ISSUE 13 / AUTUMN 2013

inCOMPLIANCE

QUARTERLY JOURNAL OF THE INTERNATIONAL COMPLIANCE ASSOCIATION

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Evasion and evolution

How do AML programmes need to evolve for anti-tax evasion purposes? **Rohan Bedi** provides explanation and advice

The European Commission defines tax fraud as including "situations in which deliberately false statements are submitted or fake documents are produced" and tax evasion as comprising "illegal arrangements where liability to tax is hidden or ignored... by hiding income or information". In February 2012, the Financial Action Task Force (FATF) revised its 40 principles on AML/CFT to include "serious tax crimes (direct and indirect taxes)" as a predicate offence. Information on tax evasion cases will now be shared through AML channels.

While the EU Fourth Money Laundering Directive (4MLD) will add tax evasion to the list of predicate offences, the UK already has an "all crimes" regime. However, this space is fast evolving and needs watching. In Singapore, for example, the Monetary Authority of Singapore (MAS) has asked banks to identify all high-risk accounts for tax evasion. These must be flagged, suspicious activity reports (SARs) filed, accounts closed down where appropriate, and of course transactions monitoring programmes enhanced. This article considers the enhancements necessary to meet this evolving environment.

Country risks

It is important to understand the tax havens where monies can be hidden, which include countries with strong banking and corporate secrecy laws. The Tax Justice Network's Financial Secrecy Index can help in this. Note, however, that there are no countries on the more formal OECD list of uncooperative tax havens, which suggests that all countries are ready to cooperate.

The second set of countries to evaluate are those that suffer from serious tax evasion and/or are actively pursuing recovery. These include the US, EU and others (for example, Russia, Indonesia, Pakistan, India, China etc) depending on the bank's business profile. These countries should be captured in the bank's cross-border policies developed by their Legal and Compliance department to cover tax evasion risks, FEX limits and rules, privacy issues, cross-border marketing rules and so forth.

Reviews and programme update

So what kind of review is required? A static review looks at the existing client database for key indicators of tax evasion. This will focus on negative indicators, although some positive indicators may counter-balance these. The positive indicators would cover, for example, whether the bank account is being used for tax payments, any client declarations on tax compliance that give comfort, and whether the client has a respectable firm (e.g. Big 10) as a tax advisor.

The red flag list for tax evasion needing further investigation is given in **Box 1**. It was developed using various sources, including US cases, OECD reports, FATCA regulations, Singapore reports and experience. In a typical static review of the client information the first eleven indicators in **Box 1** should be reviewed and balanced against the positive indicators to determine whether enhanced due diligence is required. If it is required, then a further review for any new negative news, beneficial ownership, and transactions review (including source and use of funds) will be necessary, as well as a confirmation that transactions are in line with the known source of wealth. In this more detailed review all 30 red flags will be applicable.

This list needs to be incorporated into the static one-time review as well as the more dynamic ongoing transactions monitoring reviews for tax evasion. A scenario does not have to be created for each red flag (indeed, this may not be possible). The Relationship Manager (RM, where there is one) plays a key role in assessing the tax evasion risk profile of a client (e.g. in private banking).

Tax statements – banks' capabilities?

Besides the above, banks get financials and tax statements from their clients in lending and investment banking transactions. The bank could be given fraudulent statements, picked up through its fraud controls. Alternatively, genuine statements with misleading details in the submissions to tax authorities may be provided. For this latter category, it is difficult enough for the authorities to spot a fraud, and currently a bank's capabilities are suspect. Nonetheless, listed below are the important examples of fraud highlighted by two OECD reports of 2013.

The first concerns multinational corporations (MNCs). MNC subsidiaries may exist in low-tax jurisdictions with little evidence of value creation in order to artificially shift profits, for example through:

- shifting debt to high-tax jurisdictions by borrowing more in these jurisdictions
- transfer pricing – charging low prices for sales to (but paying high prices for purchases from) low-tax jurisdictions

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- transfer pricing – licensing patents to an affiliate in a low-tax country, meaning that income will be shifted if the royalty or other payment is lower than the true value of the license
- other ways specific to the tax laws of the two jurisdictions

The next two examples concern medium-sized enterprises. First, aggressive tax planning amongst group companies including transfers of intangibles (e.g. patents) and other mobile assets, and over-capitalisation of low taxed companies. Alternatively, medium-sized enterprises may engage in aggressive tax planning on after-tax hedging to make higher returns, without actually bearing the associated risks.

The MAS points out that "financial institutions are not expected to determine if their clients are fully compliant with all their relevant tax obligations globally". This is reasonable. Nonetheless, SAR filing is required where the bank is sure (or is uncertain) that the foreign tax violation is of a type which Singapore imposes. In July 2013, the G-20 backed a plan to curb tax avoidance by large MNCs who park profits in offshore subsidiaries. New tax laws are expected and the role of banks could also be enlarged.

Notwithstanding the above, investment banking business that is actively promoting structuring financial transactions for tax avoidance (tax reduction by legal means, for example as part of, or as add-ons to, fixed income or equities businesses) can come under regulatory scrutiny and be challenged by tax authorities. Hence, there needs to be high transparency to the tax authorities. Target clients are typically financially-sophisticated corporates and financial institutions including, potentially, the banks own operations.

Understanding FATCA

According to the US Government Accountability Office, individual income tax accounts form the largest portion of the US tax gap (see **Figure 1**), with sole proprietors underreporting receipts or over-reporting expenses (overstatement of charitable contributions, phony bad debt deductions etc). Offshore bank accounts are a key ingredient to many tax evasion schemes. US actions against Swiss banks include a US$780m fine.

The US Foreign Account Tax Compliance Act (FATCA), enacted in 2010, aims to secure information on US persons having financial accounts abroad with foreign financial institutions (FFIs, including custodial institutions, depository institutions, investment entities, or specified insurance companies). Threshold exemptions exist for individual accounts, preexisting and new (e.g. balance or value of USD 50K or less for depository accounts), and for preexisting entity accounts only (US$250k or less). The US Internal Revenue Service (IRS) will use the information provided on US accounts and accounts of suspected US persons to identify tax evaders. The final regulations were issued in January 2013, although further refinements to these are anticipated.

Some key features of FATCA are:

- FATCA has US "indicia" for individuals and entities, which is captured in the first six points of the list of red flags in Box 1. These will require closer scrutiny to see if the person is a "specified" US person (which includes US individuals, trusts, estates, and partnerships and non-publicly traded corporations).
- US "withholding agents" are all persons having control, receipt, custody, disposal, or payment of any withholdable payment. All participating FFIs fall in this category.
- "US Source Withholdable Payments" means any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical (FDAP) gains, profits, and income. These are subject to a

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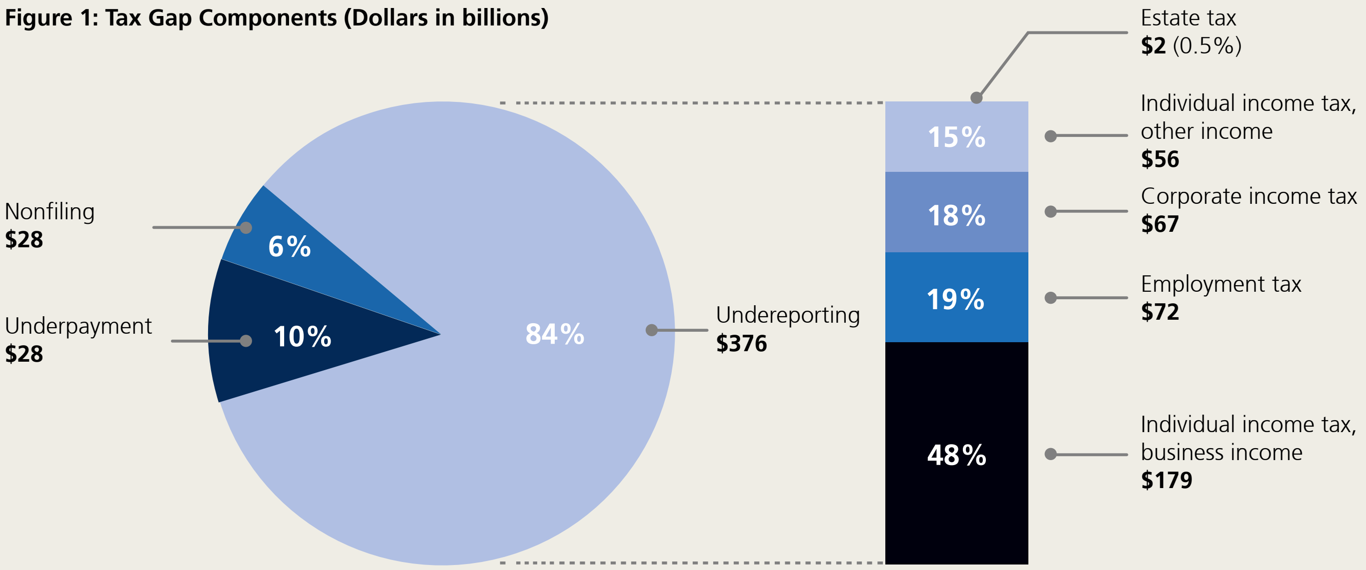
BOX 1: RED FLAGS – FOCUS FOR BANKS

1. Citizen or resident (including for entity) or place of birth of a high tax-evasion risk country (e.g. US)
2. Residential or mailing address (including P.O. Box) of a high tax-evasion risk country
3. Standing instructions to pay amounts to a high tax-evasion risk country
4. A telephone number in a high tax-evasion risk country
5. "In-care-of" or "hold mail" address which is the sole address on files
6. Power of Attorney (POA) or signatory authority to a person from a high tax-evasion risk country
7. Links to unrelated third parties e.g. POAs or signatory, loans, collaterals, nominees etc.
8. Difference in tax residence and domicile for either the customer or the beneficial owner (BO)
9. Reliable negative tax-related reports on the customer/BO or on their jurisdiction of domicile or tax residence
10. Unduly complex ownership structure (e.g. three layers) in which the BO is not clear. For example, layers of personal holding companies (PHCs)/private trusts/foundations, with nominee shareholders/directors/signatories.
11. Abusive trusts arrangements in tax evasion schemes:
    - Hide ownership of assets and income or disguise the substance of transactions
    - Effective control remains with the taxpayer
    - Frequently more than one trust, vertically layered
12. Offshore financial link to secrecy jurisdiction or tax haven
13. Structured deposits or withdrawals of cash and other instruments
14. Cash-intensive business structuring cash deposits
15. Business account not being used for utility payments
16. Accounts of a lawyer or an accountant consultant providing tax planning advice
17. Wire transfers – sending and receiving monies overseas for offshore loans
18. Wire transfers – payment of overseas consulting fees especially if loaned back
19. Cheque cashing – unregistered/registered – and structuring
20. Suspicious cash movements highlighting possible Ponzi scheme without actual investments
21. Suspected identity theft, especially if along with tax refund credits
22. Tax refunds followed by structured withdrawals
23. Tax refunds for unrelated individuals deposited into account of co-conspirator
24. Misusing tax exempt status of non-profit organisations (NPOs) to book business income as contributions
25. Structuring in a securities account and no trading activity
26. Different securities accounts in a firm, transferring within themselves and having the same address
27. Credits to accounts of non-resident foreign nationals from money services businesses (MSBs) in markets with poor AML controls, especially if from unrelated third parties
28. Transfers between companies and personal accounts or to suspected paper companies especially if in tax havens; or significant inter-company transfers in group companies
29. Counterparty in a trade transaction suspected to be a paper company especially if in a tax haven
30. Trade based laundering schemes that overprice imports used in manufacturing, shrinking profits/evading taxes. Or underpricing of goods/services export.

Figure 1: Tax Gap Components (Dollars in billions)



Source: GAO Analysis of IRS data.

withholding tax of 30% for a recalcitrant account holder (suspected US person who is not-cooperating) or a non-participating FFI (NPFFI), or as per Inter Governmental Agreement (IGAs) signed. If a US account holder cooperates, only information is passed to IRS.

- Foreign Passthru Payments (FPP) is a broad definition and includes payments attributable to a withholdable payment. Withholding on FPPs is aimed at preventing indirect investments in US assets using blockers and avoiding the FATCA provisions.

According to Carol Tello, a Partner in Sutherland and a former attorney in the office of IRS Associate Chief Counsel (International): "Foreign Passthru Payments would have taxed non-participating FFIs even if they did not have any US clients. However, in the final regulations this is reserved until a t least 2017." She further states that: "IGAs seek to replace the need for individual FFI agreements with the IRS albeit registration is still required. FFIs report certain account information to their respective tax authorities, followed by an automatic exchange under existing bilateral tax treaties or tax-information exchange agreements."

Ms Tello continues: "A Model 1 IGA has, for example, been signed by the UK on a reciprocal exchange basis. Currently a Reporting UK FI need not withhold tax for accounts held by recalcitrant account holders or close them, only reporting is needed. Aggregation across accounts is dependent on the UK financial institution's core systems being able to aggregate, and also involves the RM (if any). The IRS is working on an alternative approach to foreign passthru payments and gross proceeds withholding that minimizes burden.

HM Revenue & Customs Guidance Notes 2013 (sections 9.3 and 9.4) states that currently for Non-Participating FI's, UK FI's need to report FDAP payments made – both US source and others. Plus reporting to upstream FI's to allow withholding on US source payments."

The long list

IRS Notice 2013-43, issued in July 2013, provides a six-month extension for the effective date of the reporting, due diligence and withholding requirements. Specifically, withholding will begin for US Source FDAP payments after 30 June 2014. The long list of things to do includes:

- Screening capabilities against the NPFFI list
- Aggregation across accounts – automated and also using RMs
- Matching required against US Indicia and customer due diligence – new and preexisting
- Collecting additional documentation
- Capturing new information
- Withholding tax deductions (if needed)
- Reporting withholdings, US account holders (including suspected), payments to NPFFIs
- Managing refunds

FATCA involves a massive data-quality and technology project that needs senior management buy-in and funding. Senior AML Compliance management should work towards this. The clock is ticking and banks cannot take FATCA lightly especially if the foreign passthru payments definition gets implemented eventually in some form. The deadline for all FFIs to register with the IRS is currently 25 April 2014.

Rohan Bedi is a Fellow of the ICA (FICA), see rohanbedi.com © 2013, Rohan Bedi
Disclaimer: These are Rohan's personal views and opinions.

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