Why K2 and similar Offshore tax Avoidance Schemes Don't Work!

I am bemused by the recent sensational coverage in the press concerning the participation of Jimmy Carr (the comedian) in the ***K2*** tax avoidance scheme.

The underlying assumption of the press which has not been dispelled by any tax expert they have called upon is that the ***K2*** Scheme works!!!

K2 is the merely the name of a specific scheme and in fact most of these Offshore Employment/Payroll Solutions and Contractor Schemes function in a very similar way with the variations being insignificant for UK tax law purposes.(See diagram below)

It has astounded me that this misleading and false impression is linked to comments about the proposed General Anti-Avoidance Rule (GAAR) coming into force in April 2013. The clear impression the Press have given to their readers/viewers is that without the GAAR; HMRC are powerless and these Schemes are currently effective and costing £££millions in lost tax!

As someone who has been asked to analyse and advise on innumerable ***tax schemes*** over the last fifteen years I am really at a loss to understand why nobody knows why ***K2*** does ***not*** work!

Before I go into a legal analysis of the tax law that affects ***K2*** and similar schemes I thought I should give some sort of background to the market for such schemes.

First, let me start with some truths that HMRC have failed to communicate!

Since Investigations and challenges started into income tax avoidance in 2001 using Offshore Employee Benefit and other offshore trusts: **No** Scheme promoters have taken any case beyond the First tier Tax Tribunal (with the exception of Huitson which went to the Court of Appeal and lost!!)

All other cases have settled with the scheme promoters conceding to HMRC that the the schemes do not work and the unfortunate taxpayer paying the tax, and interest and the costs of the lengthy investigation!

So, with such an appalling record and complete lack of success; why you will ask are they still being sold!

Simple – they are enormously profitable for a whole coterie of promoters, salesmen and tax advisers and barristers who are making their own fortunes by being involved with these Schemes!!

They make large sums endorsing, selling and administering such schemes and negotiating with HMRC. When they go down, they liquidate and start all over again! Many of the Promoters are based in the Isle of Man, jersey, Guernsey and other tax havens. UK HMRC has no jurisdiction in these Islands and when faced with too many awkward questions they simply liquidate or have multiple Companies/ entities and liquidate those under HMRC Investigation.

The HMRC for their part are *ponderously* slow in investigating such Schemes, taking up to 2-3 years and permitting huge delays on the part of the advisers hired by the Scheme Promoters (whose sole objective is to delay as long as possible the inevitable). This they may do by raising legal issues, putting forward complex but wholly flawed arguments, ignoring questions and claiming vital documents are outside the UK and cannot be easily retrieved. The effect is that the delay slows the

whole legal process down, because they know that there is precious little chance of success in the Courts!

The individual – the Jimmy Carr, the computer contractor, the successful consultant, has to effectively transfer assign his income rights to an offshore entity. That entity normally being an Isle of Man Jersey/Guernsey limited company. Ironically, in some of the earliest variants and later variants, a direct transfer into a Trust was the means by which the rights were effectively transferred. However, Section 739 is a very broadly drawn section and it doesn't really matter what type of entity offshore that the rights or income is transferred to, whether it is direct, part of a whole series of transactions, the key phrase are the words "Power to Enjoy". That basically means that if the person who was resident in the UK assigns or transfers, directly or indirectly writes that he has and has some means either directly or indirectly enjoying the benefit of the income that he is effectively assigned or transferred then the section breaks through that transaction and taxes the individual on the income that he has assigned on an arising basis as though it was his income; it effectively ignores the whole of whatever the complex means by which the income has been transferred to someone outside the UK.

It also contemplates the use of a loan or repayment of a loan. This section therefore is the principal reason and as I have said, all leading Counsels seem to agree on this, why K2 schemes on any variant will fail. In fact, in the case in [check date], known as the Vesty case, a second section was added to the legislation which attacks people who benefit from such structure who weren't the original Transferor. In the Vesty case, the transfer to an Offshore Trust made in 1919 by the Beneficiaries' Grandfather, were held not to be taxable in the UK because at the time there was no mechanism to charge people who hadn't made the original transfer.

However, we are not faced with such a problem in the K2 scenario. What some Counsel has mentioned in their Opinions (although in my view quite weakly) is that there is a defence to Section 720 which is known as the Commercial Defence, that is if the purpose of the transfer was done not to avoid tax but for some other specific commercial purpose. There has again been recent case law concerning the commercial purpose defence which has shown that it may be quite limited in its scope and that in a modern court, bearing in mind the wider awareness of tax benefits that might be gained, the defence will be of very limited scope.

In my view, such a defence would not have any serious chance of success in a K2 type scheme. There is simply no need for a Jimmy Carr like person to justify that he needs to transfer his income rights to an offshore company and if he was to try and say it was to protect him from litigation then that argument could be dissipated by the simple formation of a UK company.

What are the other legislative principles? One second problem that could emerge that has been used to gain such companies is that when the offshore company, that is the company in the Isle of Man, Jersey or Guernsey which has affectively had the assignment of some of the rights or part of the rights and pays the transferor or the 'Jimmy Carr' guy his basic salary on which they submit to full UK PAYE tax, there is a very strong argument which would not be protected by the double tax arrangement with any of these jurisdictions that each individual employee of the offshore Isle of Man, Jersey or Guernsey company, affectively constitutes a branch or agency of that company and that that company is trading in the UK. That would have a catastrophic affect on the whole structure because then the offshore company would suffer UK Corporation Tax. This argument has been raised several times by the HMRC and to my mind would be a real problem.

A country which has a double taxation agreement with the UK are generally protected by an Article 5 which basically says that unless they have a branch, agency or permanent establishment in the UK then they are exempt from taxation in the UK and are protected by the treaty. It is this definition of permanent establishment which again has, through court decisions in various jurisdictions probably been slightly widened in certain cases, that there is actually an exposure for the Isle of Man offshore company itself.

I am personally aware that several offshore companies when faced with a threat by the UK HMRC that they were assessable to UK Corporation Tax on this basis, have simply liquidated themselves overnight!!