Contractor offshore tax solutions: understanding the risks and the benefits

Contractors seeking to reduce their tax liabilities can choose to use an **offshore tax solution**, some of which can result in substantially increasing net income from, typically, 65% to 85% of contract value.

However, contractor offshore solutions are not appropriate for all contractors. Many solutions only offer genuine benefits to very high earners and the offshore route does not fit the risk profile of some contractors, even higher earners.

Before using an offshore tax solution, contractors should ensure that they fully understand the risks as well as the benefits and choose a scheme accordingly. Plus, they should always seek professional advice from an independent offshore tax specialist who understands UK contractor taxation issues.

Common offshore tax solutions

For the seriously wealthy, tax planning specialists can create a complex web of offshore trusts and shell companies in tax havens that can cut tax liabilities to virtually zero. Such services are expensive and only the savings made by the very well off can justify the related professional fees. Few contractors are likely to fit into this bracket.

But higher earning contractors can choose from a range of more standardised and affordable contractor offshore tax solutions. The most common include:

Employee Benefit Trusts (EBT)

Devalued currency loans

S615 Pension schemes.

Each of these approaches takes existing tax and financial structures and adapts them to apply to contractors. For example, Employee Benefit Trusts are well-established mechanisms for large, often staff-owned firms, to manage assets on behalf of employees. Contractor EBTs pay contractors a small salary and loan the remainder of the contract value, less fees, to the contractor. Because the cash is a loan and not income, the contractor pays no tax on it.

Devalued currency loans are complex loan-based arrangements that rely on currency devaluation to reduce the paper value of the loan over time to virtually zero. This leaves the contractor with no liabilities, despite having 'borrowed' to the value of the contract.

S615 pension schemes are popular with some contractors working overseas. The schemes allow a pension pot to be created over time, and this eventually converts into a tax-free lump sum for the contractor.

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Evaluating the risks of offshore tax solutions

Offshore tax solutions are not for low and middle-income contractors with modest risk profiles as, although the rewards can be very high, the risks of falling foul of HMRC and facing a substantial tax demand can also be high.

So it is important that contractors take particular care to fully understand exactly how each scheme works and its potential risks. Because some schemes are aggressively marketed and sold by their providers, it is advisable for contractors to give themselves a self-imposed cooling off period before signing up, and during this period to consult with an appropriately qualified and independent offshore tax expert who understands contractor issues.

It should also be noted that some schemes claim to have 'HMRC approval' and/or 'tax counsel's opinion' that the offshore schemes are within UK taxations rules. But HMRC never approves tax schemes, although any tax avoidance scheme must be registered with HMRC. And whilst tax counsel may give an opinion to the effect that a scheme is within the law, such opinions can be for subtly different schemes to the one the contractor is investigating. Plus, of course, not only can laws be changed, but existing law can also be reinterpreted as a result of ongoing case law.

'Going offshore' – benefits versus risk for contractors

Ultimately, the downside risk of contracting through an offshore tax solution is that HMRC decides to investigate all the participants and concludes that the scheme is just that, a scheme, and therefore falls outside the rules. In such cases, each contractor who is part of the offshore scheme will have to pay substantial back taxes, plus interest on them, as well as penalties.

HMRC also uses retrospective legislation to declare a scheme that was legal some years ago as no longer legal now. By backdating the legislation, HMRC can catch all the contractors who joined the scheme when it was legal.

On the upside, most offshore tax solutions offer contractors the opportunity to retain up to 85% of their contract value, versus a typical 65% of contract value retained by **umbrella company contractors**. And the rewards can be substantial. For a contractor earning £150,000 per year, that's an extra £30,000 per year, or £2,500 a month. For some, that additional income is worth the risk.

HMRC is gaining increasing powers and budgets on an ongoing basis to tackle tax avoidance. High-earning contractors are profitable and relatively easy targets for inspectors, and this is another key factor contractors should consider when evaluating whether an offshore tax solution is for them.

As of Dec 2009, Employee Benefit Trusts (EBT's) are no longer a tax efficient option for UK contractors due to *NEW* legislation. See **Contractor EBT options end due to "disguised renumeration" laws**.

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