA 1981). The "bounty" allegedly provided was the increase in share value *after the acquisition of shares* which it was hoped would follow if X's "insider knowledge" came to fruition - as it fortunately did. The Inland Revenue, of course, have 20/20 hindsight vision.

As a simple matter of factual logic it is difficult to see how any bounty could have been provided. As a matter of share valuation law it is clear that special knowledge or information in the mind of a willing seller of shares cannot attach to the shares themselves.

Analysis

As to whether or not the contingent likelihood of the shares increasing in value could properly be treated as "bounty" provided by X, there is a whole string of decided cases culminating in *CIR v Plummer* 54 TC 1. There the House of Lords considered in detail whether the sale of an annuity at a market value contained an element of bounty. Apart from *Plummer*, perhaps the best known case regarding the provision of bounty is *CIR v Leiner* 41 TC 589 where the Court indicated that an individual had to be "worse off" immediately after a disposal of assets in order to demonstrate that bounty had been provided. On the facts in the instant case, X was, if anything, better off immediately after the transaction than he had been previously - had he been able to sell such a large tranche of shares on the open market, in all probability he would have had to suffer a discount in price achieved because of the number of shares transferred. As it was, the price received by X for the sale of shares to Y Ltd did not take into account any discount which would certainly have been suffered if a large shareholding had been offered in the market place for disposal by a quoted company director. Nor, even, did the transaction take place at the CGT "quarter up" figure (s.272(3) TCGA 1992) - the price adopted was the highest price for dealings for the day as reported on the Stock Exchange.

For capital gains tax purposes, any transaction which takes place between "connected persons" must be treated as taking place at market value (s.17(1)(a) TCGA 1992). "Market value" must, by definition, exclude any element of bounty and so prohibits any further price adjustment by reference to "notional bounty". Even if X were connected with the trustees (and s.286 TCGA 1992 does not make X a "connected person") it is difficult to see how any "bounty" could be imputed in his sale of shares to the trustees.

Conclusion

While to a certain extent it is possible to sympathise with the Inland Revenue attitude

- namely, that such a simple and straightforward transaction should not, in a perfect world, have such efficient tax saving results - it is perhaps typical of current times that this case has been pursued by the Inland Revenue with more regard to sentiment than to legislation and case law. Continued pursuit of unmeritorius arguments and demands and requests for information and documentation in the hope of wearing the taxpayer down, partly through worry and partly through the expense of continued professional fees, is now simply another fact of being a tax adviser in the 1990s. Opponents who fight hard but can concede gracefully attract more respect than those who stubbornly stick to their position with closed ears and minds.