THE OFFSHORE ENVELOPE TRICK

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The purpose of this Article is to explain how chargeable gains can be realised by offshore trustees without those gains being subject to capital gains tax under Schedule 5 to the Taxation of Chargeable Gains Act 1992 (the offshore settlor provisions) or, for that matter, under s.87 of the 1992 Act (the offshore beneficiary provisions).

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 1992 Act applies to attribute the company's gain to the trustees. It is also well known that s.13(5)(a) provides that in certain circumstances the company's gain is *not* to be attributed to the trustees. For example, if within two years after the gain accrues to the company, a dividend at least equal to the gain is declared and paid up to the trustees, there is no s.13 charge in respect of the gain. In effect, the capital gain of the company is turned into income in the hands of the trustees. Provided that the trustees can accumulate the dividend income, and provided also that the income tax settlement provisions (in Part XV of the Taxes Act 1988) and s.739 do not apply to that income, there need be no immediate charge to tax on that income. There will only be a charge if and when a benefit is received by a beneficiary (such as a child of the settlor), under s.740.

Suppose that the settlor is a beneficiary of the offshore settlement, so that a dividend up to the trustees will not avoid a tax charge. An alternative would be for the company to be put into liquidation within two years after the gain accrues, and again s.13(5)(a) will apply. However, the liquidation of the company may then trigger a gain on the shares in the company, which are deemed to be disposed of on receipt of a capital distribution from the company. Thus a s.13 gain is replaced by a gain accruing direct to the trustees.

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.