

Raising the Eyebrow C



Question

By David Willbe

Other than Roger Moore, Dwayne “The Rock” Johnson and Groucho Marx, most of us probably don’t consider our eyebrows to be assets in business – but they can, potentially, save us from making big mistakes. When someone describes a new plan that sounds great on its face, that urge you sometimes get to raise a disbelieving eyebrow can be a warning that the plan might not be the right one to take.

Even when things are strictly legal, which of course should be the primary concern, if a plan fails the “eyebrow test” (also known as the “sniff test”, the “smell test” and various other, more colourful terms) then pushing ahead with it may not be entirely trouble-free. If the plan fails the eyebrow test with you, then you must assume that it will likewise fail with other people – and those people may be unwilling to do the work required to establish whether or not the plan is in fact legal. That may put off a potential partner, investor or employee or, at worst, cause a regulator or authority to begin an investigation of your affairs – or even legal proceedings.

Developing a reliable eyebrow test is, of course, a balancing act. Success does not often come without some element of risk, and it is absolutely the case that entrepreneurs who have ignored an instinctive reaction to avoid a certain route with regard to their venture have gone on to see that risk pay off. Others, however, have seen parties interested in acquiring them put off by a complicated structure that looks wrong on first glance.

When something does fail the “eyebrow test”, it is therefore always worth considering whether the potential gains outweigh any risks. This is something that should always be in an

entrepreneur’s mind, especially when making a commitment which could put their own financial security as well as the future of their business at risk – and doubly so when the entrepreneur is making this commitment without the benefit of proper legal or financial advice.

Tax Avoidance

The subject of tax avoidance schemes has been prevalent in the media this year. These schemes are the perfect example of a situation where one should employ the “eyebrow test” in order to judge whether the potential reward of paying significantly less tax outweighs the potential drawbacks. Tax avoidance is legal (it is the structuring of a person’s affairs so that they pay less tax), but certain schemes designed to be avoidance may in fact be tax evasion (where a person does not pay tax that they ought to pay) – and tax evasion is illegal.

Even where a scheme does not amount to evasion, enough of a stigma has been built up around avoidance that those with a public reputation should consider the potential repercussions of being “outed” as a tax avoider against the potential saving. When Jimmy Carr and Gary Barlow were revealed to have been using tax avoidance schemes earlier this year, the issue was not that what they were doing was illegal – but their schemes failed the eyebrow test, and therefore they found the morality of their tax affairs being debated in the media by the leaders of political parties. If they had considered that possibility, would they still have invested in the schemes?

Such schemes are not a new phenomenon. In 1967 journalist and interviewer David Frost used a partnership with a Bahamian firm to

keep his international earnings out of reach of the United Kingdom tax authorities. Mr. Frost’s involvement with the partnership, however, also failed the eyebrow test – and, in this case, led to a protracted set of court proceedings. Mr. Frost was a UK taxpayer who was well established within the UK as a television presenter, and decided that it was time to take his skills across the pond and attempt to break the American market. Mr. Frost would not be spending too much time out of the country, and would remain resident in the UK (not America) for tax purposes, but of course payments for his American work would be made outside of the UK. He therefore began to look into whether or not he could keep those payments off-shore, and therefore avoid paying any tax on them – a perfectly legal idea to reduce the amount of tax he would have to pay.

Having received financial and legal advice, Mr. Frost entered into a partnership with a Bahamian company called Leander, which was authorised to, “carry on financial, commercial, trading or other operations” with the object of, “exploiting copyrights and...television and film consultants and advisers, publicity agents and providers of publicity services... throughout the world outside the United Kingdom...and...producing television programmes, film...and other entertainments”. Leander was a company set up expressly for this purpose.

The idea was that Mr. Frost’s American clients would not hire Mr. Frost directly, but would hire the Frost/Leander partnership which, under the partnership agreement, could then compel Mr. Frost to show up for work. Under the terms of the partnership agreement the majority of any profits made by the partnership would go to Mr. Frost, and a small portion would

go to Leander. This partnership was run completely outside of the UK and all activities to do with the partnership, including its day to day running, also took place outside of the UK – and, thus, Mr. Frost’s American earnings were kept entirely outside of the UK tax net.

Mr. Frost’s endeavours to break the American market proved to be incredibly successful and consequently the partnership did very well. The profits of the partnership were divided in accordance with the terms of the partnership agreement. Mr. Frost did not remit any of the earnings he made from the partnership to the UK (i.e. he spent or invested them all outside the UK) and so did not pay tax on them.

Court Case

The Inspector of Taxes asserted that this was tax evasion by Mr. Frost, as Leander was not a substantial company – it was set up purely for these purposes, and so the Frost/Leander partnership was not a genuine

one. The profits from the partnership were therefore included in Mr. Frost’s income tax assessment for the years 1969-1970 to 1971-1972.

Mr. Frost contested this decision in court, and it was ruled that the partnership was genuine as Leander provided administrative services for Mr. Frost’s American activities. If this was the end of the matter then it would seem that Mr. Frost was completely right, on this occasion, to ignore any initial doubts he may have had as to the risks of the scheme. Unfortunately for him, the matter was appealed by the Inspector of Taxes, which inevitably caused an increased amount of stress and cost as the proceedings became even more protracted.

The Inspector appealed on a variety of different grounds, including that the partnership was designed purely to avoid tax rather than to make a profit. The appeal was eventually dismissed as it was held that, even though the partnership may have achieved a degree of tax avoidance, this did not mean that it was not formed with the

view to realise a profit. Mr. Frost was therefore, in the end, successfully able to use the partnership to protect a sizable amount of his earnings from the UK tax authorities.

Conclusion

Mr. Frost was clearly well advised, both when structuring his tax avoidance and then throughout the court proceedings. The partnership was determined by the court to be entirely legal – but the structure did not pass the eyebrow test and, as a result, Mr. Frost incurred the cost, stress and negative publicity which go along with a multi-year investigation into one’s tax affairs. Had he known about this in advance, or properly considered the risk of it occurring, might he have felt that it was not worth the savings he made through the scheme?

Perhaps most plans that fail the eyebrow test will not end up in such protracted proceedings, but even so there are risks attached. Entrepreneurs may not have public profiles at the level of Jimmy Carr and Gary Barlow, but being involved with plans that fail the eyebrow test may nevertheless put off the likes of potential employees, investors, acquirers and commercial partners.

Most entrepreneurs will not have the benefit of being as well advised as Mr. Frost in similar situations, and in that case the eyebrow test has to detect illegality as well as something that may put off other parties from dealing with the business. This is why it is always better to take time before entering into any commitment to really assess whether a proposal fails the eyebrow test. If it does, then ensure that the potential gains are significant enough to outweigh the risks – and if unsure, always take advice.

Gary Barlow (left) and Jimmy Carr have both been accused of tax avoidance schemes

