Technical Briefing

September 2017

Subject	The Criminal Finances Act 2017 and the "failure to prevent the facilitation of tax evasion"
Effective date	30 September 2017
Impact	BVCA Members are strongly recommended to adopt reasonable prevention procedures (and to request their portfolio companies to do likewise) to mitigate against the risk of being found strictly liable for the new criminal offence of failing to prevent the facilitation of tax evasion by a third party.

This Briefing has been prepared by the BVCA Taxation Committee. The BVCA would like to thank all the contributors who have worked on this document, including Russell Warren (Travers Smith), Jenny Wheater (Linklaters), Gideon Sanitt (Macfarlanes), Jonathan Page (PwC), Nigel Barker (Deloitte) and Maria Carradice (Mayfair Equity Partners).

Summary

In July 2017 the BVCA held a series of workshops on the Criminal Finances Act 2017 and the "failure to prevent the facilitation of tax evasion" offence (the "FTP Offence"). We discussed how the legislation will affect BVCA member firms and held meetings with HMRC to discuss their feedback.

The aim of this document is to highlight the scope of the legislation and how it applies to the venture capital and private equity industry.

The facilitation offence

The new offence is contained in the Criminal Finances Act 2017 and is, in reality, two separate offences. The first is the offence of failing to prevent the facilitation of UK tax evasion. The second is the offence of failing to prevent facilitation of foreign tax evasion. However, they have many key features in common. In each case, a body corporate or a partnership (referred to as a "relevant body"), whether established for business or non-business purposes, may be prosecuted for failing to prevent the criminal facilitation of tax evasion if:

- a person evades tax (that person can be unrelated to the relevant body);
- an associate of the relevant body criminally facilitates that evasion (while acting in the capacity of an associate of the relevant body); and
- the relevant body is unable to show they had in place "reasonable prevention procedures" (or they are unable to show that it was not reasonable for prevention procedures to be in place).

An in depth summary of the legislation can be found in the May 2017 BVCA Technical Bulletin.

Key Points from HMRC meetings with the BVCA

The following guidance reflects our discussions with HMRC but they encourage firms to get in contact with them regarding specific issues. HMRC can be contacted at consult.nosafehavens@hmrc.gsi.gov.uk.

Key considerations for BVCA members:

- Tax evasion has always been a criminal offence as has the knowing facilitation of tax evasion. There should be zero tolerance of both offences. The FTP Offence now places criminal liability on a company or partnership where one of its associates is involved in knowingly facilitating tax evasion by a third party. Under the new offence, firms could be liable for behaviour carried out on their behalf so they should carefully consider risks from both a fund and portfolio company perspective.
- While member firms will already have numerous regulatory and compliance procedures in place these cannot be relied upon as "reasonable prevention procedures" for the purposes of the FTP Offence without separate consideration of the specific risks relevant to this area and the policies required to address these risks. A different and stand-alone approach is required.
- The FTP Offence is a criminal offence. HMRC are therefore obliged to conduct questioning under caution when investigating a relevant body which they suspect may have committed an offence. HMRC have confirmed that questioning under caution would not be made public prior to any court process.

In relation to putting "reasonable prevention procedures" in place, we recommend that the following is completed by 30 September 2017:

- **Risk Assessment** – a firm must have undertaken a risk assessment to identify its associates and consider the extent to which they may have the means, motivation and opportunity to facilitate the tax evasion of third parties.
- **Top Level Commitment** – the firm's board or partners must demonstrate commitment to developing, and then committing to, an FTP policy and ensuring that they foster a culture in which activity intended to criminally facilitate tax evasion is never acceptable. A single board member/partner should be appointed to take overall responsibility for ensuring the development of the policy, implementation of the procedure and ensure ongoing compliance.

We recommend the following is implemented as soon as is reasonably practicable after 30 September 2017:

- **Policy** – following the risk assessment reasonable and proportionate procedures should be adopted and incorporated into a firm's prevention of the facilitation of tax evasion policy (the "FTP Policy"). The timeframe for the adoption of these procedures and policies will be determined largely by the size and complexity of the organisation in question.
- **Communication and Training** – once adopted, the firm should commence a training programme for its employees and, where appropriate, other associates. Refresher training should be should be provided regularly.
- **Ongoing due diligence & risk assessment procedures** – written procedures alone will not be a sufficient defence and firms will need to demonstrate that such procedures are actively implemented and monitored. Firms will need to consider the appropriateness of their risk assessment procedures in light of their due diligence of those risks. Their control, proximity and supervision of the associates in question will help inform their approach.

- **Monitoring and review** - the risk assessment and relevant procedures should be kept under regular review, for example as part of an annual review cycle. Firms should identify new risks as they emerge and adapt policies and procedures as required. In particular, regard should be given to any new guidance published by HMRC or any breaches of the firm's existing policies and procedure.
- **Timing** - in most cases, HMRC will expect relevant procedures and policies to have been adopted and training completed in the 12 to 24 month period following 30 September 2017 but we recommend that this is undertaken as soon as is reasonably practicable.

Further information and contact points with HMRC:

- The legislation and HMRC guidance can be found here.
- HMRC have offered to benchmark procedures through their policy team.
- If firms wish to seek further assurances or guidance on new potential risks they may have identified, they can contact HMRC directly through the fraud contact point.

Other industry guidance:

- **UK Finance** (formerly the BBA) have drafted Financial Services Guidance (available soon).
- **The Law Society** have drafted separate guidance for their members, which is available here.

Q&A with HMRC – issues for venture capital and private equity firms

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1. Risk Assessment

Overview

Q – What steps towards implementation of reasonable prevention procedures should firms have in place by 30 September 2017?

We recommend that firms should have completed their initial risk assessment by 30 September 2017. Without evidence to demonstrate that an appropriate risk assessment has taken place, firms are unlikely to be able to successfully raise the reasonable prevention procedures defence in court. A list of prevention procedures alone, without documentation of an appropriate risk assessment which provides evidence to support the proportionality of those prevention procedures based on the risks faced by the relevant firm, is unlikely to be sufficient to form the basis of a successful defence.

Firms are expected to complete a risk assessment by the end of September 2017 and then they should develop an implementation timetable based on prioritising procedures to address the highest level risks first.

The risk assessment should cover both client facing risks and also the risk that the firm's own staff or service providers deliberately facilitate tax evasion with or without the tacit approval of management. This will involve considering the means, motive and opportunity that relevant associates (including employees) have to knowingly facilitate the criminal evasion of tax.

Firms are likely to have existing policies and procedures in place to deal with other compliance risks such as under the Bribery Act 2010 and it may be possible to tie some of the requirements of the reasonable prevention procedures defence into existing procedures. However, firms must conduct a separate assessment of their risks in this area and policies and procedures must be specifically tailored to address these risks. Simply adding the words "and the criminal facilitation of tax evasion" into existing policies is unlikely to be sufficient and firms should consider the specific risks they face in this area, albeit that procedures may link into existing compliance arrangements.

Q – Who within a firm should be responsible for undertaking their risk assessment?

Generally, most firms will already have an individual within their organisation who is responsible for dealing with issues of fraud and anti-bribery. In many cases, it will be advisable for the same person to take responsibility for co-ordinating the approach on the FTP Offence and, as a minimum, they should be aware of and involved in the risk assessment process.

All firms, regardless of size, should identify a senior person who has oversight and control of these procedures. It will be important for this individual to have a sufficient understanding of the firm's overall policies and procedures so that they are well placed to give evidence in court if the firm were ever charged with an offence.

Q – How often should risk assessments be undertaken?

The appropriate frequency of risk assessments will depend on the level and nature of risks faced by a particular firm. In order to demonstrate that they have adopted a reasonable approach, firms with higher risk profiles, and particularly those operating in areas where the business model or the nature of risks faced by the business are swiftly changing, are likely to be expected to update their risk assessments more frequently than low risk firms with a consistent risk profile.

For example, firms could include updating their risk assessment as part of an annual review cycle in case a new risk emerges, as well as considering the position on a case by case basis if new guidance is published by HMRC or breaches of the firm's policies and procedures come to light.

Which Entities Should be covered by the Risk Assessment?

Q – Can risk assessments, policies and procedures be developed on a group-wide basis?

Ultimately, each relevant body within a group is independently responsible for ensuring that it has a suitable risk assessment and relevant policies and procedures to enable it to rely on a reasonable prevention procedures defence.

In practice, it will often be possible for one entity to take responsibility for commissioning a risk assessment to cover the activities of all relevant entities within a group. Equally, where similar risks apply across the group as a whole, it may be appropriate to develop group-wide policies and procedures, although each company should separately consider those standard policies and procedures in the context of the risk assessment as it applies to them in order to satisfy themselves that the procedures constitute reasonable prevention procedures in their particular circumstances.

Where a group is made up of a number of distinct business lines, which have substantially different risk profiles, it may be more appropriate to put in place separate risk assessments and procedures in relation to each individual business line.

Q – Which persons and entities should be considered as part of a firm's risk assessment?

Under the new rules, a firm can be liable for the actions of its associates. "Associates" is widely defined and includes both employees and agents of the firm as well as any other person who provides services for or on its behalf. This test is wide enough to make a firm liable for the actions of third party suppliers, subcontractors and anyone else employed by another legal entity on the firm's behalf.

The rules are intended to prevent firms sub-contracting out of their liability and firms can be liable even if management were not aware of the criminal activity.

The extent to which a firm will be expected to cover associates in its risk assessment and prevention policies depends on how reasonable this would be in the circumstances. This will be heavily influenced by the degree of control and influence that the firm has over a particular associate's activities. Additionally, a firm that has a higher risk profile is likely to be expected to put in place more stringent prevention procedures in respect of its associates than a firm whose associates can generally be categorised as low risk.

Q – Which entities within a group should be covered by the risk assessment and prevention policies?

There are two failure to prevent offences under the new legislation, one relating to UK tax evasion and the other to foreign tax evasion. For the offence to be committed there must be a UK nexus. Either UK tax will have been evaded, or, where non-UK tax was evaded either the relevant body must be incorporated or carry on a business in the UK or any part of the conduct constituting the facilitation offence must have taken place in the UK.

As a general rule, a group's risk assessment and prevention policies should cover all corporate bodies within the group that are incorporated in or have substantial activities in the UK. Firms should also consider the extent to which it is reasonable and appropriate to risk assess and require other overseas entities within the group to comply with the prevention procedures. This judgment will depend on a number of factors including:

a. the risk level of the group as a whole and particularly in relation to its overseas activities;
b. the extent the which overseas companies within the group provide services for or on behalf of UK-based entities such that they could be considered to be associates of the UK-based entities; and
c. the level of oversight and control the UK companies have over the overseas companies within their group.

Q – When will subsidiaries be associates of the parent entity?

Subsidiaries are not automatically associates of their parent entity. Whether or not a subsidiary is an associate of its parent depends, as always, on whether the subsidiary is providing services for or on behalf of the parent.

As a simple example, where a subsidiary operates payroll on behalf of a parent company, the subsidiary will be an associate of its parent and the parent could potentially be liable for any criminal facilitation of tax evasion in the subsidiary in connection with the operation of that payroll.

Even if liability does not flow back to the parent, liability may still be attributed to the subsidiary trading in its own right rather than on account of services provided for or on behalf of the parent company. Therefore there is a risk of reputational damage to the entire group, as well as the potential impact on parent companies of any financial penalties levied on the subsidiary itself.

It may be appropriate in larger organisations for subsidiaries with a separate management team to be given responsibility for taking the lead on implementing the group-wide prevention programme at that subsidiary's level. However, it may well be helpful for a single representative within the group to have oversight and knowledge of the implementation process, in particular to facilitate responding to any queries from HMRC.

Application to Funds and Portfolio Companies

Q – When could a portfolio company be considered an “associate” of the fund?

As a starting position funds are not automatically liable for actions of their portfolio companies. However, each situation should be considered on its particular facts and if a portfolio company is providing services for or on behalf of its fund investor then it will be an associate of the fund.

Q - How might this position change if there are investor directors from the fund on the board of the portfolio company?

Investor directors may be employees of the fund entity and as a result, they would be automatically associates of the fund. Therefore the fund will be liable for any criminal facilitation of tax evasion committed by the director in their capacity as an employee, i.e. in their role as director of the portfolio company. It should be considered whether, through the investor director, the fund could potentially be liable for activities of the portfolio company in which the investor director (or any other employee of the fund) has had involvement.

Investor directors should be conscious of their own responsibilities in relation to the relevant portfolio company. If the portfolio company is investigated by HMRC, then it is likely that a representative of the firm (which could include the investor director) will be questioned by HMRC under caution.

If investor directors appointed by a fund manager are not employees of the fund then whether or not they will be associated with the fund at the time of the facilitation activity is likely to depend on the specific circumstances and whether or not it can be argued that the individual was providing services for or on behalf of the fund.

For example, if the portfolio business is a restaurant and a member of the portfolio’s finance team criminally facilitates fraud when paying staff, it might be difficult to argue that they were acting on behalf of anyone else besides the portfolio company itself. Therefore the portfolio company would be in the scope of the offence but the fund itself should not be liable.

However, if in the same company, a director of the holding company (appointed by the manager) criminally facilitated the evasion of tax by an individual co-investor by paying dividends to an offshore account, and the legal liability to pay out dividends was the responsibility of the fund manager, then it could be argued that this was a manager responsibility delegated to the holding company director. This director would be an associated person of the manager and therefore the manager may be liable under the FTP Offence. It would then depend on the facts and the prevention procedures the manager had in place as to whether this would ultimately lead to a prosecution.

Q – If a director was working across three different portfolio companies at the time they criminally facilitate tax evasion, which entity would HMRC consider to have committed the offence? Would it always be the largest entity?

No, an entity is only liable for the criminal facilitation of its associates to the extent that such acts are committed in their capacity as an associate of that entity. In the first instance, HMRC are likely to consider which entity, or entities, the director was performing services for at the time they criminally facilitated tax evasion, as well as considering any other factors in the prosecuting guidelines. It is possible that more than one entity could be prosecuted in relation to the offence, e.g. if the same criminal facilitation activity was committed in relation to the business of each of the portfolio companies, or if the director were considered to be providing services for or on behalf of both a portfolio company and the fund. Each entity will have a defence if they have put in place reasonable prevention procedures.

For example, Person A is employed by a foreign legal entity, which is itself owned by a UK partnership. Person A pays a bribe to an overseas tax authority in connection with a debt which the foreign entity was in the process of raising on behalf of the UK partnership. Although Person A was contractually employed by the foreign entity, the UK authorities could potentially seek to prosecute the UK partnership as Person A was arguably providing services for the UK partnership at the time of the facilitation activity. Depending on whether or not the foreign entity has a place of business in the UK, or whether any part of the facilitation activity took place in the UK, it is possible that the UK authorities might also seek to prosecute the foreign entity.

To avoid prosecution, the UK partnership should ensure that it had put in place reasonable prevention procedures in relation to the foreign legal entity, for example requiring the foreign legal entity to comply with the terms of the UK partnership's own FTP Policy and procedures in relation to employees engaged in acting on its behalf.

Q – What are the risks faced by the fund in circumstances where a portfolio company is not an associate of the fund?

In practice, funds should be careful when relying on technical arguments that they are not liable for the activities of a particular portfolio company.

Tax evasion receives a high level of media attention and there is potential for adverse publicity for the fund in circumstances where its portfolio company is found guilty or even publically investigated for this type of offence. Additionally, the potential negative impact of a conviction on the profitability of the portfolio company itself should also be considered. In particular, if the portfolio company operates within a regulatory regime, they could potentially lose their licence or be required to operate under strict controls, either in the UK or in the jurisdiction where the facilitation or tax evasion offence is committed. Many jurisdictions have a zero-tolerance approach to criminal convictions, including the US and Singapore.

In extreme cases, if the portfolio company were found guilty of an offence, there is a risk that the Secretary of State could seek to bring disqualification procedures against investor directors of the company, for example if he considered that their failure to ensure that appropriate prevention procedures were put in place was evidence that they were unfit to be concerned in the management of a company.

Q – When considering an investment, what should the fund manager do to ensure the portfolio company has the correct procedures and at what level should they ensure these are in place within the fund structure?

There are a number of factors to consider when deciding on the extent of oversight that is appropriate in a particular case. These will include (a) whether the fund has control (e.g. a majority stake) over the portfolio company; (b) the likely level of risk associated with the investment; and (c) an analysis of how likely it is that the portfolio company is an associate of the fund.

Given the potential negative consequences for a fund of a conviction under this offence of one of its portfolio companies, we anticipate that most funds will put in place some degree of prevention procedures in relation to their portfolio companies.

For example, this could include a requirement in investment agreements that the portfolio company take steps to put in place reasonable prevention procedures and that it provides regular updates to the fund demonstrating its compliance. Going forward, it is also likely to be appropriate to raise relevant due diligence questions about a company's existing prevention policies and procedures, as well as their risk exposure in this area, at the time of an initial investment.

Q – When will a fund or investing company be considered an "associate" of a portfolio company? In particular, what is the position where the fund or investing company simply owns the company and passes over responsibility for running the company to another management company?

The question as to whether or not a fund is an associate of its portfolio company is fact specific and will depend on the level of involvement that the fund has with its portfolio company. As such this question should be considered on an investment-by-investment basis to determine whether the fund is providing any services for or on behalf of the portfolio company.

For example, a fund may be an associate of the portfolio company is in circumstances where the fund provides management services to the company. In particular, the position should be considered carefully where the fund takes a more active role in managing its investment, e.g. in circumstances where the portfolio company is performing below expectations or if the fund has investment directors on the board of the portfolio company.

If a management company is used to provide management services to the portfolio company on behalf of the fund, then that management company itself may be an associate of the fund, and should be considered as part of the fund's risk assessment.

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2. Proportionality of Risk-based Prevention Procedures

Determining the scope of reasonable prevention procedures

Q – If a firm is suspected of committing the failure to prevent the facilitation of tax evasion offence, HMRC have stated that they would interview relevant representatives of the firm under caution in order to establish whether the firm had reasonable prevention procedures in place.

Are there any specific policies or procedures that firms could implement to prevent this given the risk that this could cause reputational damage?

HMRC are currently talking to organisations and individual businesses now to assist them to ensure they have adequate procedures in place, but HMRC are not able to "sign off" on procedures in advance in a way which could lead to HMRC being unable to prosecute. HMRC have confirmed that if there is a suspicion that the offence may have been committed, there must necessarily be an interview under caution as there will be an investigation and HMRC will need to gather information in a form that they can submit as evidence.

Most investigations are low profile, very few are made public and the investigations would usually involve a handful of people. In most cases, provided there is a reasonable procedures defence the case would never go to trial. If an investigation were to be made public in any way, individual firms would be responsible for managing the potential media reaction.

Q – Are firms expected to put in procedures to address all possible risks? Are all firms be expected to carry out the same level of compliance?

Firms are only expected to have in place reasonable prevention procedures which are proportionate to the level of risk. Many firms are taking a risk averse approach and we understand that HMRC are stress-testing firms who invite them to do so. The proportionality of particular procedures will depend on the size of the relevant business and the risk level it faces, which will determine whether the firm could reasonably be expected to implement a particular procedure.

A large company with several compliance officers would be expected to do more than a small firm with a limited number of employees who each have multiple roles within the organisation. The procedures that firms put in place will always depend on the risk involved; if it is a low risk and low impact situation, less rigorous procedures may still be reasonable.

Q – What can firms do to ensure adequate procedures are in place and that risk is minimised?

There are no minimum procedures specified in the legislation and, in theory a firm can chose to have no prevention measures in place. However, if the firm has no prevention procedures then the defence of reasonable prevention procedures is unlikely to be available to them unless this approach is justified by their risk assessment. It is, of course, possible that a risk assessment could identify no risk and mean that having no procedures is regarded as sufficiently robust. However, in the context of the funds industry, this would be quite unusual.

Since there is no absolute requirement to put in place prevention procedures, regulators cannot generally ask to review these procedures. However, representatives of the firm will need to be able to point to relevant procedures when interviewed under caution if the firm wishes to be able to rely on the reasonable prevention procedures defence. Firms should consider the identity of the person who would defend their position in court if required and ensure that such person is aware that this is their responsibility. If, under questioning, this person appears unfamiliar with the risks and procedures in place to mitigate such risks, the effectiveness of the procedures may be more open to question.

The risk assessment is crucial to ensuring that prevention measures are adequate. Only when the potential level of risk has been scrutinised can proportionate steps be taken. Hence, the most important thing a firm can do to ensure its procedures are adequate is to conduct a risk assessment and ensure that their policies reflect the findings of such risk assessment.

Many firms will include their new procedures in updated governing policies or as part of a wider compliance programme. Firms should also monitor the adequacy of their procedures, especially with changes of personnel and structure. Circumstances change and procedures may need to revised, for example where new risks emerge or breaches of existing policies are identified. It would be good practice to review the procedures on a regular basis to see if any changes may be warranted.

Q – The HMRC guidance states that firms should consider "*proximity* and *control*" when determining the reasonable procedures to apply in the context of its associates. What does this mean in practice?

Firms are first required to identify their associates and then to consider what procedures can be reasonably be put in place in relation to them. That will depend on the risk level of each particular associate, or category of associates, and what the proportionate response is to that risk.

What is proportionate will depend on proximity and control. For example, a firm is likely to have greater proximity to someone they directly employ than to contractors. This means that the prevention requirements in relation to employees will be more onerous since it is reasonable to expect that a firm has the ability to ensure that its employees implement and comply with its own prevention procedures. It may be more difficult for a firm to ensure that its contractors comply with specific procedures, but that does not mean that a firm is absolved from the requirement to consider implementing any procedures at all. However, the procedures may be proportionately less onerous, depending on the risk level identified.

Generally, it would be good practice to request confirmation that any contractor has in place a policy and procedures to prevent the criminal facilitation of tax evasion. This may be sufficient in many circumstances. However, if a transaction involves a “high risk” jurisdiction or industry or there are other high risk factors, it may well be proportionate to undertake a more substantial review. For example, this could involve actually reviewing the policy and procedures implemented by the relevant contractor and obtaining a contractual undertaking that they will be complied with, and will remain in place throughout the duration of the project. Where sub-contractors are used, the firm could include a term in their contract requiring that any sub-contracts include equivalent provisions requiring any sub-contractors to comply with an appropriate FTP Policy.

Proportionate procedures in the context of funds

Q – Should a fund develop an umbrella policy and set of procedures that each of its portfolio companies would be required to implement?

As discussed in section 1 in relation to the risk assessment, the relevant offence is an entity-by-entity offence and therefore each entity must independently consider whether the policy and procedures it has in place are reasonable in the context of the risks it faces.

Where the portfolio companies held by a fund vary substantially in their business activities, it is likely that their risk profiles will vary and therefore those companies would need to individuals consider which policies and procedures are appropriate in order to address those specific risks. As a result, it should not be assumed that an overarching policy is automatically effective for all entities within a structure.

However, the fund will naturally be concerned to ensure that their portfolio companies have a defence to the FTP Offence and it is likely to be advisable for a fund to ensure that each of its portfolio companies are taking steps to implement reasonable prevention procedures. The way in which this is done will vary from fund to fund. In some cases, the fund may develop a set of "minimum standards" that its portfolio companies are required to comply with when developing their policies and procedures. Alternatively, some funds may consider it to be sufficient to include obligations in their investment agreements requiring portfolio companies to put in place a suitable policy and prevention procedures and also to provide regular updates to the fund on the implementation of those procedures and any breaches that may be identified going forward.

Q – As a result of this new legislation, is there an expectation that fund managers should become more actively involved in the operations of their portfolio companies, which they may have previously held at arm's length?

As noted above, except where investor directors are on the board of the relevant portfolio company, a portfolio company is likely to be an associate of the fund in relatively limited circumstances. As a result, it is more likely that the portfolio company itself would be prosecuted (if it fails to have reasonable prevention procedures) rather than the fund. However, as set out above, in practice funds should still be concerned to ensure that its portfolio companies comply with the new rules as any conviction of the portfolio company is likely to have negative financial and reputational repercussions for the fund.

The extent to which funds will become involved in the activities of their portfolio companies in this area is likely to depend on their risk appetite generally, along with an assessment of the likelihood that the relevant portfolio company might fail to independently implement suitable prevention procedures. As a minimum, it may be advisable for funds to include a requirement to implement reasonable prevention procedures as part of any future investment agreements, along with appropriate monitoring procedures.

Q – If a passive investor makes investments in a range of portfolio companies, they do not usually have directors on the boards of the portfolio companies. If something happened in the portfolio company would the investor be still be liable?

The passive nature of the investment renders it unlikely that the portfolio company or its staff or contractors could be treated as associated persons of the investor. However, this will be fact specific and, in the event it is considered a possibility, adequate procedures will need to be implemented depending upon the risks identified.

In any event, as noted above, a conviction for the portfolio company could have a negative financial and reputational impact on the investor and therefore on making an investment, the investor would be well advised to consider the prevention procedures the company has and what risks could arise in relation to that business as part of its due diligence process.

Q – Generally, the fund relies on the employees and officers of each portfolio company to identify any instances where fraudulent tax evasion may have been committed by its employees. For example if the FD of a portfolio company facilitated tax evasion and then attempted to conceal this, the fund would normally rely on people within the portfolio company to spot it. Could the

fund manager be implicated even if adequate procedures were in place at the portfolio company level?

The fund will only be directly liable if the criminal facilitation of tax evasion was carried out by one of its associates.

In the example, this will depend on the capacity in which the FD was acting at the time of the offence and whether the FD was acting "for or on behalf of" the fund or fund manager. Generally, it would be expected that the FD of a company acts "for and on behalf of" that company. However, if the FD were, for example, an appointee of the fund, closely supervised by the fund or had an alternative close relationship with the fund, it is possible that an associate relationship could exist. If the FD was an associate of the fund, then the fund could be liable unless it is able to demonstrate that it had itself put in place reasonable prevention procedures.

Q – For a first-time fund with a small staff, contracts, such as engagement letters, are often put in place to cover a number of years rather than annually re-negotiating terms. Will the firm now be expected to review all their supplier contracts to add in wording in relation to this offence?

This is a question of risk and should be addressed by an adequate risk assessment. If a fund is dealing with large regulated firms (accountants, law firms etc.), they are likely to be considered low risk as they are heavily regulated; therefore, while modifications to subsequent contracts may be advisable, an immediate change is unlikely to be proportionate to the level of risk. If, by contrast, a contract was with a provider in a "high risk" industry or jurisdiction then a review might be warranted and, if justified by the risk assessment, it may be proportionate for the fund to attempt to negotiate additional protections with regard to the offence with its contractor.

A "universal" policy of change, while it might seem to be a safe option, might indicate an absence of thorough risk analysis and a targeted approach is generally preferable. Although, where an entity has a high volume of similar contracts, it may be appropriate to take a blanket approach to certain categories of contracts, where the risk has been appropriately assessed.

Consequences of a breach of a firm's policy and procedures

Q – If HMRC has a suspicion of wrongdoing, will an interview under caution always take place? Is there a benchmark for written policies and procedures that would guarantee those procedures were adequate?

There is no benchmark for policies and procedures in guidance or legislation. Even if adequate written procedures were in place, that does not necessarily mean they are being implemented nor that they have taken account of any relevant changes in circumstance since they were first implemented. As a result HMRC are likely to question relevant individuals under caution to establish whether the procedures are being appropriately implemented and their adequacy monitored on an ongoing basis.

Q – A determined rogue individual can always find a way to get around a firm's procedures, however broad those procedures are. What are the risks faced by funds here? Even if the fund manager were not found to be an associate, presumably discovery of an offence could have a detrimental effect on the manager's relationship with investors and suffer reputational damage.

Provided that a firm has developed, properly implemented and monitored reasonable prevention procedures, the firm should have a defence to the FTP Offence. Such procedures are not expected to be perfect and the mere fact that a particular individual was able to circumvent the procedures does not undermine the availability of the defence. HMRC accept that adequate procedures may not be sufficient to deal with all situations. Nevertheless, if a breach is identified, firms should carefully review their procedures and take appropriate and proportionate steps to close potential loopholes where possible.

Inevitably, there is a risk that a link between the rogue individual's actions and the FTP Offence would be made by the press. Firms will need to manage any negative media reaction and, provided they have implemented appropriate policies and procedures, firms should be in a position to provide a robust response.

Q – Should firms self-report where they have reason to believe an offence may have been committed?

Fraudulent tax evasion and the knowing facilitation of tax evasion are already criminal offences. If a firm identifies that a tax evasion or facilitation of tax evasion offence has taken place, in the first instance the firm should consider their existing reporting obligations, for example under the Proceeds of Crime Act.

If the relevant offence has been identified through the operation of the firm's prevention procedures, then the fact that the offence has been identified may, in some circumstances, be evidence that reasonable prevention procedures are in place. Generally, it is likely to be preferable to self-report any offences in breach of the firm's policies that are identified rather than waiting for HMRC to make a discovery claim against the firm. However, the mere act of self-reporting the offence will not prevent an investigation by HMRC and potential interviews under caution, therefore it is important to seek legal advice at an early stage.

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3. Top Level Commitment

Q – What would count as top-level commitment and how can this be demonstrated at an early stage?

We recommend that top-level commitment is made within 1-2 months after 30 September although it would be preferable to have this in place for 30 September 2017 where it is reasonable to do so. A senior person in the firm should take an active role in communicating their FTP Policy and procedures, whether that is by a public announcement, an email to the firm's employees or otherwise.

The identity or office of the person taking the lead on this will vary according to the entity involved. The key consideration is determining who is best placed to drive behavioural change within the business and firms should be able to demonstrate that they have focused on this in identifying a suitable person. It may be in some circumstances that a technically less senior individual takes the lead on communications if it fits better with their existing role than with the role of a more senior individual. Seniority is not the only factor to consider. If entities are able to show that they have paid attention to this requirement and identified an appropriate way to comply with it in the context of their organisation, this should be sufficient.

4. Due Diligence

Who should be covered by a firm's due diligence procedures?

Q – The definition of "associate" is broad. Are firms expected to due diligence subcontractors?

Yes. "Associate" is defined as anyone providing services for or on your behalf, and so includes anyone acting in an agency type capacity. This includes individual sub-contractors or anyone employed by a separate legal entity on your behalf. This is to avoid firms sub-contracting out of their liability under this offence by seeking to use plausible deniability.

Whilst technically a body corporate can be an associated person, in the context of this offence it is more likely that an associated person would be an individual as criminal facilitation by a body corporate would require proving beyond reasonable doubt that the directing mind of the body corporate was directly involved in the criminal facilitation.

However, in practice firms are likely to focus their due diligence efforts both on direct individual associates, such as their employees and individual contractors, and also on ensuring that bodies corporate with which they are associated have in place reasonable prevention procedures designed to ensure that their own employees/associates do not criminally facilitate tax evasion.

Q – If fraud had taken place before the portfolio company was taken over by a PE firm, what is the PE firm required to do if this is discovered?

The new legislation does not create any new reporting obligations on the company. In the first instance, the PE firm should consider their reporting obligations under existing law, including the Proceeds of Crime Act.

If the fraud took place after the new FTP Offence comes into force, the portfolio company may be liable unless they are able to rely on the reasonable procedures defence. If their own procedures uncovered the offence and this was self-reported in a timely manner this may be good evidence to support an argument that they had reasonable procedures in place at the time of the offence. If the new PE firm uncovers the offence itself and they ensure that appropriate reporting is made as regards the portfolio company then the liability of the portfolio company will still depend on whether the portfolio company's prevention procedures in the round were reasonable.

As the fraud was not facilitated by an associated person of the PE firm (as there was no relationship at that time), the PE firm would not be liable under the FTP offence.

A firm – whether the acquiring PE firm or the portfolio company – may, if it is considered advisable in the circumstances, seek further assurances in a direct conversation with HMRC. This would not mitigate their need to comply with their reporting obligations, such as submitting any necessary Suspicious Activity Reports.

Q – If a fund manager is carrying out due diligence on a potential investment and discovers a historical instance of fraud, are they or the portfolio company responsible for reporting it? If they are unsure can this be reported beforehand to check whether there is a problem with HMRC?

It would be the responsibility of the money laundering reporting officer or in house legal representative of the fund to consider the fund's reporting obligations under existing regulations.

The fund will be required to make a report if their legal obligation to report financial crime is triggered. If the fund is unsure, they can submit a Suspicious Activity Report.

The fund manager should be mindful of the rules in relation to "tipping off" when involved in discussions with the portfolio company or the relevant seller.

It is possible that the failure to appropriately report (suspected) criminal behaviour where there is a duty to do so might be regarded as criminal facilitation of fraud in the context of this legislation in certain circumstances, for example where the fraud in question is ongoing.

Example

A tax fraud had been ongoing in Portfolio Ltd for several years. On acquiring Portfolio Limited, an executive of PE House LLP becomes aware of the fraud but makes no Suspicious Activity Report report in the knowledge that, by failing to make this report he is allowing the tax fraud to continue. The failure to make a report might be regarded as criminal facilitation of tax evasion by an associated person of PE House LLP. There would therefore be a strict liability offence by PE House LLP and PE House LLP would need to demonstrate that they had reasonable prevention procedures in place in order to avoid a conviction.

Q – What is the position for a PE house that, for example, engaged with a third party corporate contractor to provide cleaning services to the PE house and it transpired that the cleaners were paid in cash so as to allow them to evade tax?

In this situation the cleaners are likely to have fraudulently evaded tax if they deliberately avoided paying tax on their income. The individual at the PE house who has made / agreed to make the payments in cash in the knowledge that this would be used by the cleaners to enable them to evade tax is likely to have committed a criminal facilitation offence. Whilst there may be technical arguments that it is the corporate cleaning contractor and not that individual employee that is the associate of the PE house, in practice HMRC are likely to argue that, to the extent the cleaners were paid in cash in relation to their work cleaning for the PE house, the criminal facilitation was carried out by an associate of the PE house and therefore the PE house might be liable for the offence unless it has reasonable prevention procedures in place.

In order to swiftly address any investigation raised by HMRC, the PE house will want to have evidence that it has undertaken a risk assessment in relation to the cleaning contractor and that it has put in place reasonable prevention procedures appropriate to the risk level, for example including a term in the contract at time this is renegotiated requiring the cleaning contractor to have in place and comply with an FTP Policy, or requesting assurances from the relevant company that such a policy and procedures are in place.

Q – PE firms set us as LLPs are entitled to pay their members gross (although some choose to operate a tax reserve and pay the tax over to HMRC on behalf of their members). Is there any obligation for the firm to make sure that the partners are reporting their profit share on their self-assessment tax returns correctly?

If the individual at the LLP (an associated person as they are an employee) who is responsible for making the payments to the LLP members criminally facilitates tax evasion by, for example, colluding with a member to pay them gross knowing that the member will not report the profits for

UK tax purposes then the firm could be liable under this offence unless they have reasonable prevention procedures in place.

If the individual paying the members has no knowledge and has not deliberately turned a blind eye to members evading tax on their profit share then that individual will not have committed a facilitation offence. The firm will not be liable under this legislation as long their associated persons are not knowingly facilitating or complicit in the tax evasion.

Prevention procedures in this area should be focussed on the person in the firm who makes the payments. Random sampling and double-checking work may be a helpful prevention procedure, as would the provision of training about the offence and the consequences of facilitating tax evasion for relevant employees. Reserving and paying over the tax would clearly be a reasonable prevention procedure but this may not be necessary provided other prevention procedures are in place that can reasonably be considered to be sufficient to address the level of risk identified.

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5. Communication (including training)

Q – After the risk assessment has been completed, how soon would firms be expected to implement training and procedures?

HMRC acknowledges that the time taken to implement procedures will depend on the size and scope of the firm. HMRC also acknowledge that in the case of training, it may well be reasonable to take at least six months to roll out an appropriate training programme and that this could take up to 1-2 years to complete if that is reasonable based on the size of the relevant organisation. Firms should remember that they may ultimately have to convince a court of how reasonable their procedures are (which will include the timing and prioritisation of implementing relevant procedures).

A key area for firms to consider is the behaviour of middle management teams and employees in roles outside functions such as finance, legal and tax. Whilst high-level employees or those who work in compliance or legal departments will be aware of the legislation, other departments are less engaged and there will need to be evidence that they were made aware of the procedures and, where appropriate, provided with appropriate training.

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6. Monitoring and Review

Q – How frequently should policies and procedures be reviewed?

Many firms will include procedures in updated governing policies or as part of a general compliance programme. Firms should also monitor the adequacy of their procedures, especially with changes of personnel and structure. Circumstances change and procedures may need to be amended. It would be good practice to review procedures on a regular basis to see if any changes are warranted.

The appropriate frequency of risk assessments will depend on the level and nature of risks faced by a particular firm. Generally, in order to demonstrate that they have adopted a reasonable approach, firms with higher risk profiles, and particularly those operating in areas where the business model or the nature of risks faced by the business are swiftly changing, are likely to be expected to update their risk assessments more frequently than low risk firms with a consistent risk profile.

For example, firms could include updating their risk assessment as part of an annual review cycle in case a new risk emerges, as well as considering the position on a case by case basis if new guidance is published by HMRC or breaches of the firm's policies and procedures come to light.

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7. Enforcement

Q – What does HMRC consider when deciding whether to take a case to court?

HMRC will review existing risk management procedures, consider whether the procedures were reasonable and whether they were appropriately enforced.

In theory, a taxpayer, the individual facilitator and a corporation could each be taken to court for three separate offences in relation to the same tax evasion activity. However, this is unlikely. In practice it is more likely that, initially, a taxpayer who has committed dishonest behaviour is given a civil penalty. As part of the disclosure process, they disclose the names of enablers and this would result in enquiries into those persons. Those enablers may receive civil penalties and may be induced, for example by the threat of criminal prosecution, to disclose the parties for whom they were providing services. This in turn may lead to enquiries into the position of that enabler and their role as an associate of a particular entity. The relevant entity could then be investigated to determine the extent to which it has adequate procedures in place and duly complied with.

If there has been wrong doing but it is not in the public interest to prosecute, the regulator may look at the control failures and suspend any criminal action (for example under a deferred prosecution agreement) but compel the organisation to improve their procedures through monitoring and/or a postponed financial penalty.

Q – Could firms be implicated by another entity without their knowledge?

Yes. For example, if Company A subcontracts a service to Company B and Company C, which is the parent of Company B, later discovers fraud in Company B, Company C may submit a Suspicious Activity Report (SAR) to HMRC and inform them that Company B committed this activity while carrying out services on behalf of Company A. In this case Company A would have been reported without their knowledge. To protect itself in the event of an investigation, Company A should ensure that it has carried out due diligence and assessed the risk in relation to Company B and also implemented appropriate prevention procedures such as contractually requiring Company B to implement an appropriate FTP Policy and procedures.

Q – Practically, if an offence is committed, could there be dialogue between HMRC and the firm beforehand to see if the correct procedures are in place?

No. If there is a suspicion of a crime then there is likely to be an interview under caution in line with the Police and Criminal Evidence Act. If HMRC finds that adequate procedures were in place, then no case would be brought. HMRC will only engage directly beforehand if there is a newly identified risk for firms to consider or if firms approach them directly for assistance in "stress testing" their prevention procedures.

Q – To what extend has HMRC been discussing these offences with other regulators in the UK and overseas?

There are two offences under the legislation with HMRC responsible for the domestic offence and the Serious Fraud Office responsible for the overseas offence. The FCA helped write the guidance and there is a lot of overlap with financial crime prevention requirements and the Senior Management Regime. Financial intelligence units are exchanging intelligence regarding suspected enablers of tax evasion, with the aim of finding the web of advisers who are helping to facilitate tax evasion.

HMRC has had meetings in a number of jurisdictions and has asked if there would be any ramifications in that country if a company was convicted in the UK. We understand that several countries have told HMRC that the company would lose their licence to operate, or would have to operate under strict supervision if it were to be convicted of such an offence in the UK.

If you have any questions on the topics raised in this note, please contact Chris Elphick celphick@bvca.co.uk.

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