COMPANY SALES BY TRUSTEES AND RESTRICTIVE COVENANTS BY TARGET COMPANY DIRECTORS

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A Lesson for Corporate Lawyers When Buying From Offshore Trustees

This is a cautionary tale for non-UK trustees who hold shares in a company and who sell those shares where the purchaser requires restrictive covenants from directors or others who may or may not be vendors of shares.

The tale is told by reference to the sale of an English company where directors are asked to enter into restrictive covenants but the warning sounded may well affect any non-UK resident trustees who sell companies in any part of the world where UK domiciled and resident or ordinarily resident individuals enter into restrictive covenants or where a person who is not so domiciled and resident enters into restrictive covenants and then becomes so domiciled and resident. The position is examined from two particular standpoints, first, where the directors giving the restrictive covenants are or are capable of being beneficiaries under the trust and, second where the directors are not beneficiaries and there is no intention on the part of the trustees to give any benefit to them.

The word "beneficiary" for the purposes of this article includes persons who are or could become members of an Appointed Class or similar, i.e. it covers anyone who is intended to benefit at some time under the terms of the trust.

The Background

There are many trusts which were set up prior to 19th March 1991 by UK resident or ordinarily resident and domiciled settlors or by settlors who were non-resident and non-domiciled but who have come back to the UK and are resident or ordinarily resident and domiciled in the UK. Some of these trusts own companies resident in the

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UK that the trustees wish to sell for commercial reasons to reap capital gains. Where those trusts are resident abroad with foreign trustees they fall into the pre-FA 1991 regime for capital gains tax purposes (now in s.87 TCGA). This means that the capital gains tax liability will be deferred until such time as a capital payment representing the gain is made to a beneficiary who is resident and domiciled in the UK (or to a beneficiary who is resident but not domiciled in the UK and who remits the capital payment to the UK). The beneficiary will have trust gains apportioned out to him in a sum equal to the capital payment so that he will be liable to pay capital gains tax on the capital payment at the rate prevailing for the fiscal year in which the distribution is made plus a supplementary charge under s.91 TCGA.

The benefits to be achieved from this sort of structure are deferral of the payment of capital gains tax or the possible avoidance of capital gains tax if capital payments are made to beneficiaries who are resident and ordinarily resident outside the UK (wherever domiciled); or become so resident outside the UK in the fiscal year preceding the distribution and maintain that residential status for long enough to be accepted as non-UK resident by the UK Revenue; or resident or ordinarily resident in the UK but domiciled outside the UK and do not remit the capital payment to the UK. This enables gross growth on the capital inside the trust and a compounded income yield (subject to distributions or attributions of income).

Where such trusts have been created after 19th March 1991 the FA 1991 regime applies. The trusts will be "qualifying trusts" within s.86 and Schedule 5 TCGA. Consequently, the capital gains arising to the trustees will be apportioned out to the settlor and taxed on an arising basis.

Pre-19th March 1991 trusts can fall foul of the FA 1991 regime in a number of ways and, if they do, all future trust gains that arise will be apportioned out to the settlor or settlors. For the purposes of this article the two principal concerns are:

1. Any addition of property or income to the trust by anyone (Schedule 5 para 9(3) TCGA).

2. The addition of certain beneficiaries (e.g. members of the settlor's family) (Schedule 5 para 9(5) TCGA).

Set out at the end of this article is a brief note about the effect of the Budget of 17th March 1998 on such settlements.

When a company is sold a purchaser is concerned usually to protect the goodwill of the company and to stop persons from competing by insisting that the vendors and any retiring directors enter into restrictive covenants relating to non-competition and confidentiality. The directors may have service agreements which contain restrictive covenants which will be binding on them after the determination of those agreements; however, such covenants are not as enforceable as covenants given in connection with a sale of shares. In any event a purchaser is likely to require covenants in his own pet form, which may be stronger or more extensive than those in pre-existing service agreements. It is more than likely that the purchaser will want to obtain injunctive relief and not merely make do with a claim for damages. The objective has to be to find a way which protects the non-qualifying status of the trust and yet is commercially acceptable to the purchaser.

Schedule 5 para 9(3) TCGA provides that a settlement created before 19th March 1991 will become a qualifying settlement for the purposes of s.86 and Schedule 5 if on or after the 19th March 1991 property or income is provided directly or indirectly for the purposes of the settlement:

(a) otherwise than under a transaction entered into at arm's length, and

(b) otherwise than in pursuance of a liability incurred by any person prior to that date.

In the circumstances under consideration in this article the Revenue could argue that property has been added to the trust, thus tainting the trust for the purposes of the FA 1991 regime with disastrous tax consequences in that the UK resident settlor would be taxed on the gain arising.

On a recent case that the writer has dealt with, the non-UK resident trustees of a pre-FA 1991 trust made by a settlor who was domiciled and resident in the UK at the time that he made the settlement, sold the whole of the issued share capital of an English company. The trust gains arising were some £30m which could have resulted in a tax bill to the settlor of £12m (ignoring any indexation relief as the base value was virtually nil) if the settlement became a qualifying settlement within s.86 and Schedule 5 TCGA. Clearly if this liability was to arise it would have been a deal breaker. It is true that in the particular circumstance the settlor could have emigrated prior to the sale but, bearing in mind that s.86(1)(c) TCGA states that the section is applicable, *inter alia*, if a person who is a settlor is domiciled in the UK at some time during the fiscal year and is resident in the UK during any part of the fiscal year or ordinarily resident during the year and that the Revenue ESC D2 has no application to s.86 and Schedule 5 TCGA, it could have been dangerous to have sold the target company until after the 5th April following the settlor's departure from the UK. From a commercial stance such a delay was unacceptable and would have caused the deal to be lost.

In these circumstances the major concern was the preservation of the non-qualifying status of the trust. If the trust became tainted then it would bring the gains into charge.

The basic question is whether the commercial reality is that the sale will not proceed without the restrictive covenants. If this is so, then, *primia facie*, covenants are valuable and the value attributable to them belongs to the directors.

If the directors are not compensated in some way for the restrictions placed upon them it may be said that the directors have provided value to the trust. If this amounted to the provision of property within Schedule 5 TCGA then the trust will be tainted with expensive CGT consequences.

Schedule 5 TCGA stipulates that "property" must have been contributed directly or indirectly for the purpose of the trust. The immediate question is whether the giving of a restrictive covenant is "property" for the purpose of Schedule 5 TCGA. This is an uncertain area of law. The Revenue are on record as regarding even the gratuitous provision of services as the provision of property.

Clearly the Revenue's view is open to challenge but it is an extremely strong trustee that relies upon the ultimate interpretation of the House of Lords some time in the future.

The probable arguments on behalf of the Revenue are that:

(a) the directors provide property indirectly to the trust on the basis that, by not taking anything for the covenants, effectively they divert to the trustees, through the purchaser, a proportion of the consideration to which they would have been entitled had the transaction been on arm's length terms; and

(b) the purchaser provides property for the purposes of the settlement by not paying to the directors that part of the consideration to which they were entitled for entering into the covenants.

Neither of these arguments is sound and, in the writer's view, they should be defeated if the matter came to court. "Property" is not defined in the Act and must be given its ordinary meaning. Basically, property is tangible or physical unless the word is qualified by an adjective - e.g. incorporeal property hereditaments. Here the adjective demonstrates that the property concerned is intangible but, without the adjective, property with its natural meaning would be tangible or physical. The provision of services is not tangible and, in the writer's view, cannot be construed as property. The services may add value and cause other taxation problems but should not constitute the provision of "property" for the purposes of the FA 1991 regime.

If property is provided by the directors to the settlement, clearly it is provided otherwise than by a transaction entered into at arm's length.

If property is provided by the purchaser, normally, in the absence of any connection between the vendor and the purchaser, it would be part of a transaction at arm's length. On this basis it is difficult to accept that the purchaser has provided any property for the purposes of Schedule 5 TCGA.

Both the directors and the purchasers must be concerned to see that such a settlement does not become a qualifying settlement within s.86 and Schedule 5 TCGA. This is because if property is provided then a person who is a "settlor" in relation to the settlement, is domiciled and resident in the UK during any part of the fiscal year (or is so domiciled and ordinarily resident during the year) will be liable to have any trust gains arising apportioned out to him (s.86(1)(c) TCGA). "Settlor" for this purpose means any person from whom property originated Schedule 5 para 7 TCGA). As set out above, there are arguments which show that property could have originated from the directors or the purchaser. Normally "person" includes corporate entities as well as individuals but it is arguable that s.86 and Schedule 5 TCGA relate to human settlors only or that a company is not included, as a company does not pay capital gains tax as is referred to therein (it pays corporation tax at capital gains tax rates on capital gains). In these circumstances the directors or the purchaser (if an individual), as the case may be, could be liable for capital gains tax even though they have a right of recovery from the trustees.

In order to give certainty and avoid any tainting of the settlement there are two routes which seem to satisfy the requirements of protecting the non-qualifying status of the settlement and being acceptable commercially to the purchaser:

1. The purchaser and the directors agree between themselves the amount that should be paid for the restrictive covenant, and the purchase price is reduced pro tanto.

   Notwithstanding that these negotiations would appear to be at arm's length, it is possible that the Revenue would argue that the restrictive covenants would have a different value. In terms of immediate taxation yield it might be normal for the Revenue to argue that the restrictive covenants were worth more. In order to prevent such an argument resulting in the settlement becoming a qualifying settlement it would be necessary to insert in the agreement an adjustment provision so that each director would receive a sum equal to whatever is agreed finally with the Revenue as being the value of that particular director's restrictive covenants. Interest would need to be paid, at least on any increased value, in order to prevent an addition to the settlement.

   Not unnaturally, a purchaser might be unhappy to be involved in negotiations with the Revenue and to be under an obligation to pay more, and prudently the purchaser would need to have an indemnity from the trustees against any increased payment and any interest thereon. As the trustees would not be within the jurisdiction of the English Courts the purchaser may require a retention or other security to cover this contingent liability. This will be so notwithstanding the fact that a corporate purchaser should obtain a deduction of any payments for the restrictive covenants for corporation tax purposes, thus giving immediate relief against corporation tax as opposed to the total purchase price of the shares constituting the base value for future corporation tax on capital gains if the target company is sold in the future.

   In any event, the trustees and the directors would want to be involved in the negotiations with the Revenue.

If the purchaser did accept this route, the purchaser would be likely to require that any adjustment is directly between the trustees and the directors so that the purchaser did not need to have any involvement therein. A corporate purchaser should be able to obtain a deduction for the original amount paid but not for any increased amount paid by the trustees to any director. Logically, if there is any payment back by the directors because the agreed sum was overstated, this sum should be paid to the purchaser with a provision in the vending agreement requiring an increased payment of purchase consideration to the trustees. In this case the trustees run the risk of the purchaser becoming insolvent before the payment is made unless security can be given to the trustees (which is unlikely).

If the payment was made by the director to the trustees then there may be a danger that this payment alone could be an addition to the trust. If such an addition took place in the UK tax year in which the sale took place it is probable that the relevant director could be a settlor and have gains apportioned out to him pursuant to the FA 1991 regime. This must be so because the provisions of the TCGA trap any addition during any particular tax year and trust gains are calculated on a tax year basis.

2. The purchaser agrees to pay the full purchase price to the trustees in consideration of the transfer of shares and an undertaking to procure that the directors enter into restrictive covenants in the agreed form. In this way the purchaser would obtain no immediate deduction for the value of the restrictive covenants for corporation tax purposes, although the full purchase price would constitute the base value which would benefit from indexation as time elapsed and the benefit thereof could be realised on a subsequent sale of the target company.

   The trustees would need to enter into an agreement with the directors for the provision of the restrictive covenants and such agreement would need to have a provision for adjustment plus interest as outlined above.

   If this route is adopted the purchaser is not involved in or concerned with any adjustment or interest provision. The concept of the adjustment and interest provision should not be capable of creating an addition of property to the settlement for the purposes of s.86 and Schedule 5 TCGA as whatever value is agreed ultimately with the Revenue must be paid or refunded together with interest, so that no property is added to the trust.

   Notwithstanding this, it is important that the initial payment is a proper reflection of market value. As the trustees and settlor are likely to be connected for the purposes of the Taxes Act it is essential that the value of the restrictive covenants are assessed by an independent valuer as being the current market value of those covenants. The valuer will need to review the value of the restrictive covenant of each individual and not merely on a global basis, as the question is whether any person has added property. On the basis that "person" includes the plural it would be prudent for the valuer to consider the composite value of the restrictive covenants as well. The arm's length value of the transaction is to be determined in accordance with the principles set out in para 12 of the Inland Revenue Statement of Practice SP 5/92. Usually this will correspond to the value for capital gains tax purposes, but there are exceptions (see para 13 SP 5/92).

Of course, if the value of the restrictive covenants is equal to the bulk of the consideration no advantage will be obtained, as the payment for the restrictive covenants will be taxed as an emolument in the hands of the recipient at the highest marginal rates of the individual. The balance after taxation would fall into the individual's estate for inheritance tax purposes.

The taxation treatment of the payment is of interest to the purchaser, although often it is forgotten. Indeed, as the restrictive covenants are likely to be entered into immediately after completion of the sale of shares, it is possible that any tax liability of the target company in respect of such payment is outside the scope of the vendor's tax covenant for indemnity. The target company may have a liability to PAYE and NIC.

The payment to the directors for the restrictive covenants would be brought into charge in their respective hands under Schedule E as a result of s.313 Taxes Act. This section attacks any sum or other valuable consideration which is paid in respect of the giving of an undertaking the tenor or effect of which is to restrict the conduct or activities of the holder of an office who is assessable under Case I or II in respect of that office.

It seems clear that s.313 applies to any sum which is paid to the individual concerned or to any other person. Section 313(4) extends the meaning of "sum" for this purpose to any valuable consideration otherwise than in the form of money. The time for assessment is the time when the consideration is provided.

Peculiarly, s.313 does not specify that the payment itself is assessable under any Case of Schedule E. Consequently, the payment falls under para 5 of s.19(1) Taxes Act. Since the source is a UK office the fact that the director may be non-resident at the time of being paid for entering into the restrictive covenant will not affect the liability to tax under s.313.

As the payment to the directors will be subject to income tax, there cannot be any liability for capital gains tax on the payment. The trustees are in an odd position with regard to PAYE. Should they deduct tax from the payment for the restrictive covenant? Prima facie, the trustees are not actually the employer of the director but they may be regarded as the employer (*Booth v Mirror Group Newspapers Ltd* [1992] STC 615). Notwithstanding this, the trustees, being non-residents of the UK, should be outside the scope of PAYE (see *Clark v Oceanic Contractors Inc* 56 TC 183). Consequently, the trustees would appear to have no obligation to deduct tax. If, however, they do not deduct tax then s.203 Taxes Act will operate to deem the actual employer to have made the payment and so shift the PAYE obligation to the employer (i.e. the target company) because the trustees will be an "intermediary" of the employer. Section 203 B(4) provides that:

> "For the purpose of this section, a payment of, or on account of, assessable income of an employee is made by an intermediary of the employer if it is made:
>
> (a) ....
>
> (b) by trustees holding property for any persons who include or a class of persons which includes the employee."

This would appear to be so even though the employer does not make the payment and has nothing out of which to deduct PAYE. Indeed, if the employer did have to account for PAYE it is arguable that the payment could amount to financial assistance in connection with the sale of the shares and thus be prohibited by s.151 CA 1985 unless the "whitewash" procedure under s.155 can be used.

So far as the trustees are concerned they ought to be prepared to account for tax on the payment for the restrictive covenant or to reimburse the employer for any sum due from the employer to the Revenue in this connection. The reason for this is that it should avoid the risk of prejudicing the non-qualifying status of the settlement if for some reason the trustees are themselves liable to operate PAYE as the sum that they should have accounted for might be considered as an addition of property to the settlement.

In the particular transaction referred to above the trustees were advised to adopt this second route and to retain out of the payments for the restrictive covenants sufficient monies to cover the PAYE at the highest marginal rates of the directors. The Revenue were asked to raise assessments immediately so that the trustees could discharge the liability to tax. However, the Revenue were unable to raise any assessments for PAYE immediately as there is no mechanism under the Taxes Act which permits this under these particular circumstances during the year of assessment in which the payments were made. Assessments could only be raised after the 5th April following the date of the payments. As a result of this, no interest was capable of running on the tax liability until 30 days after the raising of the assessments. Consequently, the trustees had the use of the money until the due time for the payment of the assessment. Any income or capital growth of part of the fund during this intervening period should not constitute an addition of property or income to the trust for the purposes of Schedule 5 para 9(3) TCGA.

It is possible that NIC will be payable on the payments for the restrictive covenants. Section 3 of the Social Security Contributions and Benefits Act 1992 provides that "earnings" includes any remuneration or profit derived from the employment and "earner" is construed accordingly. Section 4(4) provides that:

> "For the purposes of section 3 above there shall be treated as remuneration derived

from an employed earner's employment any sum paid to or for the benefit of an employed earner which is chargeable to tax by virtue of section 313 [Taxes Act]..... otherwise than by virtue of subsection (4) of that section".

From this it can be seen that the payments for the restrictive covenants are, prima facie, subject to NIC. It is arguable that the effects of s.313(4) Taxes Act and s.4(4) of the Social Security Contributions and Benefits Act 1992 are to exclude non-cash consideration from the scope of NIC. Consequently, if the payment for the restrictive covenant was constituted by appropriate non-cash consideration no NIC should be payable.

Depending upon the circumstances of each case it may be possible that the directors have paid all the NIC that they should have done, in which case no further NIC is exigible.

If the directors are not capable of benefiting or will not benefit under the terms of the settlement and they are not connected with or related to any of the potential beneficiaries, it is arguable that the terms of any sale which include a payment to directors for the provision of restrictive covenants are on an arm's length basis and that, consequently, the settlement is not tainted. Schedule 5 para 9(3)(a) TCGA excludes from its tainting provisions any property which is added directly or indirectly for the purposes of the settlement which is effected under a transaction entered into at arms length.

There will be many cases where the trustees are unable to come to a certain conclusion that the transaction is fully at arm's length. If such a transaction would result in even the smallest addition of property to the settlement then that settlement is likely to be tainted. Consequently, trustees in non-UK jurisdictions should be wary about any sale of shares in a UK company (or in any other form of company in the circumstances postulated at the beginning of this article) which involves restrictive covenants on the part of the directors of the target company . Trustees should take good advice from professionals who are skilled in tax and trust law as they apply to offshore trusts as well as corporate law.

All trustees must remember that if there is any liability to UK tax and there are insufficient funds in the settlement to cover the liability, they may well have personal liability in respect thereof. It should be remembered also that any element of tainting, however small, will taint the whole trust for the rest of its existence. Trustees may be unaware that a taint has occurred - e.g. as a result of the settlor or a beneficiary who is a director of the target giving restrictive covenants without any compensation therefor. If this does occur then it is quite possible that sometime in the future realisation will dawn but this may be after distributions have been made or losses incurred, which means that the residual trust fund in the hands of the trustees may not be sufficient to cover the tax, interest and penalties.

Trustees may think that indemnities from beneficiaries or the settlor will suffice but these may be considered additions to the settlement themselves if they extend beyond the liabilities attributable directly to the funds appointed to those particular beneficiaries.

The lesson to be drawn from all of this for offshore trustees is that in order to protect the trust fund and to protect themselves from personal liability they should:

1. Keep a close watch on their investments.

2. Keep in touch with their beneficiaries.

3. Take legal and tax advice on a regular basis and in particular prior to any prospective sale of corporate entities.

4. Be involved in any negotiations for the sale of any corporate entities.

5. Not allow any heads of agreement or other arrangements to be entered into prior to taking legal and tax advice on the structure of any corporate sale and how the sale will affect the settlement and the beneficiaries.

6. Ensure that any obligations under the sale agreement on their part or for which they are liable are capable of being and are performed fully on or before completion. To the extent that this is not possible, trustees should ensure that any continuing liability falls within the limitations on liability (see 7 below). Please note that there may be continuing liabilities other than in connection with the commercial warranties and tax indemnity.

7. Ensure that any liabilities under any sale agreement (i.e. under the commercial warranties, the tax indemnity and the agreement itself) are such that at least they:

   (a) are limited in point of time (say two years for commercial warranties, six years and nine months after the end of the target company's financial year which is current at completion for tax indemnities and six years under the agreement itself).

   (b) are limited in amount (i.e. to the net value of the trust fund from time to time plus a *de minimis* level for small claims and an exempt amount).

   (c) are several liabilities and not joint and several. If the liabilities were to be joint as well as several then the trustees could have personal liability for the liabilities of others. Similarly, others could end up discharging the liabilities of the trustees and thus have provided property within the meaning of Schedule 5 para 9(3) TCGA.

   (d) do not prohibit distributions (capital or income) out of the trust.

(e) do not affect the type of investments that can be made.

(f) are proportionate to the trustees' interests in the proceeds of sale in respect of each and every claim (e.g. if the trustees own 20% of the target company then their liability should be limited to 20% of any claim).

8. Ensure that if they have to accept joint and several liability then there is a contribution agreement entered into between all the vendors ensuring, *inter alia*, that all vendors contribute on a proportionate basis to each and every claim.

9. Retain some control over proceedings against the target company or dealings with the Revenue which could lead to warranty or indemnity claims against the vendors.

10. Try to ensure that if security is required by a purchaser to cover the liabilities of the trustees under the sale agreement the trustees do not accept a retention by the purchasers. It is far better to take all the purchase price and then deposit monies by way of security

The list set out above is not exhaustive but should constitute sound guidelines when trustees are faced with the ownership or disposal of a corporate entity. This article has concentrated on the possibility of restrictive covenants causing a problem under s.86 and Schedule 5 TCGA but there are many other scenarios where property may be added unwittingly to trusts. Trustees should remain vigilant and take advice; where the trustees' personal positions are involved, that advice may need to be independent advice from the beneficiaries' normal advisers.

It should be noted that the Inland Revenue Budget 98 Press Release IR 39 dated 17th March 1998 states broadly that, inter alia:

1. With certain exceptions the charge created by the post-19th March 1991 qualifying trust regime is extended to those trusts set up before 19th March 1991 in respect of disposals made on or after 6th April 1999 or where appropriate after Budget Day.

2. The settlor charge under the qualifying trust regime is extended to a trust created on or after 17th March 1998 from which the grandchildren of the settlor or of the settlor's spouse or the spouses of grandchildren or companies they control can benefit. This charge will apply also to settlements created prior to the 17th March 1998 if they become tainted.

3. Where capital gains of an offshore trust are not within the charge on the settlor then beneficiaries of the trust who are domiciled and resident or ordinarily resident in the UK are, generally, taxable in respect of gains made when, and to the extent that, they receive a capital payment, or a benefit in some other form, from the trust.

These are far reaching changes and the provisions of the Finance Act will need to be studied in detail. Nevertheless, it is clear from the Press Releases and the Finance Bill that the problems envisaged above will remain for those settlements which are not within the settlor charge and settlements for grandchildren (and others) of the settlor which existed prior to 17th March 1998.

In addition it will be necessary to consider the changes made in the Budget of 17th March 1998 to PAYE and NIC, although it may be unlikely that the changes affect what is set out above.