FOREIGN COMPANIES AND THE DANGER OF CRIMINAL LIABILITY

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1 The majority of articles that appear in this journal (I have to admit, mine included) tend to be aimed at securing that the reader adopts the "cold towel over the head" mode. This article, however, is mercifully free from any technical difficulty. It is concerned with the circumstances in which advising on or acting in connection with an offshore company can give rise to criminal liability. Why write such an article? Because, I suspect, there are still some practitioners who are walking around with their eyes closed. While this category should not include readers of this journal, offshore matters often concern several professionals and the actions of one may give rise to the possibility of charges against all involved, or, if not a charge, a considerable hassle!

2 In March 1997, three men, two professionals and a lay client, were prosecuted for tax fraud.[2] At the heart of the alleged fraud were three Jersey incorporated companies. The prosecution alleged that, while the lay client was stated to be a consultant to them, in fact, central management and control lay with him. On this basis, each of the companies was UK resident, subject to corporation tax but, as was intended, did not notify that liability. Each of the defendants was convicted and sent to prison. Does this ring any alarm bells?

3 I must first state what this article is not about. I am not concerned with the rightness or otherwise of the convictions or the decision to prosecute (the convictions are, I understand, under appeal). Nor do I wish to provide a critique of the Judge's summing up (although certain passages on the meaning

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2 *R v Chipping and others,* March 1997.

of "central management and control" are interesting). I merely take it as given that the Revenue may prosecute in similar circumstances and that convictions may be likely.

4 My concern is with the circumstances where actions of professionals, advising on the set up or operation of offshore companies, may stray towards the risk of criminal liability. The first rule of all tax professionals must be to keep their clients (and, dare I say, themselves) out of prison. While it is perfectly legal to use offshore companies, I believe it is now important for tax professionals to have a very clear idea of what is and is not acceptable in the setting up and running of these entities. The downside of getting this one wrong may not just be an outing to the local Commissioners! Since that downside is totally incomparable with other risks taken on when advising clients, it must be sensible to adopt a "no risk" strategy.

5 Readers of this journal will be well aware of the usefulness of offshore companies in tax planning, both for corporate and private clients. I am not suggesting that offshore companies should be avoided. What I am advising is that any offshore entity must fit properly within the commercial structure and that commercial reality must be recognised, from day one. If, very occasionally, this means that an offshore company is unsuitable, this must be accepted. I add that there was nothing intrinsically illegal in the type of structure used in the *Chipping* case, indeed, there were commercial reasons for employing non-UK resident entities. The problems were caused by the way the offshore structure was to work in practice.

6 There were three Counts in the Chipping case. Count 1 can be dealt with briefly. It concerned the lay client alone. The allegation was that certain monies paid to one of the Jersey companies was his income. This company had nominee shareholders and the defendant claimed that it was nothing to do with him. The Inland Revenue's case was that, in reality, it was his company and acted as his moneybox (shown, it was alleged, by its providing benefits to his family). The income was therefore his. If, the Revenue alleged, it was, and he fraudulently concealed this (by failing to declare it), the jury should convict. They did.

7 There is a clear distinction between a company receiving cash as a nominee and beneficially but, in the latter case, the facts can differ significantly. Such a receipt should not be the taxpayer's income but may still be taxable on him or her as it arises through, in particular, ICTA 1988 section 739. Section 739 was not mentioned in *Chipping* but it should be appreciated that, had the companies received the sums beneficially, section 739 applied and, had the taxpayer appreciated this, setting out deliberately to conceal this could also have grounded criminal liability.

8 The main lesson from Count 1, however, is clear, even if it sounds trite. Where payments are to be made into or within an offshore structure, from which the client is not excluded, the legal rights and obligations must have been clearly put in place concerning, first, the ownership of each entity (particularly if a company has nominee shareholders), second, the reason for each payment and third, who, and which entities, can make decisions and on which points. It must be remembered that these legal rights and obligations may be governed by a foreign proper law and appropriate advice may need to be taken on this. Assuming it is secured that the company in question takes beneficially, any section 739 liability needs to be returned timeously. This needs great care since some practitioners tend to assume that the liability is greater than it actually is, while a few tend to assume that there is no liability at all. (This is only likely to be the case with very well planned arrangements.)

9 Count 2 requires more consideration. Again, it concerned only the lay client. Briefly, and simplifying the facts, the prosecution's case was that the Jersey incorporated companies had their central management and control in the UK, with Mr Chipping. He had the technical and financial knowledge they needed and, in reality, controlled what they did, so that the Jersey director was not in control. The defendant's case was that the companies were managed in Jersey (by the Jersey director) and that the defendant was merely a consultant. The jury's verdict meant that they thought central management and control lay with Mr Chipping.

10 There are lessons in this point. Before the Special Commissioners, an argument on central management and control will probably concern the detailed legalities of the documentation and evidence from the taxpayer company's witnesses as to what was done and how decisions were taken. In *Chipping*, the question was to be determined by members of a lay jury, who were likely to boil it down to "who was in control". The evidence in *Chipping* included that of a number of "outside" persons who dealt with the Jersey companies, the question being, whom did they perceive was in control of the business?

11 Those experienced with the operation of offshore companies where, commercially, UK residents need to have business input, will not be slow to see the danger. While the documentation may clearly show that the client is merely a consultant to an offshore company, the perception of others on the ground may differ. This can be seen on a simple level, where, for example, the offshore company holds shares as part of a capital gains tax mitigation arrangement and the lay client is physically engaged in negotiating the sale of its only asset (typically, shares in another company). The position can also be potentially dangerous where directors of a UK company are involved with those who have business dealings with an offshore associated company, in

matters where the foreign resident directors would be expected to be in the driving seat. The problem may well come down to lack of thought and care with the organisation, from the inception of the arrangements: if commercial input from the UK is needed, this must be recognised and put into a clear legal and commercial framework from the start. Obligations must not be entered into if they are not going to be followed "on the ground". It is uncertainty and inconsistency which, when challenged by the Revenue, leads to uncertain and inconsistent answers from those involved.

12 Of course, the mere facts that the Jersey companies had their central management and control in the UK and failed to pay any corporation tax due, was not enough for Mr Chipping to be convicted. It was also necessary that he appreciated the liability and either participated in conduct designed to deceive the Revenue into thinking that the companies were resident abroad, or concealed the profits in order to evade tax. It will be appreciated, however, that if a defendant knows that he or she (or, say, a UK company) was controlling the offshore entity, he or she may have difficulty in persuading a jury that he or she did not think it was liable to pay tax on its profits. He or she is then left with arguing that there was no intent either to make the Revenue think that the company was foreign resident, or to conceal the facts. If, however, the Revenue have been told that the company is foreign resident, the jury is quite likely to find that the allegations of cheat are proven.

13 What if nothing at all is said to the Revenue and offences of deception are not in point? The modern position seems to stem from section 32(1), of the Theft Act 1968, which abolished common law cheat, except as regards cheating the Revenue. This therefore leaves, as part of the law, authorities going back to the fourteenth century, which declared that merely keeping funds known to be owed to the Crown was indictable.

14 In *R v Redford* [1988] STC 845, where the taxpayer failed to register for VAT (and therefore kept the "output tax"), the Court of Appeal held that the common law offence of cheat did not require deception, the sole question being whether the taxpayer should have declared a receipt or paid sums to the Revenue. Cheating the Revenue is therefore wider than the normal idea of defrauding a person: Lane LCJ at page 851c. There was, the Lord Chief Justice said, no authority to support the view that cheat could not be committed by omission: page 852a. Similarly, in *R v Mavji* [1986] STC 508, Court of Appeal, Michael Davies J stated that cheating the Revenue could include conduct which results in depriving the Revenue of money to which it is entitled.

15 Nor, at least in *Chipping*, did it matter whether the taxpayer had a statutory duty to make a return. Indeed, since the liability lay with the Jersey companies, of which Mr Chipping was not even an officer, he could have had

no such duty. Assuming *Chipping* is correct on this point, anyone concerned with the operation of such a company, who knowingly takes part in causing it to fail to make a return, could be caught. It may not just be the lay client and could, for example, be an accountant who agrees that no return should be put in. The dangers are clear. On a simplistic level, most readers of this *Review* will not need to be told that any tax planning which works on the basis that the Revenue are not (and need not be) told should be avoided like the plague. Further, a detailed treatise on the finer points of the reporting requirements set out in the Taxes Management Act 1970 is unlikely, in the current climate, to be of much interest to a Crown Court judge and jury. The approach seems to be, roughly, should the "offshore" company have returned its profits and did the defendant knowingly take part in conduct designed to prevent this happening? In this climate, anyone seeking to rely on the "We had no duty to make return" defence may be disappointed.

16 Count 3 charged Mr Chipping, his solicitor and the Jersey resident director with conspiracy to cheat. It is unclear, from the verdict, which offence(s) of cheat admitted by, or alleged to have been committed by, Mr Chipping, they believed all had conspired to commit. While this Count referred particularly to misleading the Revenue in their investigation, it is clear that a conspiracy to cheat would have been committed by the three agreeing to fail to disclose known or future tax liabilities (e.g. arising because central management and control of a company is in the UK, not Jersey) even without a Revenue investigation.

17 At this stage, the reader is likely to have come up with at least four points showing why the above is irrelevant to him or her. These may be:

Argument 1

17.1 First, however the structure is run on the ground, the Revenue only prosecute where lies are told in an investigation and I would never be a party to that, so there is no problem.

17.2 This is what, I believe, is known in the Civil Service as the "bold" approach. It has the following drawbacks:

17.2.1 the Revenue may not feel themselves restricted to prosecuting only in cases where "cover up" lies had been told; or

17.2.2 your firm may be replaced and your successors may mislead the Revenue (probably innocently, through lack of knowledge of all the facts) or may panic and blame you; or

17.2.3 the Revenue may obtain information from the lay client first, who may both mislead the Revenue and blame you.

The bold approach is naive.

Argument 2

17.3 Second, that I work in a big firm and these matters only concern the minnows.

17.4 The Revenue, understandably, prosecute professionals in tax fraud cases, and in a high profile way. They may be very careful in ascertaining if someone in a major firm is involved in tax fraud but if they believe that he or she is, it would be unrealistic not to expect a "high profile" prosecution.

Argument 3

17.5 Third, this matter will never be investigated by the Revenue.

17.6 In the era of "random checks" this argument does not deserve a reply.

Argument 4

17.7 Fourth, I will secure that everyone concerned tells the whole truth.

17.8 This assumes, first, that you are still in the frame when the Revenue ask questions, second, that you will be a party to everything the Revenue are told, third, that you will be able to control what is said and fourth, an enviable faith in one's fellow man and woman, both to ascertain what is the truth and stick to it. (They may not seek deliberately to lie: they may simply have messed things up and panicked.) "Bold" is not the word here!

18 In the real world, it is not impossible for a professional to be caught up in a tax fraud investigation concerning control of foreign companies where others have either set out to conceal the truth from the start, have "got it wrong on the ground" or simply failed to think through what was required to secure foreign residence and then determine not to put in returns on the basis that the company is UK resident. From that point, a guilty verdict may depend on whether you knew that control was being exercised from the UK and that the company was not making tax returns. The decision to prosecute, and verdict,

might well turn on whether you were aware of certain facts which, as a matter of law (decided by a Crown Court judge), amount to the retention of central management and control in the UK. For example, these may be that the offshore company bought and sold Dürer woodcuts, that the directors knew nothing about art, that the lay client was an expert who viewed these prints at auction and met with the company's customers and that the correspondence and other documentation from the directors appears solely to be concerned with their fees. On those facts, particularly if you are standing next to your former client, you may have trouble in persuading twelve new friends that the prosecution has got it all wrong.

19 Why am I so concerned about a prosecution for tax fraud concerning offshore companies, since people are prosecuted throughout the year for various tax frauds where, at the heart of the matter, is a deliberately false tax return? There are four reasons. First, there is, I believe, a view which still exists among some tax professionals (and certainly their clients) that when considering where an offshore company is resident, one is allowed to suspend disbelief. Thus, an accountant who scrupulously checks an indexation computation twice may be happy to advise that an offshore company does not need to put in tax returns and pay corporation tax even though he or she knows that the directors always phone up Mr X in Watford to find out what to do next. Second, it is becoming clear that the Revenue are likely to prosecute in cases of suspected tax fraud involving offshore companies, especially if professionals are involved. Third, hardly ever will the professionals in the UK know precisely what is going on "on the ground". Fourth, the technical provisions in question may be of considerable complexity. The only sensible course therefore has to be to err on the side of caution.

20 Enough of the gloom and doom. Offshore companies are a perfectly legitimate and useful tool, both to UK corporates and individuals, in tax planning, particularly where the transaction relations to third countries, or foreign domiciliaries are concerned. What the professional adviser needs to know, therefore, is what he or she should do when acting for clients involved with, or wishing to use, offshore companies. Specific advice must of course depend on the role of the professional, whether accountant, lawyer, offshore or onshore, but the following are amongst those matters which might be regarded as basic considerations:

20.1 Advisers must be fully aware of the nature of the proposed business to be carried on offshore.

20.2 The structure put forward must be wholly suitable commercially and if control of business policy, realistically, has to be exercised from the UK, this should be accepted now.

20.3 The ownership of each entity must be clear and properly documented, especially companies with bearer or nominee shares. There must be no confusion.

20.4 If commercial input from the UK will be needed, the role of any UK entity or individual concerned must be thought through and properly documented. Advisers must satisfy themselves that, on the basis of that input and their advice, central management and control would be abroad.

20.5 The directors of a foreign company must be chosen with care and in the light of the proposed business of the company. If particular commercial expertise is necessary, for control properly to be exercised by them, a board member should possess it.

20.6 Those running the company must be fully aware of their responsibilities to take the business policy decisions. It is sometimes forgotten that, as well as securing the exercise of control abroad, the retention of the right to control must not be in the UK (*B W Noble Limited v Mitchell* 11 TC 372, first instance only, where Rowlatt J applies the *Ogilvie v Kitton* principle to corporate residence, at pages 411 to 412).

20.7 The directors must keep full board minutes, preferably discussions as well as decisions. Minutes must make it clear if a director is attending by telephone and from where. All transactions must be properly documented.

20.8 All technical issues should have been properly thought through first, especially in these days of self assessment.

20.9 Lastly, in my opinion, the advisers will need to be satisfied that the arrangements work on the basis that tax liabilities have been mitigated, that is, that a potential charge to tax which might otherwise have accrued or arisen should not accrue or arise because of how matters are structured. Some advisers, however, may wish also to distinguish between the (clearly illegal) evasion of an assessable liability, and structuring matters so that an assessment can only be made upon an entity which is foreign resident and unlikely to meet such liability. This, in my view, is not a distinction likely to appeal to the judge and jury at Guildford Crown Court.