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Alert

The UK Criminal Finances Act 2017 — Failure to Prevent the Criminal Facilitation of Tax Evasion

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The UK Criminal Finances Act 2017 enacts — with effect from a future date, expected to be in September 2017 — a new corporate criminal offence of 'failure to prevent' the criminal facilitation of tax evasion. HM Revenue & Customs ('HMRC'), the UK's tax authority, has also issued draft guidance in relation to the new corporate criminal offence, which will be finalised prior to the effective date.

The territorial scope of the new criminal offence is very wide, and many funds, fund managers and other fund service providers, whether located in the UK, the US or elsewhere, are potentially within its reach. All funds and fund managers need to be aware of the details of the new UK corporate criminal offence and consider what steps they should be taking now to ensure that they do not commit the new offence.

The Corporate Criminal Offence

Under the new law, a 'relevant body' (which could be either a body corporate or a partnership), such as a fund or a fund manager, potentially commits a criminal offence where an 'associated person' of the relevant body facilitates tax evasion by another person. The tax evaded could be either UK tax or foreign tax.

There are therefore two prior criminal offences which are necessary pre-conditions before a relevant body can be found to have committed the new failure to prevent offence. First, a third party (for example, an investor) must commit a criminal offence of tax evasion (either UK tax or foreign tax). Secondly, an associated person of the relevant body must commit the separate criminal offence of facilitating the third party to evade their taxes, for example, by being knowingly concerned in the tax evasion or aiding and abetting the tax evasion by the third party. Associated persons of a relevant body are widely defined to include the relevant body's employees, its agents and any other person who performs services for or on behalf of the relevant body. Thus, a fund's investment manager and administrator are associated persons of that fund. Whilst employees of the investment manager or the administrator are not themselves associated persons of a fund, their acts may be attributed to their employer which is an associated person.

It is not a requirement that there should have been actual convictions or prosecutions of the two prior offences — the actual tax evasion and the criminal facilitation of that tax evasion. It is sufficient for a relevant body to commit the new failure to prevent corporate criminal offence that conduct should have taken place which would have been capable of prosecution under both of those two prior offences even if not actually prosecuted, for example where a case has been settled or compromised.

Territorial Extent

The territorial reach of the new failure to prevent offence is broad, and many non-UK funds and fund managers are potentially within its scope. Where the tax evaded by the third party is UK tax, then no other connection to the UK is necessary for a relevant body to be potentially guilty of the failure to prevent offence if one of its associated persons has facilitated that evasion of UK taxes by the third party. There is no requirement for either the relevant body or its associated person who is facilitating the tax evasion to be in the UK or to have any connection to the UK (and the conduct that constitutes the criminal facilitation offence does not have to have taken place in the UK).

Where it is non-UK taxes that are being evaded by the third party, it is a requirement that both of the two prior criminal offences — the evasion of taxes by the third party and the facilitation of that tax evasion by an associated person of the relevant body — should be offences both under the law of the non-UK jurisdiction and under UK law. However, where that is the case, any relevant body can commit the offence of failing to prevent its associated person from facilitating a third party in evading those non-UK taxes, if the relevant body is a UK entity or carries on any part of its business in the UK, or if the associated person commits any part of the facilitation offence in the UK.

UK fund managers (and non-UK funds with UK managers) will therefore be clearly within the territorial scope of the new offence in all cases, whether the taxes evaded are UK taxes or non-UK taxes (assuming that the evasion of non-UK taxes would be an offence under both UK law and the law of the other jurisdiction). Non-UK entities otherwise carrying on a business in the UK, for example lending in the UK, would be caught in the same way. However, owning an equity stake in a UK entity would not, of itself, deem the non-UK entity to be carrying on business in the UK. Non-UK entities, such as Cayman or US funds or US fund managers, with no connection to the UK should, however, appreciate that they too could commit the failure to prevent offence if one of their associated persons — for example, a service provider in the case of a fund or an employee in the case of the manager — either facilitated an investor in evading UK taxes or facilitated an investor in evading non-UK taxes and carried on any part of that facilitation activity in the UK.

The Defence of Reasonable Prevention Procedures

The new failure to prevent criminal facilitation offence is a strict liability offence. If the two prior criminal offences have been committed — tax evasion and the criminal facilitation of that tax evasion — then the relevant body is *prima facie* guilty of the new corporate criminal offence. The relevant body has a defence only if it can successfully demonstrate that it had reasonable procedures in place to prevent the facilitation of tax evasion by its associated persons (or, exceptionally, that it was not reasonable in all the circumstances to expect it to have any prevention procedures in place).

Fund managers and funds should therefore be considering now the kinds of policies and prevention procedures which they need to put in place to ensure that they would have a robust defence to prosecution, if any of their staff, service providers or other associated persons were to engage in activity that constituted the criminal facilitation of tax evasion by a third party, such as an investor. HMRC's draft guidance — which will be finalised prior to the effective date of the new offence — identifies six guiding principles to which relevant bodies should have regard in developing their prevention procedures:

1. Risk assessment — relevant bodies should undertake an assessment as to how far their associated persons might have the motive, the means and the opportunity to facilitate tax evasion offences.

2. Proportionality — prevention procedures should be proportional to the level of perceived risk.[1]
3. Top-level commitment — senior management should take responsibility for determining and implementing prevention procedures, including by raising awareness, having responsibility for risk assessments and overseeing the implementation of the policy.
4. Due diligence — relevant bodies should conduct a level of due diligence on their associated persons that is consistent with a level of risk identified under their risk assessment.
5. Communication and training — relevant bodies in high-risk sectors are likely to need to communicate their policies and procedures to staff and other associated persons to ensure that these are well understood throughout the organisation.
6. Monitoring and review — relevant bodies should monitor their risk assessment and other prevention procedures over time and ensure that these are kept up-to-date as necessary.

Implications for Fund Managers

Fund managers must put in place reasonable prevention procedures to ensure that their staff, contractors, services providers and other associated persons are not involved in the facilitation of tax evasion. The burdens on managers may be greater given that they will have a larger number of its own staff involved in running its business. The manager could, for example — if it did not have reasonable prevention procedures in place — commit the corporate criminal failure to prevent offence if one of the manager's investor relations team or a third-party placement agent procured or allowed an investor to invest in the fund whilst knowing or suspecting that the investment was being made as part of arrangements for tax evasion (such as non-declaration of income or assets to tax authorities).

It will therefore be particularly important for managers to put in place appropriate measures for staff training in relation to the specifics of the new offence, and communicate to all staff that the manager has adopted, with the full endorsement of senior executives, and will enforce a 'zero tolerance' approach to tax evasion. As well as training staff and communicating policies with a view to establishing an appropriate culture, managers are likely to need to supplement these measures by establishing clear and robust 'whistleblowing' and reporting procedures where staff either suspect tax evasion by investors they are dealing with or are concerned that other members of staff or associated persons of the firm may be facilitating tax evasion.

Other aspects of the six guiding principles will also remain relevant to fund managers. In particular, fund managers are likely to need to consider measures in the areas of risk assessment, demonstrating the commitment of senior executives, and due diligence, review and monitoring, both in relation to their service providers and also to their employees, staff, consultants and other associated persons.

Implications for Funds and Fund Directors

For funds, appropriate measures are likely to include ensuring that the directors have a full awareness and understanding of the new offence and demonstrate a commitment to putting in place and operating reasonable prevention procedures. Fund directors should regularly review and monitor the fund's relationships with its key service providers — such as the administrator and investment manager — and keep in mind that they have a responsibility to consider whether those service providers may be involved in facilitating tax evasion.

[1] It is anticipated that most businesses in the financial services arena, including funds and fund managers, will be considered to be operating in a sector that poses a high risk of tax evasion, particularly where there is an offshore element.

Fund directors should also consider how the implications of the new offence, and the fund's policies and procedures for avoiding its commission, are communicated to investors, for example by way of disclosures or risk factors in offering memoranda or marketing documents, and by communications in investor side letters. Funds should also consider whether their subscription documents should be amended so as to require representations that investors are not investing in the fund as part of activities that might constitute tax evasion.

Finally, fund directors should consider carefully whether any dealings in interests in the fund offer any indications of tax evasion by investors (and indirectly of the facilitation of that tax evasion by the investment manager, the administrator or other associated persons of the fund). Such evidence might be, for example, the making of a fund investment followed by its immediate redemption, frequent switches of an investment between different currency classes of the fund or a lack of clarity over the identity of the ultimate beneficial owners of an investment in the fund. Managers should also be on the lookout for these kinds of activities, since they could equally be an indication that staff or other associated persons of the manager were engaged in facilitating tax evasion by an investor.

Next Steps

When implementing prevention procedures, both funds and their managers may want to build upon their existing anti-bribery and corruption or anti-money-laundering procedures. Whilst this may offer a useful starting point, funds and managers will now need to consider tax evasion as a separate matter and develop their practices and awareness to ensure that updated policies and procedures are appropriate to address their obligations in the context of the new criminal offence.

Authored by Nick Fagge and Christopher Hilditch.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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London | New York | Washington DC
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