C L I F F O R D

C H A N C E

FAILURE TO PREVENT THE FACILITATION OF TAX EVASION

THE NEW EXTRA-TERRITORIAL UK CRIMINAL OFFENCE AND ITS IMPACT ON PRIVATE EQUITY

The UK has enacted a new corporate criminal offence of failing to prevent the facilitation of tax evasion by employees and other associated persons. It is highly extra-territorial, applies to businesses worldwide, and can apply to the evasion of non-UK taxes as well as UK taxes.

There is only one defence to the offence: that the business has put reasonable procedures in place to prevent the facilitation of tax evasion.

This creates new risks for private equity. It's possible, but very unlikely, that an employee of a private equity fund could deliberately set out to facilitate tax evasion for a third party. What's much more likely is that a private equity company finds itself prosecuted for tax evasion by foreign tax authorities over what in reality is a civil dispute. Either scenario may now result in UK criminal liability for the fund and/or manager, with the prospect of unlimited fines and considerable regulatory and reputational damage.

This briefing summarises the new offence, and the prevention measures private equity funds and fund managers should have in place now so that, if worst comes to the worst, they can avail themselves of the defence.

Why is the UK enacting this legislation?

There have been several well-publicised cases of bank employees outside the UK facilitating tax evasion by UK residents. The UK authorities wished to prosecute the banks involved, but under current law found themselves unable to do so.

The British Government therefore created two new corporate criminal offences in the Criminal Finances Act (**CFA**). One applies to the facilitation of UK tax evasion; the other to the facilitation of foreign tax evasion. Both are "strict liability" – i.e. the intention of a company and its senior personnel is irrelevant, and the mere fact that there has been facilitation of tax evasion by an employee or another associated person is sufficient for a criminal offence to have been committed. Whilst the original target of the legislation was banks and financial institutions, the legislation applies to all businesses.

The British Government wishes other countries to adopt similar legislation, and HM Revenue & Customs (**HMRC**) are in active discussions with their counterparts around the world to encourage them to do so. The hope, therefore, is that if the UK passes legislation criminalising the facilitation of (for example) German tax evasion, then Germany will respond by criminalising the facilitation of UK tax evasion.

What would be the consequences of a private equity fund being successfully prosecuted?

The immediate consequence would be unlimited fines for the fund and/or the fund manager.

However there could in many cases also be significant regulatory consequences for the fund manager. The regulatory authorisation of many fund managers is often dependent on it being a "fit and proper person". Regulators may assert that a fund manager that has been convicted of a criminal offence is not "fit and proper" and therefore, in a worst-case scenario, regulatory authorisations could be lost. Such a prosecution can also affect relations with investors, both in existing funds (such as breach of representations by the fund manager as to compliance with laws) and on future fund-raisings (such as under "bad actor" rules).

Which private equity entities are within scope of the offences?

All companies and partnerships worldwide are within scope if their employees or other associated persons facilitate UK tax evasion, whether or not the businesses themselves have any connection to the UK.

Where it is foreign tax that is being evaded, a company or partnership is in scope only if it is established in the UK, carries on business in the UK, or any of the conduct which facilitated tax evasion took place in the UK.

So if, for example:

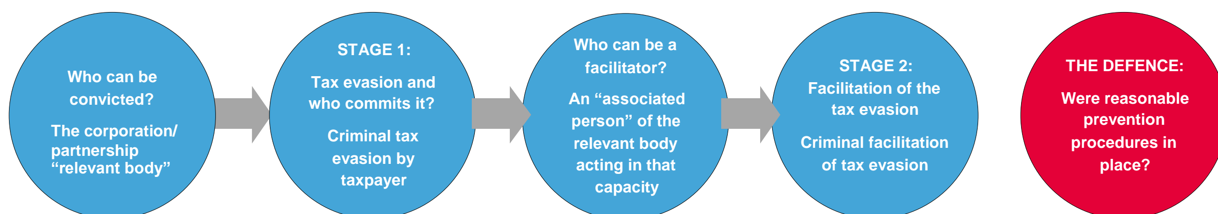
- If an employee of a UK private equity fund manager facilitates the evasion of German tax, then the fund manager has potentially committed an offence.
- If on the other hand the facilitation of German tax evasion is committed by an employee of a US fund manager of a US private equity fund, then the fund manager and fund should be out of scope.
- If a private equity fund invests in a UK oil and gas exploration business , and an employee of that portfolio company facilitates the evasion of

Nigerian tax by a Nigerian subsidiary, then the portfolio company may have committed an offence (but likely not the fund or fund manager; see further below).

What are the conditions for the offence to apply?

The offence will apply if:

- there has been criminal tax evasion of UK or non-UK taxes by a taxpayer. For evasion of non-UK taxes, the corporate offence will apply if the tax evasion is a criminal offence in the taxpayer's home jurisdiction and would also be an offence if it were committed in relation to UK tax;
- an employee or other "associated person" of a company or partnership facilitates tax evasion for that taxpayer; and
- the act of facilitation itself is a criminal offence in the taxpayer's home jurisdiction and (if that is not the UK) would be an offence if it were committed in relation to UK tax.



The "associated person" concept is broad in scope and includes any person who acts as agent for a company/partnership, or who carries out services on its behalf. So, for example:

- An employee of a fund manager is likely to be an "associated person" of the funds he or she manages, as well as of the fund manager entity. Hence their actions potentially put the funds and fund manager at risk.
- An employee of a fund manager who acts as director of a portfolio company is likely to be an "associated person" of the portfolio company, the fund manager, and the fund or funds holding the portfolio company. Hence their actions potentially put the portfolio company, the funds and the fund manager at risk.
- An employee of a portfolio company who is not an employee, partner or agent of a fund manager is likely to be an "associated person" of the portfolio company, but not of the fund manager or the fund or funds holding the portfolio company. Hence their actions should only have the potential to put the portfolio company at risk.

What are some examples of how a private equity fund entity could commit an offence?

Some examples based upon our previous experience are:

Carried interest

- Bob is a UK resident non-domiciled individual who works in the UK for a UK private equity fund manager.
- The fund manager has taken advice around the tax treatment of "non-doms" like Bob, and has been told that under the new rules their carried interest will be subject to UK tax, irrespective of their status as non-doms. It has passed this advice onto Bob and his colleagues.
- Bob asks his friend Ned, who works in the fund admin department, to pay his share of all carried interest into an offshore account in the name of a nominee so that HMRC won't be able to trace the money.

Bob has evaded UK tax and Ned facilitated that evasion. The fund manager is criminally liable, and potentially subject to unlimited fines. Its only defence is to show that it had reasonable prevention procedures in place to stop evasion of this kind.

Tax structuring that crosses the line

- Alice is a UK-based fund manager working on a private equity acquisition of Teasdale Ltd, a mining company in Freedonia. Freedonia is a developing country with weak institutions and rule of law.
- Alice is advised by Freedonian tax counsel that any debt which is "pushed down" into the Teasdale operating company will not technically give rise to interest tax relief - however the tax authorities in Freedonia are understaffed, and it is unlikely they will ever check this point.
- Alice proceeds with the debt push-down, and instructs the Teasdale accounting team to claim tax deductions for the pushed-down debt.

Teasdale has evaded Freedonian tax and Alice facilitated that evasion. The fund and the fund manager are each criminally liable in the UK, and potentially subject to unlimited fines. Their only defence is to show that they had reasonable prevention procedures in place to stop evasion of this kind.

Historic liability

- Firefly Partners IV, a US private equity fund, acquires Sylvania AG, a boutique Swiss private wealth adviser.
- It subsequently transpires that, for years, Sylvania's employees have been systematically helping UK customers to hide their funds in offshore structures to evade UK tax. Firefly Partners IV and its fund manager had no knowledge of this.

The UK customers evaded UK tax and Sylvania's employees facilitated that evasion. Sylvania is criminally liable in the UK and potentially subject to unlimited fines. It seems unlikely on the facts that the defence will be available.

There should be no question of liability for Firefly Partners IV or its fund managers – however the value of their investment may be significantly impacted. The fact that Firefly did not own Sylvania at the time the evasion took place is irrelevant.

Referral

- Claypool Partners is a private equity fund manager based in London.

- Rosa, an executive at Claypool, is speaking with Ricardo, an executive at one of their Italian portfolio companies, when Ricardo complains about the very high level of tax he is currently paying in Italy.
- Rosa refers Ricardo to Driftwood LLP, an Italian tax boutique which she knows has been the subject of criminal enquiries for helping clients evade tax, and she suggests to Ricardo that makes them ideal for his purposes.
- Driftwood LLP subsequently help Ricardo hide his assets from the Italian tax authorities.

Ricardo evaded Italian tax with the assistance of Driftwood LLP. Rosa facilitated this. Claypool Partners is criminally liable in the UK and potentially subject to unlimited fines, and the private equity fund itself may be liable too.

What is the defence?

The only defence is that the companies/partnerships in question had reasonable prevention procedures in place. These procedures will often include:

- commitment from top level management to prevent employees facilitating tax evasion and fostering a culture where tax evasion is unacceptable;
- applying proportionate due diligence procedures to persons it will do business with (or refer business to), to mitigate potential sources of tax evasion risk;
- a risk assessment exercise to assess the risk of tax evasion facilitation by employees and other "associated persons" in the different areas/geographies of its business; and
- putting proportionate measures in place to mitigate risks identified in the risk assessment exercise, for example training or tax evasion-specific guidance and policies.

Some businesses will have extensive procedures in place already; for others this will be a new area. However in all cases it is necessary to take at least some clear steps as a direct response to the CFA.

The principles in relation to reasonable prevention procedures are the same as those required to defend a charge under section 7 of the Bribery Act 2010, so many institutions should already be familiar with them (see our briefing). However, the substance of what is required is different given the more amorphous and varied nature of tax evasion, and should be considered on a case-by-case basis.

Does the offence apply to tax avoidance?

No – the offence only applies to criminal tax evasion.

Sometimes tax authorities and commentators try to blur the boundary between evasion and avoidance, but the difference is that evasion involves deception and/or hiding assets, funds or elements of a

transaction or arrangement from a tax authority, whereas avoidance does not involve deception or concealment.

Under what circumstances will the UK prosecute a foreign business for facilitating the evasion of foreign tax?

The UK prosecuting authorities will have no hesitation in prosecuting UK or foreign businesses for failing to prevent facilitation of UK tax evasion. In the case of foreign tax evasion, a prosecution will only be brought if there is a public interest in doing so.

So, for example, small scale facilitation of Greek tax evasion by employees of a Greek bank is unlikely to be of much interest to the UK authorities, even if that bank has a UK representative office and so is technically within the scope of the offence.

However prosecution is much more likely if a particular instance of tax evasion facilitation becomes widely publicised and/or the subject of political controversy in the UK. This is perhaps most plausible if the evasion is particularly large-scale, and/or involves prominent individuals.

When do the new rules come into force?

The new offences come into effect from 30 September 2017.

This creates quite a challenging timeframe for the private equity industry. HMRC guidance permits implementation of new prevention measures to take place after 30 September, but the risk assessment exercise must be complete by that date and there must be a implementation plan ready.

Further information

If you would like further details on any aspect of this briefing, or how it applies to your business, please speak to your usual Clifford Chance contact or any of those listed below.

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