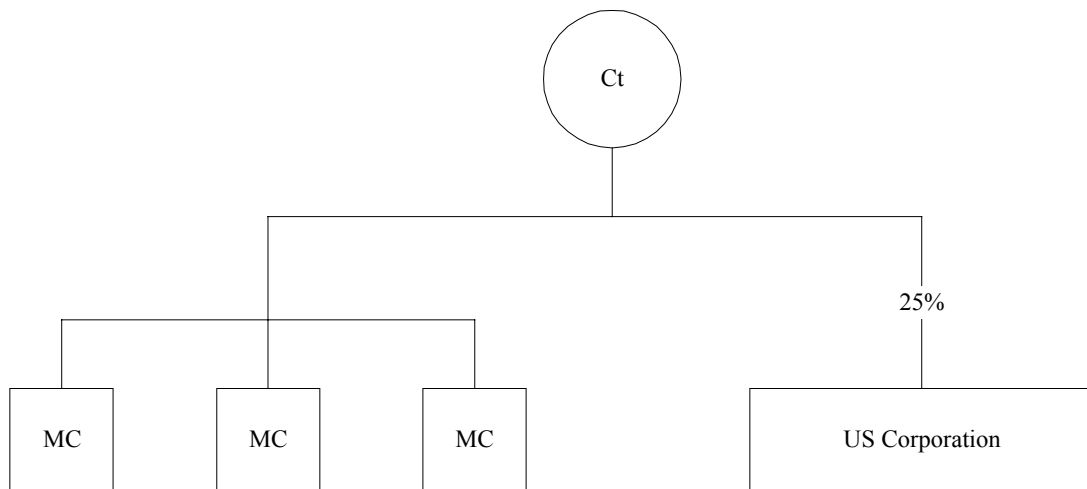


ALTERNATIVE OFFSHORE STRUCTURES

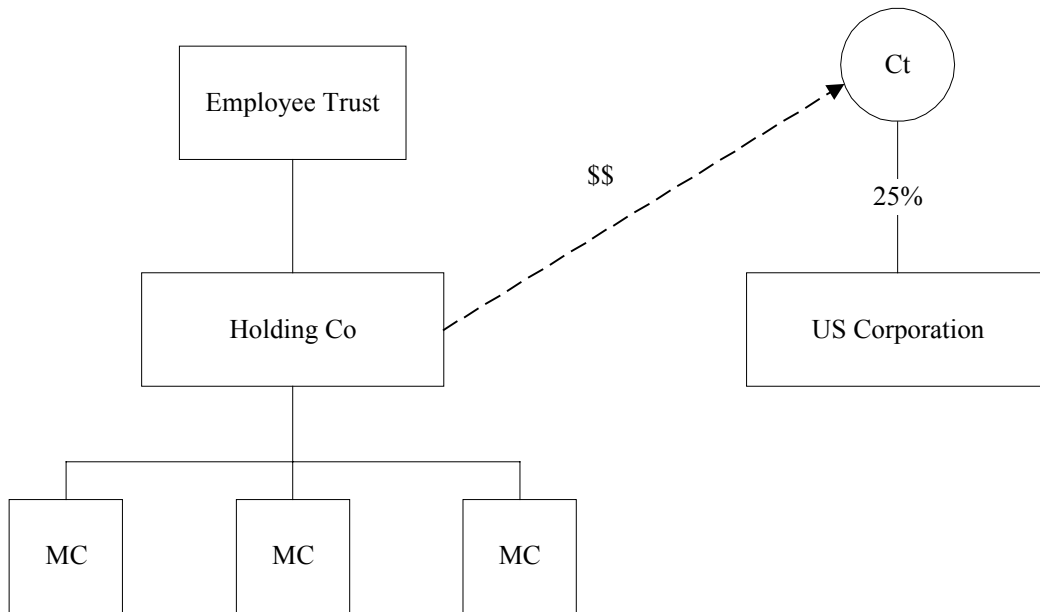
Milton Grundy

Many of us can remember a time – and it isn't all that long ago – when one could conduct a quite respectable offshore advisory practice by knowing about discretionary trusts and underlying companies. Maybe in some parts of the world one still can, but anti-avoidance legislation in many countries has made it increasingly difficult, and we have now reached the point in the United Kingdom that people with offshore trusts and underlying companies are being advised to forget about tax planning and bring the assets onshore. It is this development which has stimulated me – and has no doubt stimulated other advisers also – to think about *Alternative Structures*, and it is these thoughts I plan to articulate here. I hope they are going to be of more than parochial interest, and that structures which have started life as answers to problems faced by UK taxpayers will prove helpful to taxpayers elsewhere.

But I should like to start with an example which has nothing to do with the United Kingdom. All those who were present at our meeting in Amsterdam last May were, I am sure, as riveted as I was by the talk given by Stephen Gray. He was essentially talking about designing offshore structures for US taxpayers, and in his first example the taxpayer was a US corporation. The client was a non-resident alien who owned some Eastern European manufacturing companies and had a major stake in the US corporation.

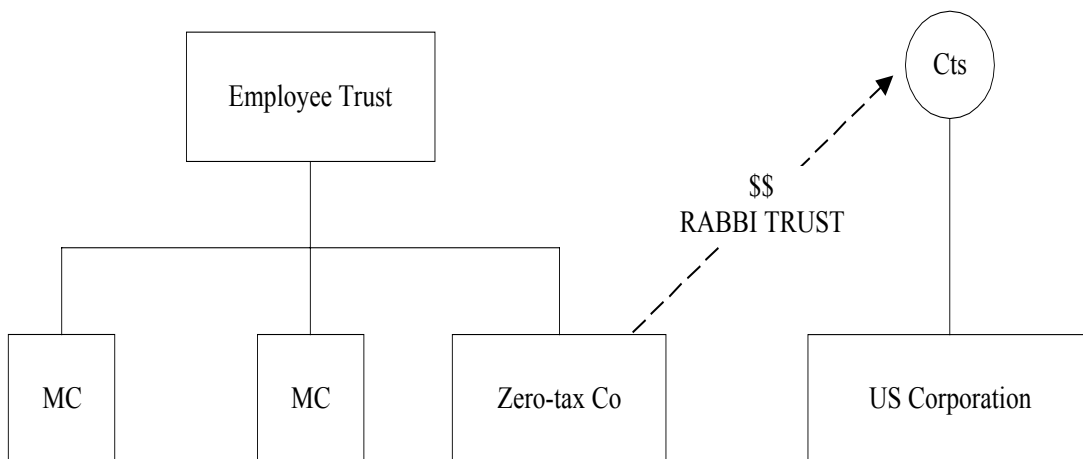


He wanted to make his profit in the manufacturing companies (shown in the diagram as “MC” and charge a high price to the US corporation, which bought and distributed the product. This would run into transfer pricing difficulties, as you may imagine. What he did was



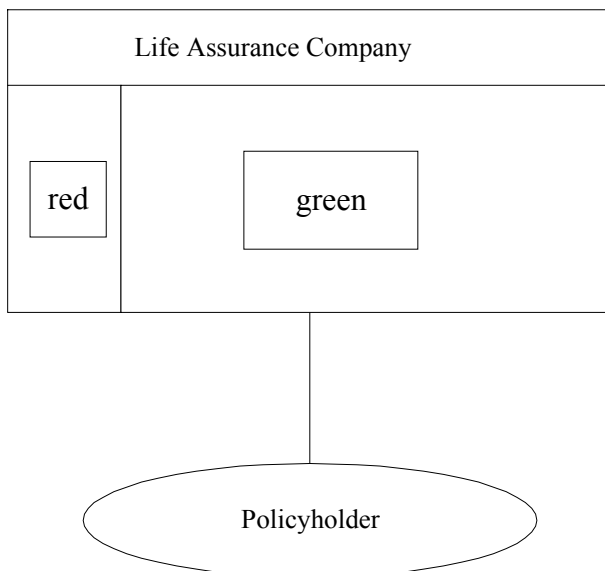
to put the manufacturing companies under an offshore holding company and put the holding company under an offshore trust for the benefit of the employees of the manufacturing companies. The holding company employed him at a salary which effectively mopped up the manufacturing profit, and the transfer pricing problem was eliminated. As Stephen put it himself, what was done was to substitute contract for ownership.

His next example was similar, but here the client was about to take up residence in the United States.



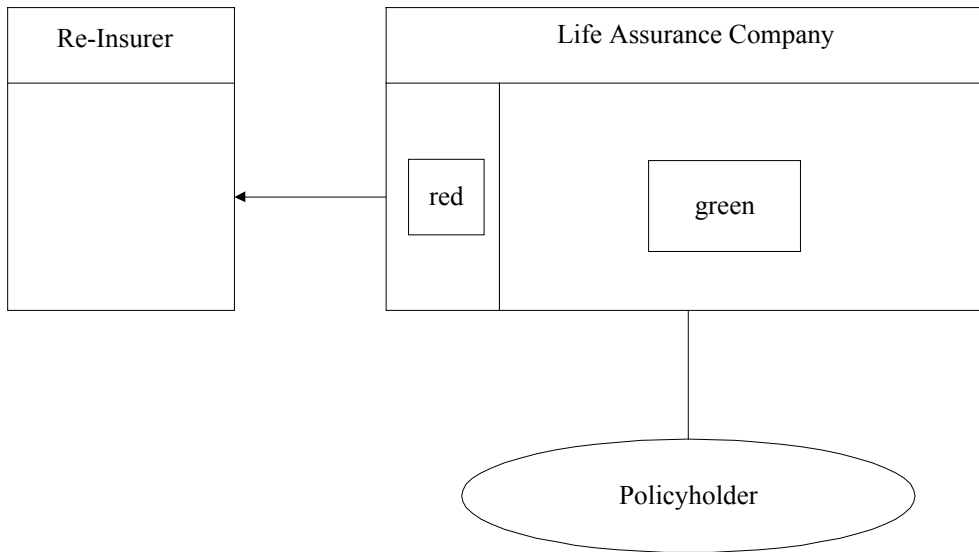
In this case the offshore employee trust created a company in a tax haven and that company entered into the employment agreement. The important feature of the employment agreement was that the compensation arising under it was deferred – the amount being put aside into a separate account under an arrangement which I think is called a “Rabbi trust” – though it has little to do with Rabbis and nothing to do with trusts. Once again, the essence of the transaction was that what the client enjoyed was a contract and not ownership.

Does this concept have wider implications? I think it does. Most high-tax jurisdictions nowadays have some form of anti-avoidance legislation directed against the use of offshore structures, and it is interesting that what this legislation generally focuses on is what the taxpayer *owns* – like the shares in a company, or an interest in a trust or foundation, and does not always pay the same attention to the benefit of a contract which the taxpayer enjoys. A common example of the benefit through contract rather than through ownership is, of course, the contract of life assurance. This comes in many forms, but I should like to focus here on the with profits endowment policy, with a single premium: I pay £x to an insurance company; the insurance company invests the money and rolls up the dividends; at the end of the term – ten or twenty years, or whatever it may be – I get the cash equivalent of the rolled up fund, less the insurance company’s charges; but if I die before then, my estate gets a certain sum. A policy document can have pages of provisions in an 8-point font, but the essence of the policy is very simple: I think of it as being like a suitcase with two compartments.

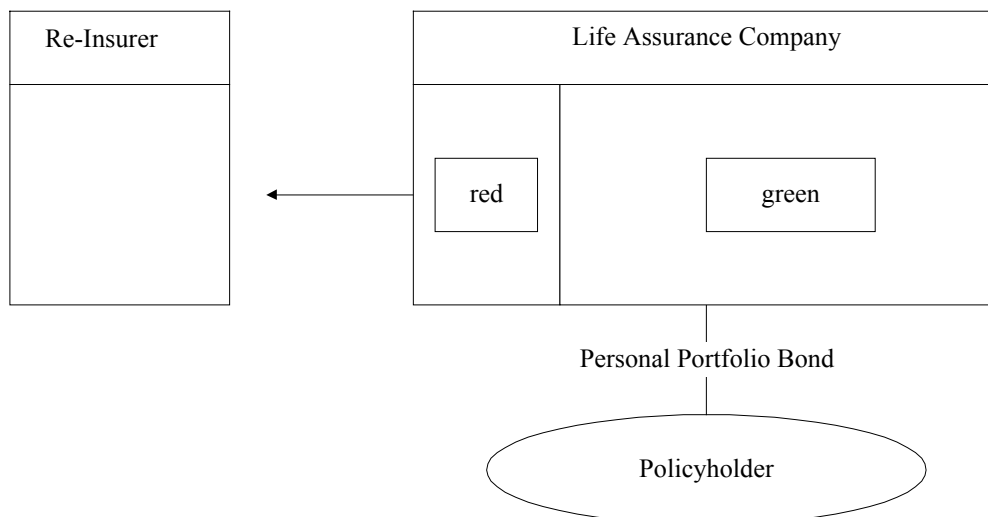


One compartment is the life cover – which I show as red in the diagram. And one compartment is the investments, which I show as green.

I think there are countries where a taxpayer can simply take out an endowment policy with a company in an offshore centre, and no tax consequences follow until the policy matures or is surrendered – and, sometimes, not even then. In such a case, the tax position is very straightforward: the insurance company devotes the red part of the premium to paying for the life cover, and it may reinsure the whole or part of that risk elsewhere, like this:

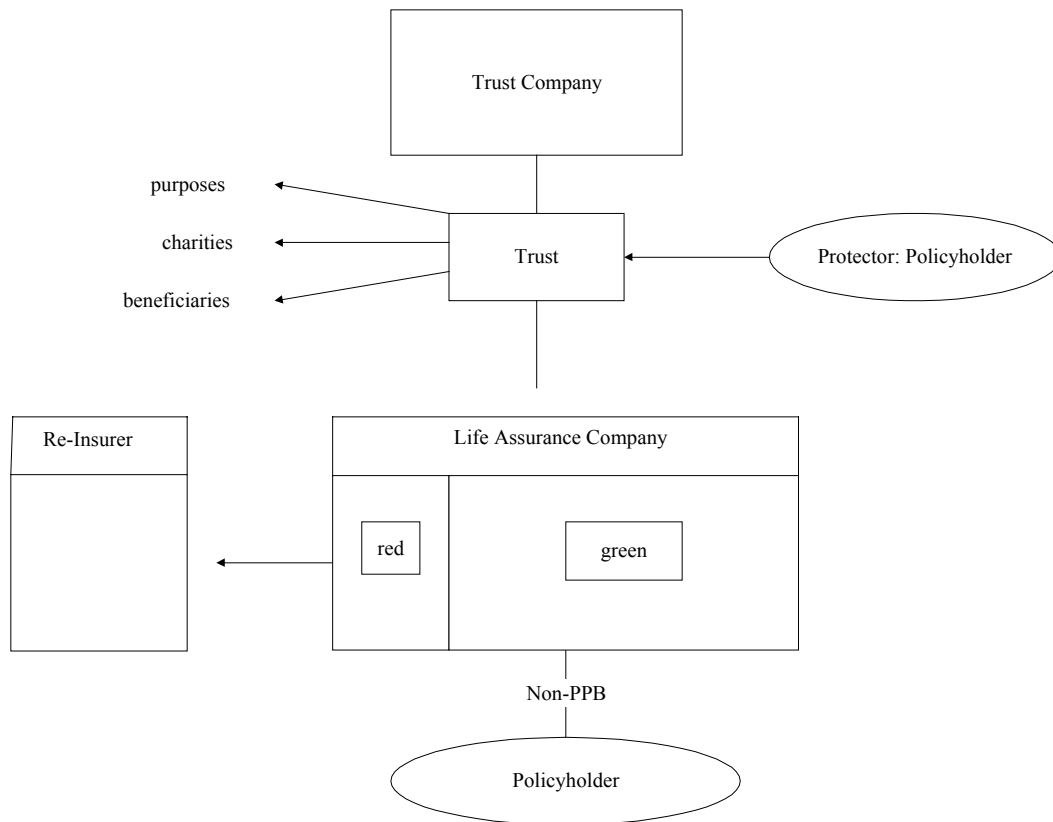


The green money is invested, and the income and gains from the portfolio are accumulated. Where this starts to get more difficult, from a wholly practical point of view, is where the policyholder would like to see the green money invested not in some well-balanced portfolio of listed stocks, but in some speculative enterprise – the legendary gold-mine in Peru, or an investment in a movie or a stake in that up and coming new company, *Never-never-land.com*. This is not something your regular life company will want to do. But what this diagram shows is that you don't need a regular life assurance company to issue the policy. Anyone has the capacity to issue a policy, so long as he can find a reinsurer for the life element. The policyholder does not need to have any control or ownership of the life assurance company: the terms of his policy can allow him to dictate to the company what investments the company will make to support his policy. This is what is called in the United Kingdom a personal portfolio bond. I used to be rather proud of having invented this expression in the early seventies, but in 1998 it was picked up by the Parliamentary draftsman and embodied in some quite unusually ferocious anti-avoidance provisions¹, which now effectively prevent such policies from being used by UK residents, so I am happy to disassociate myself from the authorship of the expression. But all the same I have put it into the diagram,



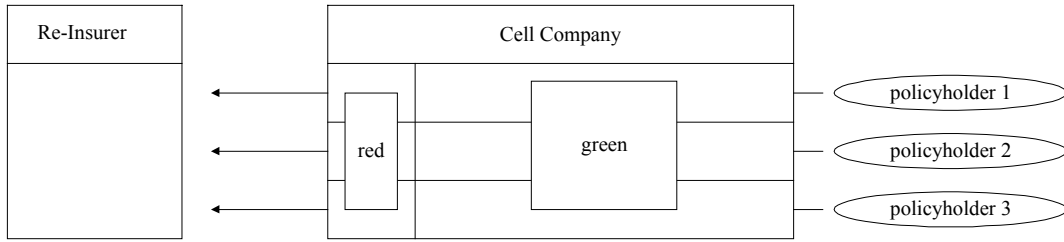
because it is a very useful way of describing a policy which allows the policyholder to have his own way about how the green money is invested.

Another way of achieving the same effect



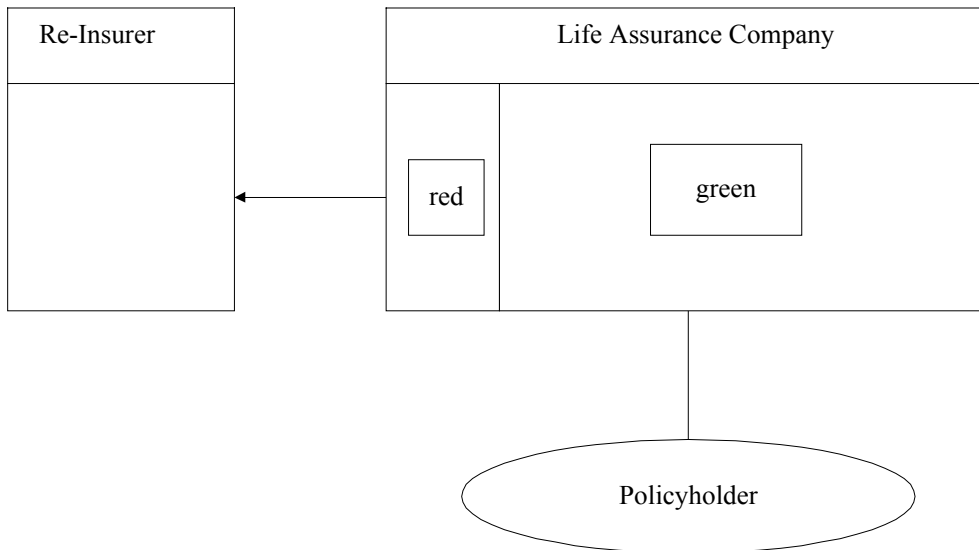
is for the policyholder to have a policy without any personal portfolio provisions, and for the company to be owned by a trust of which he is the protector. The diagram shows the trust company at the top, with the trust beneath it. The beneficiaries have nothing to do with the policyholder: they could be charities, or the trust could be a purpose trust. The object here is not to give the policyholder any shares in the profits of the life assurance company, which go to the trust by way of dividend, but only to enable him to change the trustees, if he is not satisfied about the way in which the trusts – and the company – are being run. The policyholder has got to be satisfied that the investments he is proposing for the company will make profits for the company as well as for himself, so that his exercise of his powers as protector cannot be impugned as being not for the benefit of the trust.

I am assuming in these illustrations that the life assurance company has only one customer. If the company only does one deal, it may not need a licence to carry on the business of life assurance, but – more importantly – one has to bear in mind that an important difference between having the benefit of the contract and being the beneficiary under a trust is that if the company you are contracting with can't pay its debts, your policy may be valueless, whereas if a trust company has creditors unrelated to the investment of your trust fund, they have no claim on the assets subject to your trust. So if we are going to introduce more than one policyholder, we are going to need the kind of firewall which is provided



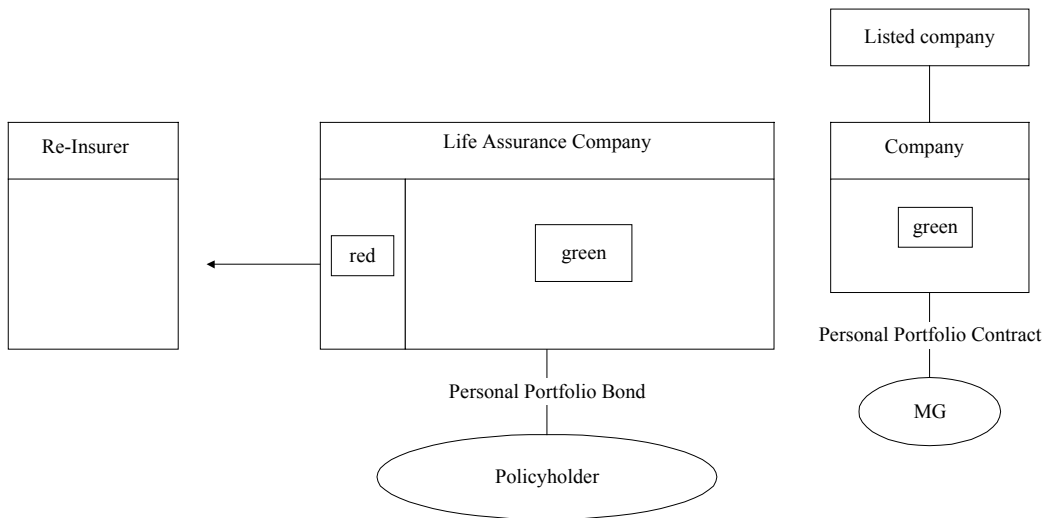
by the cell company. This is a familiar feature of insurance companies in the United States. It was adopted by Guernsey in 1997, and it now features in a number of offshore jurisdictions. The policyholders in this diagram would need to have personal portfolio bonds. There may be an alternative with trusts and protectors, but that would be much more complicated.

But let me go back to my earlier, and simpler, diagram.



One policyholder with one personal portfolio bond and the life element reinsured. Looking at this diagram, I ask myself, “Why do I need the reinsurance?” Does the policyholder really want any life insurance, or is that just a frill, which makes it easier for the insurance company to sell the policy? Thinking about this question, a little while ago, I came across a curious fact. There is a firm of London investment advisers who will manage my portfolio on a discretionary basis. The mechanism is that I give my money to an insurance company in the Isle of Man, which issues to me what is called a “Policy”. It is like an endowment policy with no life element – that is, it is simply a contract under which I become entitled upon demand to a sum calculated by reference to the performance of the green money – the portfolio and its accumulated dividends. Actually, I do not think the scheme is at all tax-driven: it assumes that I am perfectly content to have the investment managers make decisions about my investments, but I would prefer them not to have their hands on the money. The insurance company in the Isle of Man is a listed company, or under the control of a listed company, which means that it is “open” for UK tax purposes, and the upshot is that there is no machinery for attributing capital gains of the portfolio to me. I think I may have problems with the income arising from the portfolio, but I come back to that question a little later on.

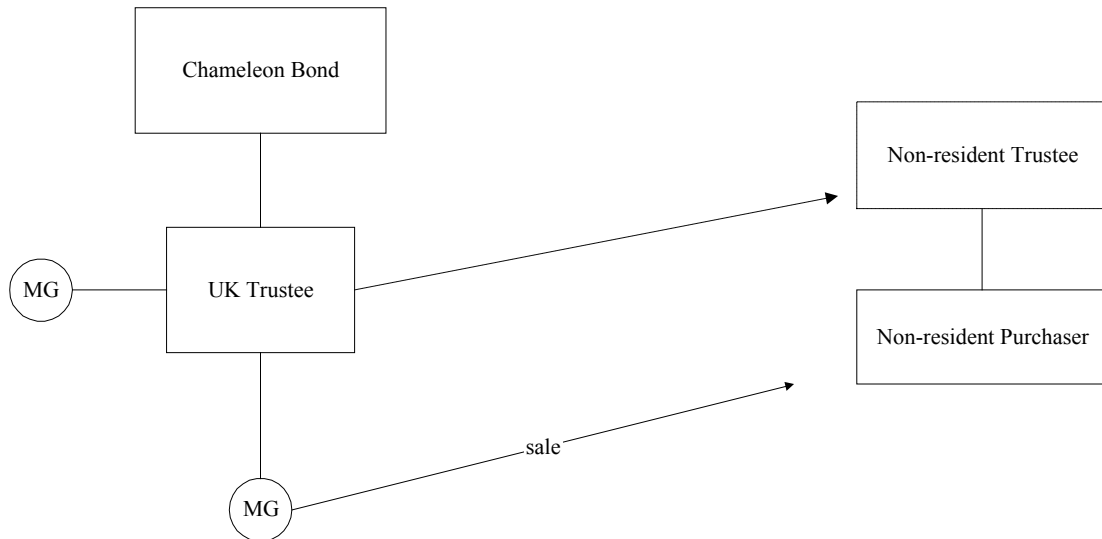
So here are my two options, side by side.



There on the left is the policyholder who has his bond and his life cover. And here am I on the right who has not a bond but a contract with no life element made with a company controlled by a listed company. There are many variations – some of which are simply cosmetic, like having the policyholder contract with a UK company which acts as a nominee for an undisclosed principal offshore, or perhaps acts as principal and reinsures the whole of the risk with an offshore company, so that the making of the investments is undertaken offshore.

Of the jurisdictions I know a little about, I think there may be some mileage for this in Australia, so long as the policy is held by an offshore discretionary trust: I believe they have machinery for attributing the income of offshore policies to Australian policyholders and the income of offshore trusts to Australian beneficiaries, but no machinery for attributing the income of offshore policies to offshore trustees, so as to attribute it onwards to the beneficiaries. The rules in the United States are set out in the excellent paper read by James Walker at our meeting in Charleston, South Carolina two years ago. It can be downloaded from the website.

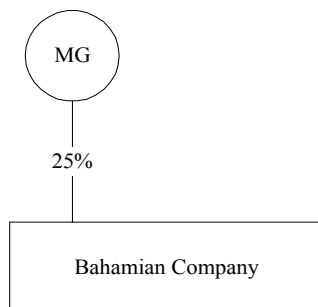
Before I leave this part of my topic, I should like to fantasise a little. Could I have a bond which sometimes has a life element and sometimes not, depending upon the wish of the policyholder? I have not tried to draft such a contract, but I see no reason why it should be impossible. I think a UK taxpayer would have a use for such a – what shall I call it? - *Chameleon Bond*. Suppose



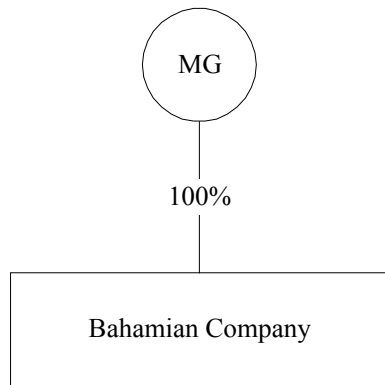
the Chameleon Bond were held on a UK trust mainly for my benefit – a so-called “thin” trust – a concept I shall return to later. I could sell my interest in the trust to a non-resident purchaser, and the new rules which require the trust assets to be re-valued at that point would not bite, because the Bond is a life policy². The non-resident purchaser can appoint a non-resident trustee in place of the UK trustee. He will then want to help himself to the trust fund and surrender the Bond. If the Bond is still a life policy at that point, the liability to tax would come back to haunt the settlor of the UK trust³, but it seems to me that that liability would not arise if by this time the Chameleon had changed colour and there was no longer any life element in the Bond. This is just a fantasy to ponder.

I should now like to say something about offshore capital gains. Once again, I am going to start with the United Kingdom, and hope that what I say has a wider application.

Let me take myself as an example. I am a UK resident (and ordinarily resident and domiciled in the UK), and if I own more than 5% of the shares in a non-resident company (which would be what our legislation calls a “close” company⁴ if it were resident in the United Kingdom), an appropriate percentage of its capital gains are attributed to me⁵.

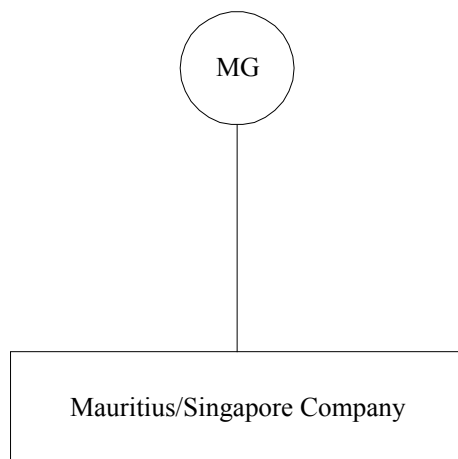


So suppose I own 25% of the shares in a Bahamian company which makes a gain of 100. I shall be treated as making a gain of 25. And if I have 100% of a Bahamian company

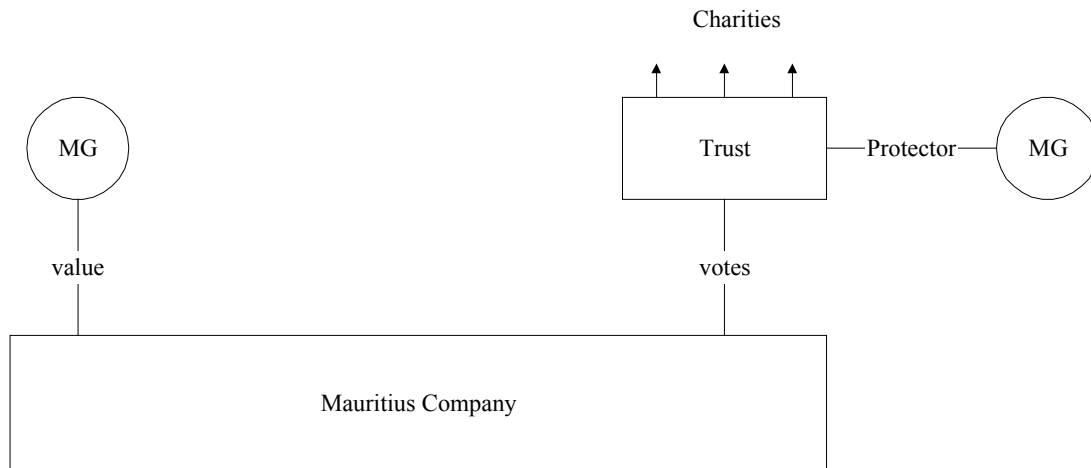


then the whole 100 will be attributed to me. But there is an exception to this rule. If, instead of a Bahamian company, we contemplate a company resident in a country which has an appropriate treaty with the United Kingdom – one which reserves to the foreign country the right to tax capital gains, then the rules for attributing part of the gain to me are not to be applied. So let's put the Bahamian company somewhere else. There is no point in going to a jurisdiction which has a capital gains tax of its own. I think the two favourite candidates are Mauritius and Singapore.

So here I am

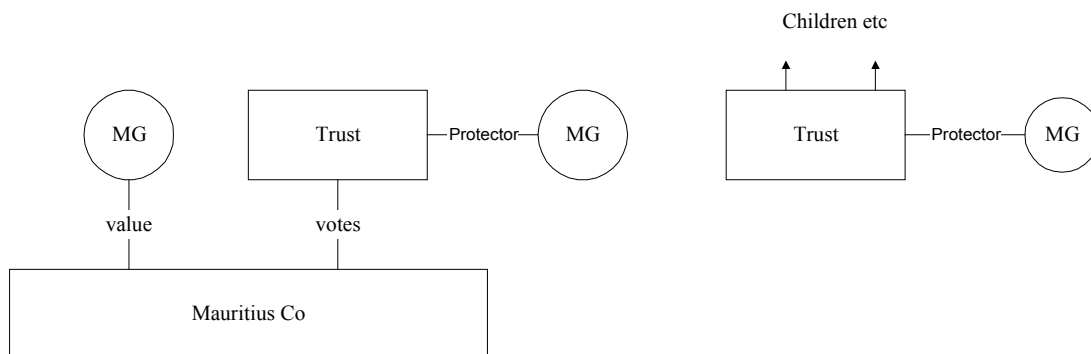


with my company in Mauritius or Singapore, which is going to make capital gains. When I refer to a company "in" Singapore or Mauritius, I of course mean one which is a resident of Singapore or a resident of Mauritius for the purpose of the respective treaty, and so what is to be avoided is any suggestion that its place of effective management is in the United Kingdom. We therefore need a local board of directors and fully minuted directors' meetings, in the usual way, but if the company is an investment company, rather than an active trading company, the door is open to the argument that it is not really the board of directors but the controlling shareholder who effectively controls the business, and I think the prudent course is to give the UK shareholder shares with a majority of the value but a minority of the votes, and to give a local company, as trustee, shares with a minority of the value but a majority of the votes.

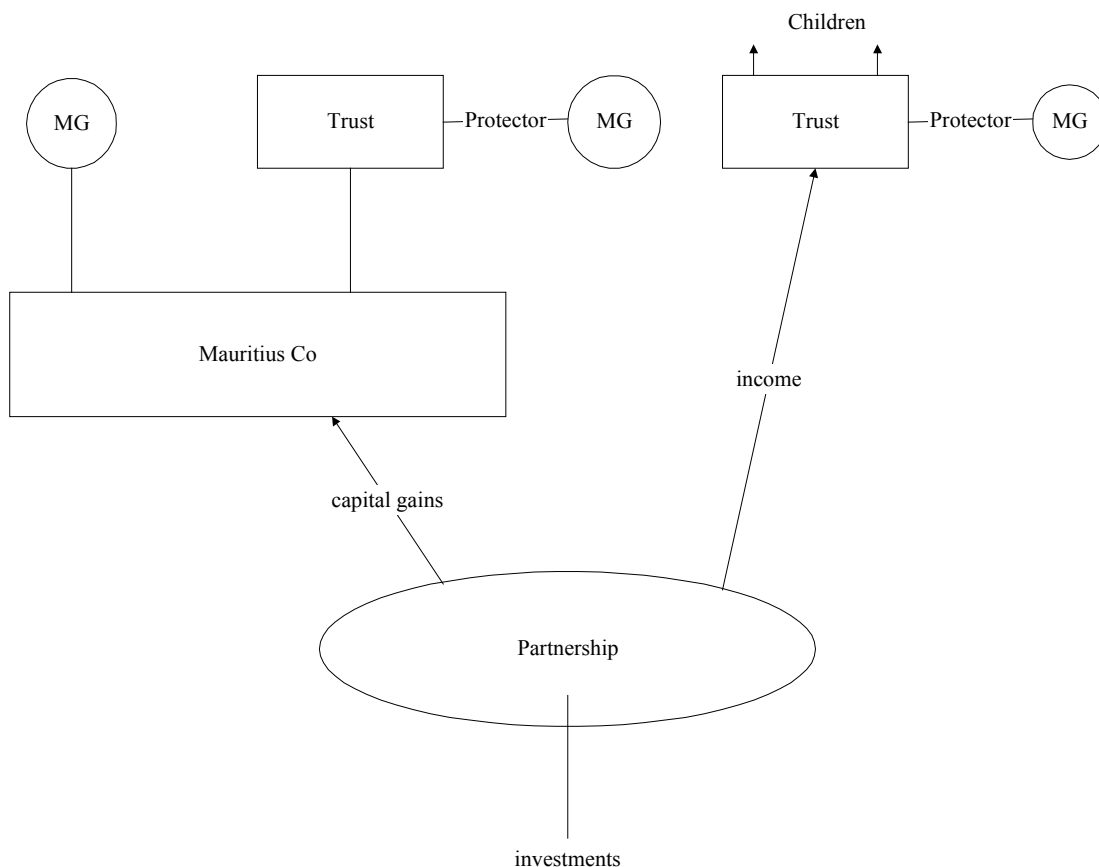


I envisage that the trust here will have no UK-resident beneficiaries. In practice, it can well be a charitable trust. Someone who has enough money to afford a structure like this is going to have to support good causes of one kind and another, and it is actually quite convenient for him to have a pocket out of which such contributions can be made. I have shown *myself* there at the side of the trust, not as a beneficiary, but as the Protector or similar person who has power to appoint and dismiss trustees. Having that power, I am going to find that the trustees listen very carefully to my advice about what good causes should and should not be supported.

So much for the capital gains. Now what are we going to do about the income? Strangely, the UK anti-avoidance rules for income are less stringent than they are for capital gains. For income, I can at any rate defer any charges to tax by using an offshore

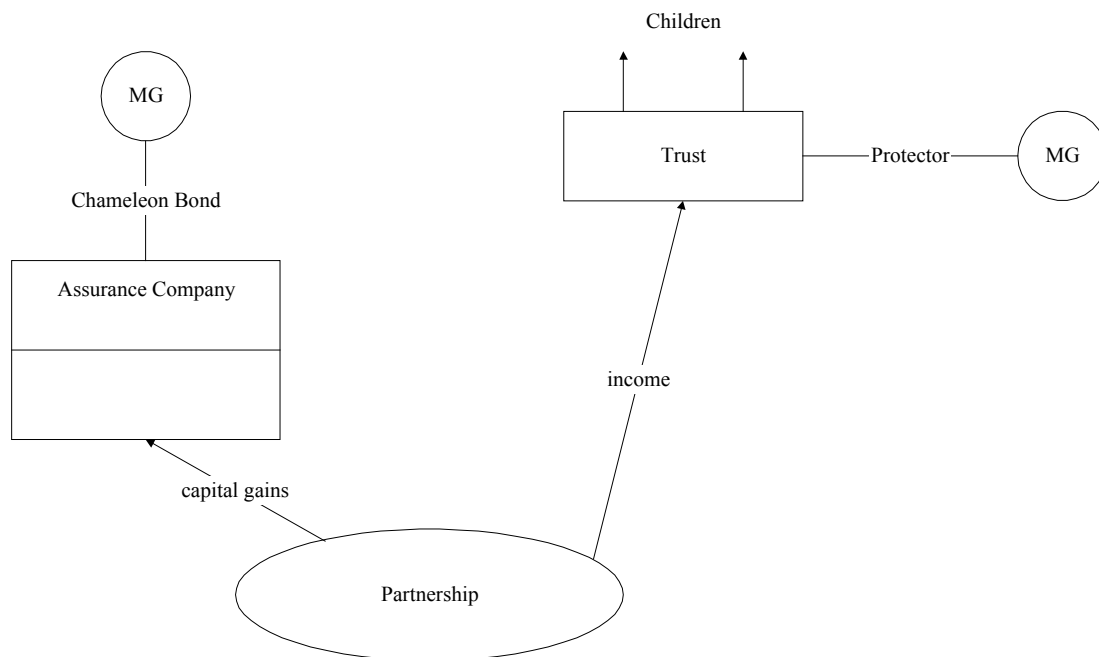


trust for the benefit of my children and remoter issue⁶. The structure on the left-hand side of the diagram is for making capital gains. The trust on the right is for receiving income. How do I make sure that the trust gets only income and no capital gains, whereas the Mauritius company gets capital income and not income? This can be achieved if the Mauritius company

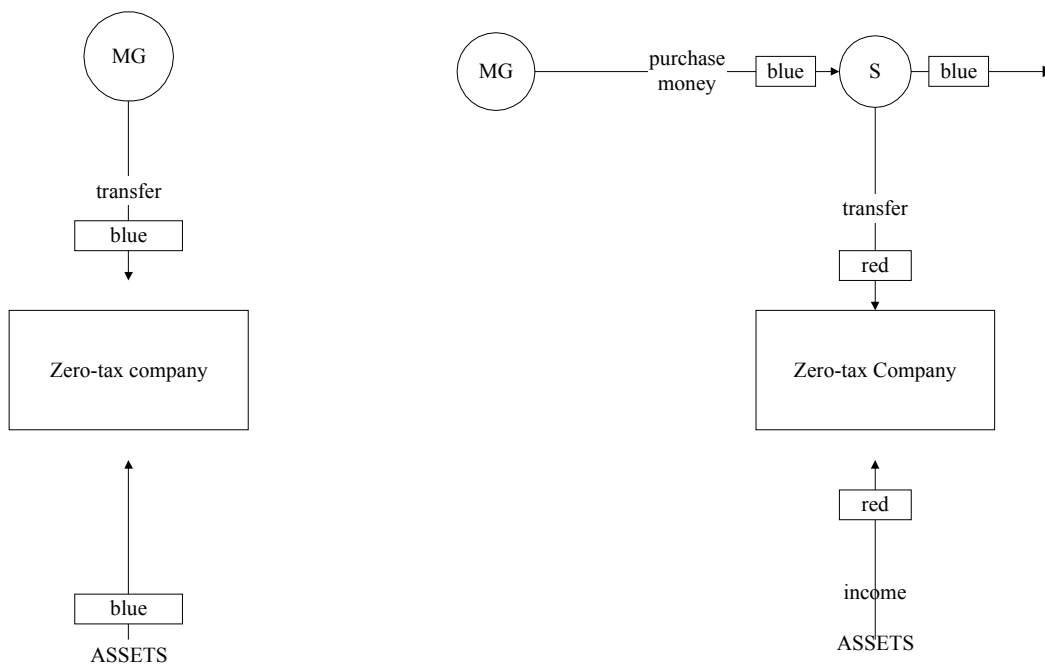


and the trust go into partnership, on terms that all the income will belong to the trust and all the capital gains will belong to the company. It is the partnership which makes the investments – whatever they are. Some of its capital will come from the company, and some from the trust, and income and capital gains will be allocated to the partners in accordance with the terms of the partnership agreement, though it may be many years before any actual distributions are made.

If I want to give the capital gains as well as the income to my children, I may use the partnership to send the income stream to the children’s trust and the capital gains to the Chameleon Bond, like this.



These examples presuppose that I want to give away the income to my children and remoter issue. But suppose I prefer to keep it for myself. Can I be the owner of a zero-tax company to which the income is payable instead of to the children's trust? Well, here we run straight into the oldest anti-offshore provisions on the Statute Book – those contained in what is now s.739 ICTA 1988. The detail of these provisions need not detain us here, but I need to mention the principle involved, because the way the UK taxpayer can circumvent these provisions may suggest a way in which taxpayers in other jurisdictions can circumvent the corresponding provisions in their laws.

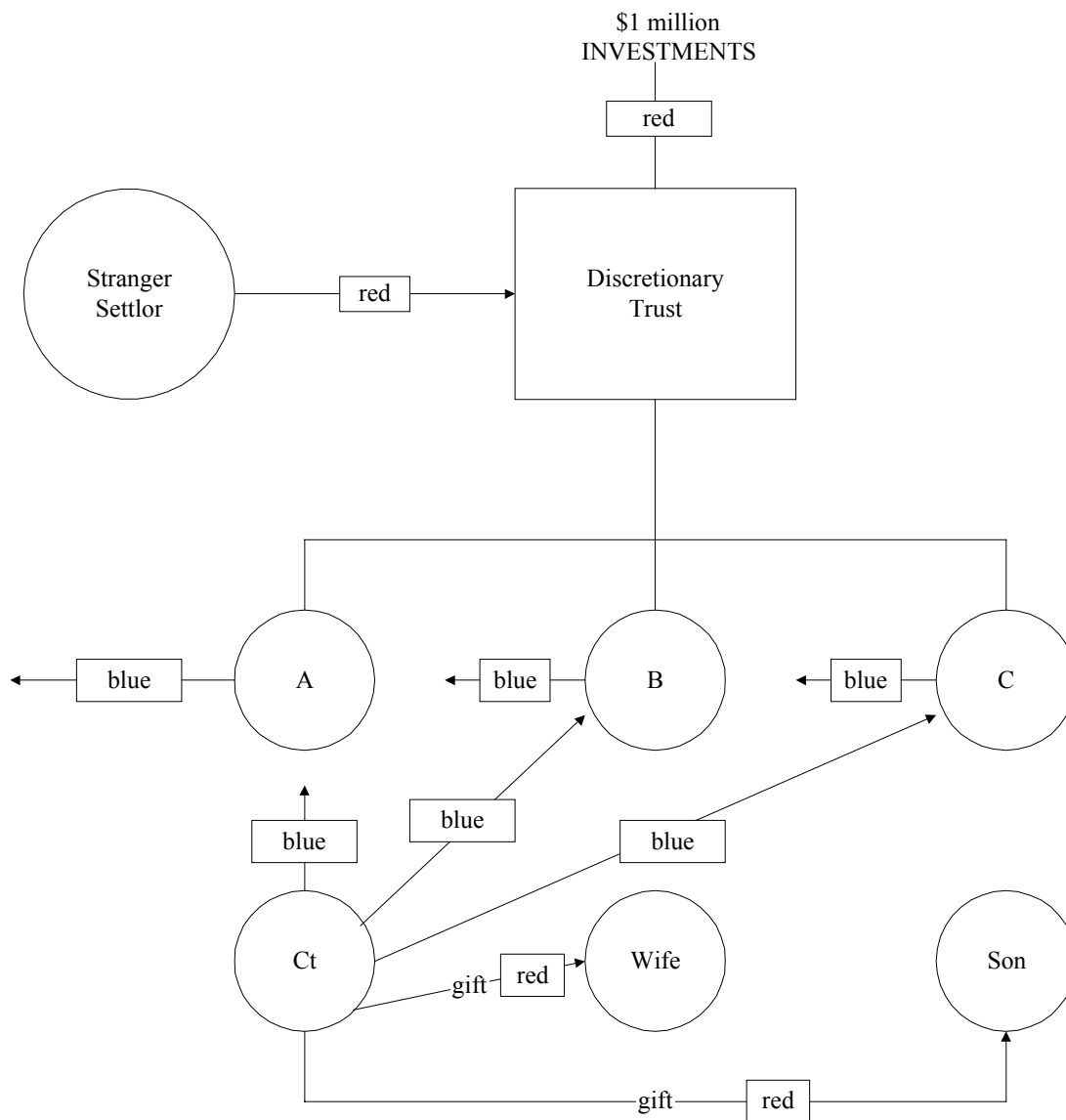


I am caught by s.739 if I transfer money to an offshore company which invests that money in income-producing assets. That is on the left side of the diagram. I show my

money in blue as well as the assets it buys and the income they produce. That gives me a s.739 liability. But suppose a different scenario. Here is a stranger (shown as “S” in the circle) who, some time ago and quite unbeknown to me, has transferred his money to an offshore company which has invested it in income-producing assets. His money is shown in red and so are the assets it buys and the income they produce. I now come along and give my blue money to S, in exchange for which I get the shares in his company. The difference here is that it is not my transfer of assets that causes any income to arise to the zero-tax company. The Stranger takes my blue money and spends it, for all I know, on champagne and chorus girls. The reason the company has income has got nothing to do with my blue money; it is derived from the Stranger’s red money. May I for convenience call that a “second-hand structure”? It is not one which the taxpayer himself has created; he has simply bought it from someone who has created it at some earlier time.

The second-hand principle is not confined to shares in companies. The taxpayer might buy any of the forms of policy I talked about earlier. If he buys, let us say, a Chameleon Bond from Stranger, the assurance company’s income cannot be attributed to him, because it is not his money which has caused that income to be payable to the assurance company. So if his bond is second hand, he not only gets protection against capital gains tax but income tax protection as well. The second-hand principle can also be applied to trusts.

I now want to say something about the merits of assets which cannot be valued. We are all familiar with the discretionary trust. It is one of the features of the discretionary trust that the interest of each of the beneficiaries is a little bit like a lottery ticket. In a lottery, no one ticket has any significant value, but the value of the aggregate of the tickets is equal to the value of the prize. Similarly with a discretionary trust. If you could get together the interests of all the beneficiaries, they would have an aggregate value equal to the value of the trust fund, but any one of the interests – taken by itself – does not have any ascertainable value. The asset with no ascertainable value is very useful when you are thinking about taxes on capital – that is, a tax on death or an annual tax on wealth. So suppose a situation like this.



The bottom left circle represents a client who is going to live in a country where they have a wealth tax or an estate tax. The two circles to the right represent his wife and his grown-up son. At the top of the diagram we have a discretionary trust which has been set up some time ago by some stranger for the benefit of A, B and C. The client buys from them their interests in this trust. The interest he buys from B he gives to his wife. The interest he buys from C he gives to his son. The interest he buys from A he keeps for himself. The trust fund is worth a million dollars. A, B and C together will charge a million dollars, plus a small premium – say 5%. Here is the client’s money in blue, which goes to the former beneficiaries A, B and C, and they do with it whatever do with it. But the red money, which came from the stranger settlor is represented by the million dollar’s worth of investments up at the top there and that it is in those investments that the client and his family now have interests – the lottery tickets, if you like, together worth as much as the investments, but individually of no ascertainable value. The client now goes to live in the country with the wealth tax or dies in the country with the estate tax. Has he avoided those taxes? I have no doubt that the answer would be different in different jurisdictions, but at the moment I just want to consider the principle: assets with no ascertainable value are very hard to tax. A similar situation arises when the profits of a partnership are to be divided between

the partners according to some formula which depends upon events to happen in the future – a future agreement or a future arbitration or the future results of different aspects of the business. Until the partnership shares have been ascertained, do the partners have any income for tax purposes? And are their partnership interests of any value for wealth tax or estate tax purposes? Could one apply the same principle to policies of assurance or Chameleon Policies? The tontine principle is well known – where participators contribute money to a central fund and the last of the contributors to remain alive is entitled to the entire fund. Maybe members of the same family could have policies which provide that the policyholder has to be alive if he is to claim the benefit on maturity. Does the policyholder who dies avoid the estate tax? Does he in the meanwhile have an asset for wealth tax purposes? Or to ask more difficult questions, what happens about forced heirship? Or, to make the question more difficult still, supposing a policyholder had to be not only alive but solvent to claim on maturity, does he have built-in asset protection?

I should like to end on a mathematical note. Most of the structures I have been considering do not so much avoid tax as postpone it. What I hope to demonstrate by this calculation

Investment return: 10%	Tax rate: 40%
<u>Anniversary</u>	<u>Investment</u>
0	100
1	110
2	121
3	133
4	146
5	161
6	177
7	195
8	214
9	236
10	259 less tax on 159 = 195
11	285 less tax on 185 = 211

is that if a tax liability can be postponed for a number of years, the tax is effectively not payable at all. If my algebra were better than it is, I am sure I could express this proposition as an equation, but to do the sums mathematically, I need to make some assumptions about the figures. So here I assume a tax rate of 40% and a return on investment of 10%. I assume that I have just done a transaction *offshore* which, if I had done it onshore, would have cost £100 in tax. I have not paid the tax, so I am in a position to invest what is in a sense the Government's money. If the yield on my investment is such that, even when I have paid tax on the yield I still have £200, I can pay off the original tax liability and still have my £100. Looking at the table, we can

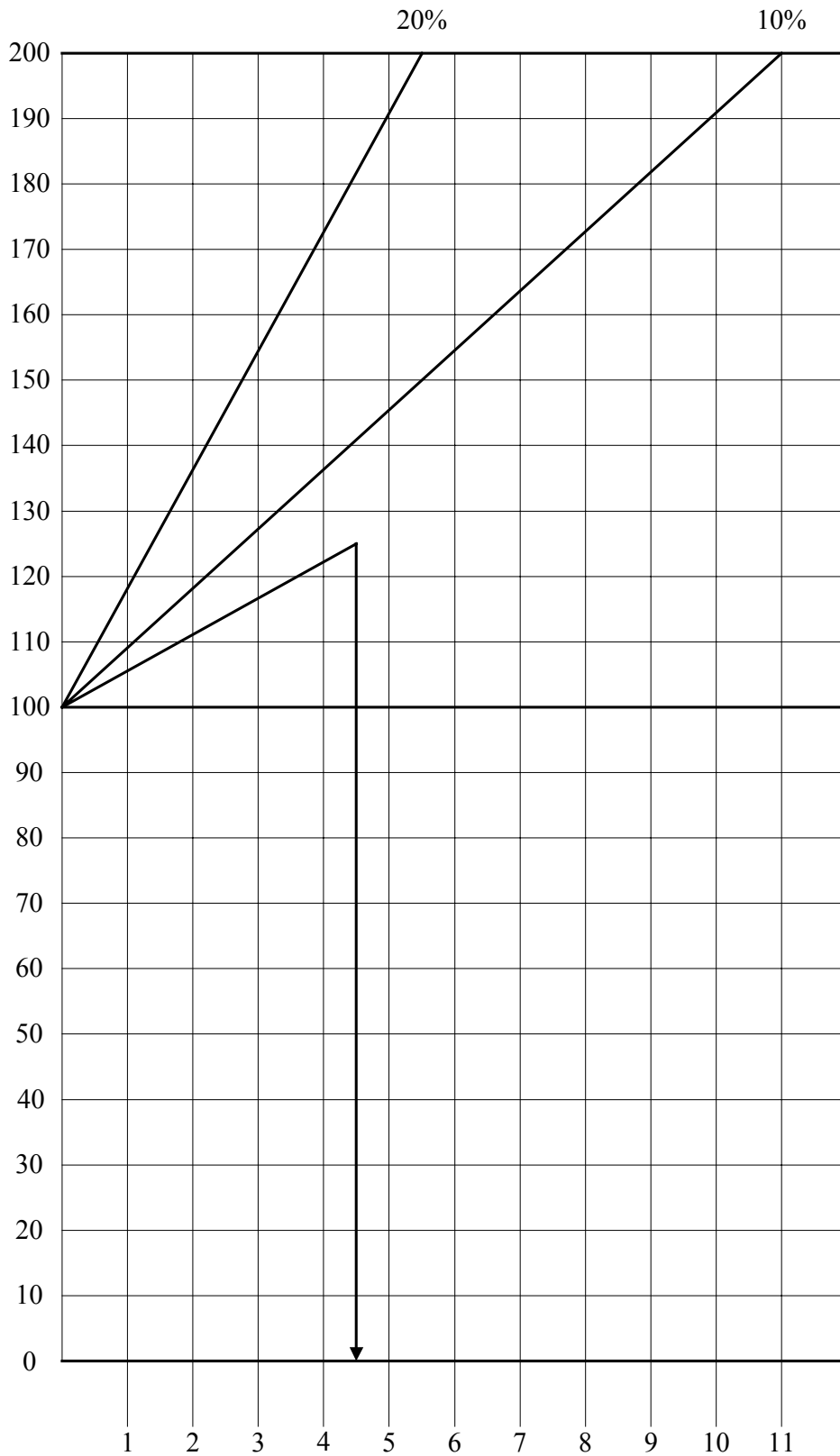
see that on the first anniversary of the transaction there is £110. On the second, there is £121, and so on down to the tenth anniversary, when there is £259. Suppose the tax becomes payable at this point. First of all, there is the tax on the £159 accumulated interest which leaves me with £195 – not quite enough to pay the whole of the tax postponed and still have the £100. But if I leave it to the eleventh anniversary, there is £285, which after tax comes to £211, so I can pay the tax which ought to have been paid in the first place, and still have my £100, plus £11 profit. If I can invest at 20%.

Investment return: 20%

Tax rate: 40%

<u>Anniversary</u>	<u>Investment</u>
0	100
1	120
2	144
3	173
4	207
5	245 less tax on 145 = 187
6	309 less tax on 209 = 225

the tax liability will disappear somewhere between the fifth and sixth anniversaries. These tables illustrate the simple proposition that people who successfully invest at 20% grow rich twice as quickly as people who invest at 10%, and if what you are investing is money you would not have had if you had not done your transaction offshore, mere postponement of the liability can be a profitable exercise. Here



are the figures in the form of a graph – starting with the 100 in the middle, the 10% investment shown by the line reaching the 200 between anniversaries 10 and 11, and the 20% investment shown by the line reaching the 200 between anniversaries 5 and

6. Looking at these two lines, one might draw the conclusion that, if only the money could be invested to yield not 20% per annum but 200%, the problem could be solved before the first anniversary. But that is a very risky strategy. The clue here is to turn what I call the Government's money into more money, so that all the taxes can be paid. If the opposite occurs, and what I call the Government's money is all lost – and I show this with the descending line – then you are no better off than you would have been if you had not gone offshore in the first place. And with that rather sobering thought, I come to an end.

¹ Section 553C ICTA 1988; Personal Portfolio Bonds (Tax) Regulations 1999, SI 1999/1029.

² No chargeable gain accrues to the person making the disposal, unless he is not the original beneficial owner and acquired the rights or interest for a consideration in money or money's worth: s.76 TCGA 1992. But by virtue of s.76A, Schedule 4A paragraph 4, the trustees of the settlement are treated for all purposes of the Act as disposing of and immediately reacquiring the relevant underlying assets. The deemed disposal takes place at market value: paragraph 9. However, s.210(2) TCGA 1992 provides that no chargeable gain shall accrue on the disposal of an interest in, or the rights under a policy of assurance (defined by s.210(1) as any policy of assurance on the life of any person).

³ Under s.540 ICTA 1988, the surrender in whole of the rights conferred by the life policy is a chargeable event. Section 541(1)(b) provides rules for the valuation of the gain arising in connection with the chargeable event and s.547(1)(a) provides that if the rights conferred by the policy are vested in an individual as beneficial owner, or held on trusts created by an individual, the amount of the gain shall be deemed to form part of that individual's total income for the year in which the chargeable event happened.

⁴ By virtue of s.288(1) TCGA 1992, "close company" has the meaning given by ss.414 and 415 ICTA 1988.

⁵ Section 13(1) – (4) TCGA 1992.

⁶ Under s.740 ICTA 1988, no charge to income tax arises until benefits are *received* by the beneficiaries. Equally, under s.660B ICTA 1988, a settlor only becomes liable to income tax on income *paid* to or for the benefit of his or her unmarried minor child.

I am indebted to my colleague, Claire Simpson, for the compilation of these end-notes.