THE PITFALLS OF GUARANTEE COMPANIES[1]

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In this article I examine "guarantee company structures". The rationale of such structures is shortly put; although these are many and varied, depending on, for example, whether the asset is or is not already valuable at the time that a particular tax planning exercise is undertaken and whether holdover relief under TCGA 1992, s.165, is to be claimed, the guarantee company is, in whichever structure it appears, a device to circumvent the application of TCGA 1992 s.13. In this article I intend to point out potential pitfalls. I intend to develop the points raised in this article and consider, in detail, solutions to those pitfalls in later articles.

TCGA 1992 SECTION 13(2):

TCGA 1992 s.13(2) reads: "... every person who at the time when the chargeable gain accrues to the [non-UK resident close company] is resident or ordinarily resident in the United Kingdom, and who holds shares in the company, shall be treated for the purposes of this Act as if a part of the chargeable gain accrued to him."

The basic application:

The variety of guarantee company structures is endless. To illustrate the potential problems of such structures, I shall consider, initially, the most basic structure. A non-UK resident guarantee company is established without share capital by the UK resident and domiciled owner of an asset ("the owner") in respect of which a gain will ultimately be realised. Let us assume that this asset comprises shares in

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a trading company ("Target") which is not yet valuable but which will become so in the future. I shall focus on Isle of Man guarantee companies which are in common use, although it may well be that it would be appropriate in certain circumstances to establish a guarantee company in another jurisdiction which permits incorporation of such companies, say Gibraltar. An Isle of Man company would be registered as an exempt company.

The owner sells the shares in Target to the guarantee company at market value, which, as I have said, I assume is currently low.

The guarantee company ultimately disposes of the Target shares at a substantial gain. The guarantee company, assuming that its non-UK resident status is beyond challenge, is outside the UK corporation tax on chargeable gains net. The gain would not be subject to tax in the Isle of Man. Finally, since there is no share capital held in the guarantee company, there are no "shares" for s.13(2) of TCGA 1992 to fasten upon and thus no gain can be attributed to the owner of the guarantee company under s.13.

Preserving non-UK Residence

This structure is undoubtedly marketed, without more, by several advisers. An immediate and apparent pitfall arises at this stage in respect of the non-UK residence of the guarantee company. The Inland Revenue would undoubtedly seek to argue that the central management and control of the guarantee company is in the hands of the owner who, we recall, is UK resident and thus within the UK. The problem is exacerbated if the guarantor is UK resident. The articles of the guarantee company should, therefore, be carefully tailored to ensure that meetings may not be held in the UK and that the guarantor/owner cannot be one of the directors of the guarantee company in the Isle of Man for all board meetings etc.

The interposition of an offshore trust between the guarantee company (with the original owner of Target as an income beneficiary) and the owner is an important safeguard against any residence argument made by the Inland Revenue. Non-resident trustees cannot be directed by the owner but must exercise their fiduciary duties independently. Only the trustees (and not the beneficiaries) should be directors of the guarantee company.

These observations must be qualified if one is dealing with an individual guarantor (if there is no offshore trust) or beneficiary (if an offshore trust is interposed) where the guarantor/beneficiary is, say, a strong-willed individual who is likely to try and influence the directors of the company and/or his trustees to implement a certain course of action. The counsel of perfection is, of course, to accept that the directors of the company and the trustees have fiduciary duties to members of the company and the beneficiaries of the trust and are unlikely to act in a way so as to frustrate tax planning on behalf of the guarantor beneficiaries. In the real world, however, this is of course not always the case. If advisers are faced with potential consistent interference by the guarantor/beneficiary, a damage limitation exercise may well be to make that guarantor/beneficiary one of the directors of the guarantee company and ensure that the articles require him to go to a non-UK location to take part in any decision making process. However, in the absence of the sort of guarantor/beneficiary of that type, it is worthwhile repeating that the guarantor/beneficiary should not be one of the directors of the guarantee company. It may well be of course that the input of the guarantor/beneficiary is required in terms of the business of Target. Say, for example, that the Target business was a computer business which required the input of the guarantor/beneficiary. This can easily be catered for by implementing a consultancy agreement which was strictly limited in its terms to technical input in running the business, as opposed to any questions of overall policy, particularly in relation to buying and selling the business.

The interposition of the offshore trust takes us to what is a common structure for the complete deferral of a gain in respect of an asset which is not yet valuable.

Assume an offshore trust (with the original owner of Target as an offshore beneficiary) holding all of the interests in an Isle of Man guarantee company, ("guarantee company 1") which guarantee company holds all the interests in a second Isle of Man guarantee company ("guarantee company 2"). The asset in question (once again let us assume that the asset comprises shares in a company - "Target") which is not yet valuable but which will become valuable is sold at market value to guarantee company 1. When Target is to be sold, guarantee company 1 transfers Target to guarantee company 2 for market value left outstanding on loan account. This disposal takes place on a no gain/no loss basis (see TCGA 1992 s.14). Guarantee company 2 sells Target and within two years is liquidated. TCGA 1992 s.13(5)(a) provides that in the circumstance the gain of guarantee company 2 will not be imputed to guarantee company 1. The loan from guarantee company 1 is repaid in the course of liquidation. There should be no gain in a liquidation for guarantee company 1 (which may be imputed under s.13) provided that guarantee company 2 does not sell Target at a significantly greater price that what it paid for it.

This structure provides a number of defences to a Revenue attack, namely the no share capital defence, the so-called "sub-subsidiary defence" and the liquidation defence by reference to s.13(5)(a); I shall not consider these last two defences in this article, since they are not peculiar to guarantee company structures.

Does "Share" mean "Share"?

Does the "no share capital defence" work? There are two ways that the Inland Revenue may attack the use of guarantee companies to circumvent the operation of s.13(2).

Firstly, they may argue that "shares" can be interpreted to include "interest in a guarantee company". This I think is unlikely to succeed. The UK tax legislation makes it clear when "shares" are to be given an extended meaning; see, for example, ICTA 1988 s.704E(3) where "share" is defined as including "stock and any other interest of a member in a company" (which would of course include the interest of a guarantor in a company limited by guarantee).

Secondly, it may be suggested that the words "and any other interest of a member in a company" should be read as impliedly appearing in s.13(2) after the word "shares" in that subsection. The argument for this proposition is likely to be based on the assertion that absurdity otherwise arises since Parliament could not have intended that section 13 be avoided by use of a simple device. There is recent authority for the proposition that words may be implied into a taxing statute where the intention of Parliament is clear to implement that perceived intention: *O'Rourke v Binks* [1992] STC 703, where the Court of Appeal held that the intention of Parliament was apparent on the face of the provision under scrutiny (CGTA 1979 s.72(4)) and the context of CGTA 1979 as a whole and thus s.72(4) of that Act was limited in its application to small distributions even though there was no express limitation contained within that provision.

However, the analysis adopted by the Court of Appeal in *O'Rourke v Binks* does not transpose easily to extending the application of s.13(2) to guarantee companies. The Court of Appeal in *O'Rourke v Binks* permitted itself to read in words as appearing by implication in CGTA 1979 s.72(4) by reference to two factors. Firstly, because s.72(4) was one of a group of subsections, the other members of which related to small distributions, "as a matter of first impression"[3] the Court of Appeal held that it was natural to read subsection (4) as one of a group of subsections *all of which dealt only with small distributions*. Secondly, the terms of s.72 revealed on their face that s.72(4) was enacted to remedy a particular anomaly[4] and, having regard to that particular anomaly and very specific perceived rationale of s.72(4), that rationale restricted, by implication, the application of that subsection to small distributions.[5]

Considering first the question of "impression", it is difficult to see how it can be sensibly argued that s.13 of TCGA 1992 can be said to encompass interests in companies other than those of members holding share capital. The terms of s.13(2) set out above refer specifically to shares and make no reference to any

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3 Vinelott J in the High Court [1991] STC 455 at 464, approved by Scott LJ at 707 and Lloyd LJ at 710.

4 I shall not discuss this anomaly in any detail: for detailed discussion of *O'Rourke v Binks* in the context of the construction of fiscal legislation, see my article in *1994 British Tax Review* 126.

5 Scott LJ at 706, Lloyd LJ at 710.

other type of interest in a company. So far as the perceived rationale of s.13 is concerned, once again the terms of s.13 make it quite clear that the draftsman is interested in, specifically, attributing gains to shareholders in share capital companies. After all, guarantee companies have been in existence a lot longer than capital gains tax. Thus, in my view, it will be an uphill struggle for the Inland Revenue to persuade a court to construe s.13 against the taxpayer who uses a guarantee company structure by extension of the terms of s.13 to interests in a guarantee company. However, one must remember that in the case of any matter which proceeds to litigation, the court will be faced with an entirely tax driven structure and the sympathies of the court are likely to be with the Inland Revenue; one cannot guarantee that the courts will not, in response to an argument that it is a patent absurdity that such a simple device as a guarantee company circumvents the application of s.13, apply the robust observation of MacKinnon J:

> "when the purpose of an enactment is clear, it is often legitimate, because it is necessary, to put a strained interpretation upon some words which have been inadvertently used ..."[6]

My short conclusion on this point is that the technical arguments are firmly with the taxpayer but it is possible that a court will adopt a broad brush approach and construe s.13 in such a way as to defeat a guarantee company structure.

Alternative structures

It is convenient at this stage to very briefly mention an alternative to a guarantee company structure.

Put shortly, guarantee companies used to circumvent s.13(2) may find (although it is unlikely) that s.13(2) is construed against them in the courts. In any event it would of course be extremely easy to legislate against at any stage. Alternative structures such as a "split share scheme", where an offshore share capital company is held by a combination of an offshore trust or trusts and the UK resident owner of the asset in respect of which the gain will ultimately be made, may be more attractive, at least on these considerations. Such schemes operate on the basis that the rights on liquidation of the original UK resident individual are minimal (say 1% of the assets available on a winding up) thus ensuring that the attribution of the ultimate gain under s.13 to that UK resident individual is also therefore minimal see s.13(3):

> "That part [of the chargeable gain apportioned under s.13(2)] shall be equal to the proportion of the assets of the company to which that person

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6 *Sutherland Publishing Company v Coxton Publishing Company* [1938] Ch 174 at 201.

would be entitled on a liquidation of the company at the time when the chargeable gain accrues to the company."

The use of call options ensures that the proceeds are ultimately held by the offshore trust of which the UK resident individual is a beneficiary. It is even more difficult to see how s.13 could possibly be construed, as it presently stands, to defeat this structure than in respect of guarantee structures and, furthermore, it is difficult to see how this structure could be easily legislated against without the use of complex and probably clumsy provisions permitting the artificial attribution of rights on liquidation. Certainly, legislation to counter such structures would be far more complicated than that needed to counter the use of guarantee companies. Furthermore, the amendments to the UK offshore funds legislation in the most recent budget make split share schemes easier to operate.

Indeed, it is worthwhile to make the point that such alternative structures are attractive but only for this reason, but also that they are less commonly used than guarantee companies and thus less subject to immediate attack.[7]

Extraction of proceeds by original owner

The offshore trust structure which I consider above assumes, on the basis that the UK resident owner is a beneficiary of that trust, that the owner accepts that he will be taxed on the income arising within that trust under ICTA 1988 s.739. The fact of the matter is that in sheltering the capital gain, the individual has 40% greater capital generating income than he would otherwise have had. Extraction of the capital proceeds is a difficult and complicated exercise, should one wish to repatriate these proceeds to the UK, rather than leaving the moneys in the offshore guarantee company. A straightforward dividend paid by the guarantee company is clearly Case V income. A liquidation of the guarantee company would give rise to a capital gain.[8]

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7 I intend to consider such split share schemes in more detail in a later article.

8 If the guarantee company is for some reason held via a UK resident company (whether the UK resident company is held by a UK resident individual direct or by an offshore trust) and the UK resident company wishes to extract the proceeds realised by the gain made by the offshore guarantee company, a simple device to bring the proceeds into the UK would be to import the offshore guarantee company by bringing central management and control of that company into the UK and then paying the proceeds to the UK company under a group income election. If undertaken within two years the gain realised by the non-UK resident guarantee company would not be attributed to the UK holding company: s.13(5)(a). If the non-UK resident status of the guarantee company is preserved there is, of course, no time limit to this device; one is not restricted to the two year period specified in s.13(5)(a).

Loan

It is often suggested that the guarantee company lends the proceeds from the sale generating the gain to the owner (if the guarantee company is held directly without the interposition of an offshore trust) or, if an offshore trust is interposed, that the guarantee company lends the proceeds to the offshore trust which on-lends those proceeds to the original owner of the asset who is a beneficiary of the trust. Such a loan is, unless very carefully structured, vulnerable to an attack under ICTA 1988 s.703. The plea that the guarantee company structure avoids CGT and thus is outside the scope of s.703 will fail. The proceeds realised on Target could have been extracted as Schedule D Case V income. Furthermore, *Bird v IRC* [1988] STC 312 makes it clear that s.703 and s.419 (the UK close company provisions dealing with loans to participators) are alternative provisions. The guarantee company is clearly a company within s.704D(ii) (i.e., any company under the control of not more than five persons or, alternatively, unquoted). Section 703 can equally clearly apply to non-UK bodies corporate since "company" includes any body corporate, which is not restricted to UK resident entities (see s.709(2)).

Section 704D

The provisions of this paragraph apply if "in connection with the distribution of profits of a company to which this paragraph applies, [a person receives consideration on which he does not pay or bear tax and which also falls within paragraph C(1)(b)(i)-(iii)]".

So for paragraph D to apply, to turn the capital gain into Schedule D Case VI income, one needs:

(1) a transaction in securities (ICTA 1988 s.703 (1)(b);

(2) a tax advantage (ICTA 1988 s.703(1)(i) proviso);

(3) a distribution of profits; and

(4) a person receiving non-taxable consideration (a) falling within paragraph C and (b) in connection with the distribution.

The sale of Target and the liquidation of guarantee company 2 are clearly transactions in securities; *IRC v Joiner* [1975] 3 All ER 1050.

The receipt of a non-taxable loan rather than Schedule D Case V income is clearly a tax advantage.

Given that "distribution" includes the transfer or realisation of profits (s.709(3)(b)), the sale of an asset by guarantee company 2 and the onward lending of the proceeds, either direct to a member or via a trust to a beneficiary, is clearly a transfer of profits and thus a distribution within the meaning of s.704D. It is true that the balance sheet position of a lender does not alter, since cash has simply been exchanged for a debtor asset. However, there need be no diminution of assets for there to be a distribution for section 703 purposes: *Cleary v IRC* 44 TC 399.

The consideration undoubtedly will represent the value of assets available for distribution by the guarantee company and thus falls within paragraph C(b)(i).

The consideration must be "in connection with" the distribution (the transfer or realisation). In a situation where the guarantee company sells an asset and shortly thereafter lends the proceeds, either direct to an individual member or via a trust, to a beneficiary is, to my mind, undoubtedly caught by s.704D. Thus careful structuring of any intended loan to the owner/beneficiary must be achieved to circumvent s.704D.

Section 86 TCGA 1992

The gains of a non-resident trust will be attributed to the settlor who is domiciled in the UK, and is either resident in the UK during part of the year or ordinarily resident during the year in which the gain arises (s.86(1),(2),(3)). The charge applies if the settlement is a "qualifying settlement". However, "settlement" is not defined for s.86 purposes and I am firmly of the view that there must be a formal Chancery settlement, i.e., a trust, established before s.86 can apply. A guarantee company is clearly not a trust. Thus s.86 should be of no application to the sort of structures we are dealing with.

Section 87 TCGA 1992

Section 87 is, however, a different matter. Firstly, unlike s.86, s.87 employs the ICTA 1988 s.681(4) definition of settlement which includes any "disposition trust covenant agreement or arrangement". Section 87 applies to attribute gains realised by the trustees of a settlement encompassed by it to the beneficiaries of that settlement. The gains are attributed to the beneficiaries in proportion to any capital payment received by them (see s.87(5)). A capital payment includes a loan (see s.97(1),(2)). Thus if the structure involving a guarantee company (whether held directly by a UK resident individual or by an offshore trust) constitutes one single "arrangement", a capital payment (such as a loan) would result in a part of the trust gains being attributed to the beneficiary to whom the loan is made.

The whole question of the effect of s.87 on guarantee company structures is something I shall deal with in a subsequent article.

Inheritance tax

Inheritance tax: business property relief

While it is rare, it can be that a guarantee company originally used to circumvent s.13 will eventually contain a trade and thus prima facie be eligible for Business Property Relief for IHT purposes. Business property relief is only available in respect of "shares" and "securities" in a company which is either a holding company permitted by s.105(4)(b) of IHTA 1984 or a trading company permitted by s.105(3). "Shares" and "securities" in this context do not include an interest in a guarantee company. However, this problem can be circumvented by interposing a share capital company between the offshore trust and the guarantee company. The guarantee company would be a "subsidiary" of the share capital parent in terms of CA 1985 s.738 and two companies would together form a "group" (see s.103(2)). Thus business property relief should be available in respect of any transfer of value of the shares in the share capital company.

One must of course remember that this technique is only effective to obtain Business Property Relief if the guarantee company **itself** would have qualified for relief by reason of having a trade which qualifies for relief. No relief would be available by use of this technique if the guarantee company was an investment company (IHTA 1984 s.105(3)).

Non-fiscal problems

(1) Articles of Association

The standard articles of association of an Isle of Man guarantee company purchased "off the shelf" will often contain a provision that interests in a guarantee company are non-transferable. This will give rise to severe problems if an individual owner holding a guarantee company dies. Problems will also arise if an offshore trust is interposed between a UK resident individual and an offshore guarantee company where an individual who is a sole trustee dies. If an offshore trust is interposed to hold the guarantee company, consideration should always be given to appointing a corporate trustee in addition to any individual trustees who are appointed. The problem is exacerbated since standard articles permit the directors of the company to appoint new members **at any time** without referring to the existing members. This provision should always be altered if it appears in the articles and advisers will be exposed to justifiable criticism if such alteration is not made.

It should be considered whether it is desirable to amend the articles to provide that interests should be transferable in any event.

(2) The Isle of Man Companies Act 1931 s.21(2) (the corresponding provision in the UK is contained in the Companies Act 1985 at s.15(2)) provides that if the undertaking of a guarantee company is, in the memorandum or articles, or by resolution, divided into shares or interests, that division shall be treated as the provision for a share capital, even though there is no nominal value or number of shares expressed in the division. Assuming that this deemed share capital will also constitute share capital for tax purposes and in particular section 13 purposes, this must be avoided. For example, the memorandum and articles should not provide for fixed interests to income or assets on a liquidation.