Analysis

The international tax compliance landscape in 2019

Speed read

The international tax compliance landscape has become increasingly complicated and is often unclear. The main reason for this has been due to a proliferation in domestic measures (sometimes with extraterritorial application), such as FATCA, the Russian GAAR and the UK Criminal Finances Act 2017, which consequently require enterprises with a multinational presence to comply with such varying measures across the countries in which they operate. This is compounded by measures introduced through international instruments, such as in relation to hybrid entities in the OECD's multilateral instrument (MLI) and DAC6.

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The last decade has seen a significant increase in tax compliance measures. Due to the increase in globalisation and ease with which businesses can transact cross-border, these measures have been introduced by a range of international instruments and domestic measures. In HMRC's recently published strategy for offshore tax compliance, *No safe havens 2019*, it notes that since 2010 the government has introduced 'over 100 new measures to tackle tax non-compliance'. Aggregated with measures introduced unilaterally by other countries and those introduced through international instruments, this makes for a complicated and often uncertain international tax compliance landscape.

Domestic measures

In the realm of information exchange, the effects of the Foreign Account Tax Compliance Act (FATCA) and the common reporting Standard (CRS) are well documented. However, they help to demonstrate the distinction between the two types of tax measures described above. FATCA originated out of a US domestic measure, whereas in contrast CRS originated out of an international measure. The effect of this has been that in-house lawyers have been required to set up, monitor and comply with two different measures (arguably with overlapping requirements). A particular challenge faced in relation to FATCA is that since this is fundamentally a US domestic measure, non-US in-house lawyers are required to keep abreast of notices issued from the IRS in relation to FATCA compliance and are often required to update their on-boarding procedures accordingly. As expected, this can often be challenging for businesses that do not have an internal US tax or US compliance function.

Another example of a domestic measure to illustrate the complexity of the international tax compliance function is the new general anti-avoidance rule introduced in Russia (Russian GAAR) in 2017. This might be relevant for international businesses that pay tax in Russia. One of the provisions (amongst others) in the Russian GAAR restricts the right of taxpayers to reduce their tax base where the obligations to be undertaken in a transaction were not supplied by a specific good-faith supplier that meets all of the necessary conditions to perform the transaction or by a competent third party hired for this purpose.

The consequence of this has been that, in order to ensure that this does not apply to them, businesses in Russia have been required to assess the 'good faith' (or 'bad faith') nature of their suppliers. This process is not entirely straightforward because factors to consider include determining whether the supplier had fixed assets or an office, whether a high percentage of VAT deductions were made by the supplier, etc., which may not be information readily available to the taxpayer. This has required businesses to conduct an extensive analysis of their existing list of suppliers to determine whether they are good faith suppliers and to implement internal procedures to determine this going forward.

Similarly, the UK is no stranger to implementing tax compliance measures domestically and has over the years introduced various measures with the objective of ensuring tax compliance; for example, the offences introduced in the Criminal Finances Act 2017 in relation to preventing the facilitation of tax evasion. This article focuses on the international consequences of these offences.

The corporate offences or failing to prevent the criminal facilitation of tax evasion

The introduction of the corporate criminal offences (CCOs) in 2017 ushered in a major change to the UK's tax compliance landscape, and has had (and is anticipated to have) a similar effect on the compliance function of businesses as the Bribery Act 2010 and the money laundering regulations. However, the international consequences and effects of the CCOs are still not completely appreciated.

Before discussing some of the key international compliance issues faced in relation to the CCOs, a short summary of the offences is helpful. The CCOs apply to all 'relevant bodies'. 'Relevant bodies' has been widely drafted to include body corporates and partnerships *irrespective* of where these are formed or incorporated. The scope of this definition has two main consequences.

Firstly, the scope of this definition will mean that most entities are caught by this legislation (including entities that many may not intuitively consider would be caught, e.g. local councils). However, for completeness it is noted that natural persons cannot commit this offence.

Secondly, it is irrelevant where the company or partnership is incorporated or formed. This point must be stressed, since it is a common misconception that if a company or partnership is not incorporated or formed in the UK, the CCOs will not apply.

'Associated persons' of a relevant body has been defined to include employees, agents and any other persons performing services for or on behalf of the relevant body.

There are two types of offences under this Act which a relevant body may be found guilty of, namely:

- the UK facilitation of tax evasion offence (UKFTE); and
- the foreign facilitation of tax evasion offence (FFTE).

The UK facilitation of tax evasion offence

This is where an 'associated person' of the relevant body facilitates another to commit a UK tax evasion offence. Facilitation of tax evasion is broadly construed to mean 'being knowingly concerned in, or in taking steps with a view to, the fraudulent evasion of a tax by another person' or 'aiding, abetting, counseling or procuring the commission of a UK tax evasion offence'. If an associated person acting on behalf of the relevant body facilitates another to commit a UK tax evasion offence, then the relevant body will be found *criminally liable* (and is subject to potentially unlimited fines) unless that relevant body has in place reasonable prevention procedures (unless it was not reasonable in all the circumstance to expect the relevant body to have such prevention procedures in place).

As mentioned previously, a non-UK company or partnership can commit a UKFTE, even though it is not incorporated or formed in the UK, as long as one of its associated persons facilitates another to evade UK taxes. For example, if an associated person of a Luxembourg incorporated company (managed and operated in Luxembourg) facilitates a client of the company to evade UK taxes, the Luxembourg company can be found guilty of a UKFTE. For example, it is understood that a large proportion of businesses in Ireland that may conduct business in the UK have not conducted a risk assessment or have in place reasonable prevention procedures. This becomes important in the wake of Brexit, where some businesses are considering relocating to other jurisdictions, e.g. Ireland or Luxembourg, or have already relocated, but continue to engage in business in the UK.

Further to HMRC's published guidance, it is now commonly accepted that UK businesses should generally conduct a risk assessment to determine the risk of the facilitation of tax evasion (as a precursor to developing reasonable prevention procedures). However, for the reasons discussed above, it is also important that certain non-UK businesses that conduct business in the UK or with persons in the UK also conduct a risk assessment. Practically, only very few non-UK businesses have conducted such risk assessments or taken any affirmative steps to establish reasonable prevention procedures in relation to the UKFTE.

It is understood that HMRC has already commenced investigations into some businesses in relation to the UKFTE and, therefore, the 'grace period' afforded to implement control measures in lieu of this legislation has arguably come to an end. Further, in HMRC's single departmental plan, HMRC provides that it intends to increase investigations into serious and complex tax crimes with the objective of increasing prosecutions to 100 prosecutions per year by 2022. This signals the possible uptick in investigations related to this offence. To the extent that UK and/or non-UK businesses with UK activities have not already conducted risk assessments, implemented control measures or have implemented control measures that are not commensurate with the risk assessment of the business, urgent consideration should be given to this.

The foreign facilitation of tax evasion offence

This is where an associated person criminally facilitates another to commit a 'foreign tax evasion offence' and there is a UK nexus. The threshold necessary for a UK nexus is low. This will be satisfied where:

- the relevant body is incorporated or formed (as relevant) under UK law;
- the relevant body carries on business or part of its business in the UK; or
- any conduct that constitutes part of the FFTE takes place in the UK.

The scope of the FFTE can be illustrated by way of the following example.

An employee (E) of a US incorporated company visits the London office for a two day visit and works out of the London office. During the course of this visit and in the course of E's employment, he/she facilitates a client of the company to evade US taxes (or taxes in any other jurisdiction). Even in such a situation, where the relationship between the offence committed and the UK is minimal, the UK nexus test would be satisfied; and if the dual criminality test (discussed below) is satisfied the relevant authorities would be able to prosecute for such an offence. For completeness, it is noted that there may be potential arguments in relation to the extraterritoriality of any prosecution for such an offence. However, this has currently not been tested by the UK courts and so is not examined further here.

For a relevant body to be found guilty of an FFTE, the dual criminality test must be satisfied:

- A person (i.e. the taxpayer) must commit an offence which in the foreign jurisdiction constitutes a tax evasion offence. Further, the offence committed (or actions undertaken by the taxpayer) must be such that it would also constitute an offence if it had taken place in the UK.
- There should also be an equivalent offence in that foreign jurisdiction of facilitating tax evasion; and the offence committed (or action undertaken by the taxpayer) must be such that it would also constitute an offence if it had taken place in the UK.

Similar to the UKFTE, the only defence to a FFTE is having in place reasonable prevention procedures.

Practically, many businesses conducting a risk assessment have limited any risk assessment to only considering the UKFTE without appreciating the wider scope of the FFTE. However, it is important that businesses undertake an equivalent risk assessment for all the jurisdictions that they operate in (unless it is determined that it would not be proportionate to do so). This is because counterparties across industries (when dealing with both the public and private sector) are now routinely seeking confirmation of a business's international compliance status by way of broad warranties, representations, due diligence questionnaires, etc. in relation to these offences prior to engaging in business.

Furthermore, businesses negotiating agreements (across industries) should consider whether to include anti-tax evasion and facilitation of tax evasion representations and warranties. Practically, businesses may encounter some resistance to such provisions when negotiating agreements with foreign counterparties, especially where a specific form of agreement is usually used to obtain regulatory consent in certain jurisdictions. Practical examples of where this resistance has been encountered are power of attorney agreements in Russia, Luxembourg and other jurisdictions. However, inclusion or seeking satisfaction of a counterparty's compliance with tax laws through alternative means becomes an important step to demonstrate reasonable preventive procedures.

International measures

Various measures have also been introduced through a range of international instruments. From the UK context, these measures have largely derived from the BEPS project and EU law. Examples of such measures have been the implementation of the common reporting standard (CRS), Council Directive (EU) 2018/822 (DAC6), country by country reporting, etc. A measure that (although not a tax compliance measure in itself) will have significant ramifications for the tax compliance function within businesses is article 3(1) of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), which is discussed below to illustrate the potential complexity and administrative burden.

Withholding taxes and the MLI

The MLI entered into force on 1 July 2018 and has 87 signatory states (at the date of writing). It subsequently entered into force in the UK on 1 October 2018 and its effect has been to modify various existing double tax treaties. By way of example, the UK-Luxembourg, UK-Netherlands, UK-France double tax treaties, etc. will be modified to varying degrees by the MLI.

Article 3(1) of the MLI (which would only modify a double tax treaty if both treaty states opt for the modification to apply) introduces wording targeted at hybrid mismatches: 'income derived *by or through an entity or arrangement* that is treated as wholly or partly fiscally transparent *under the tax law of either Contracting Jurisdiction* shall be considered to be income of a resident of a Contracting Jurisdiction but only to the extent that the income is treated, for purposes of taxation by that Contracting Jurisdiction, as the income of a resident of that Contracting Jurisdiction' (emphasis added).

Simplistically put, where *either treaty state* considers a relevant entity to be tax transparent, then income derived by that entity or through (but not from) that entity will only be eligible for benefits under that double tax treaty if according to the resident state's rules, that income is treated as the income of a person in that jurisdiction (e.g. a partner of a partnership resident in the same state).

The immediate effect as a consequence has been to require in-house lawyers to first ascertain:

- the resident state's classification of that entity (i.e. opaque or transparent); and
- if transparent, to determine whether any person (e.g. partner) to whom that income is attributed is subject to tax in that jurisdiction.

This analysis is made even more difficult if multiple jurisdictions are involved, e.g. where investors from multiple jurisdictions invest in such a vehicle which in turn derives income from various jurisdictions. This has resulted in significant complications of the in-house withholding tax function, primarily because the resident state's classification appears to have been given 'preference' vis-à-vis the source state's classification.

The complications in relation to the withholding tax function of in-house lawyers have been compounded as a consequence of the savings clause in the MLI (which the UK has adopted), and the uncomfortable and unclear interaction between the beneficial ownership requirement in articles 10 (dividends), 11 (interest) and 12 (royalties) of the OECD Model Tax Convention on Income and Capital 2017 and article 3(1) of the MLI.

The MLI has not been currently ratified by many countries. Therefore, the potential complications associated with this treaty modification are still unclear but it is expected that many jurisdictions will ratify and deposit their instrument of ratification, acceptance or approval with the OECD in the coming year. In-house lawyers should consider how this provision could impact their existing withholding tax function and assumptions.

The MLI also brings about significant modifications to double tax treaties in relation to the rules on residence, treaty abuse, permanent establishments and dispute resolution, which are not covered here.

Council Directive (EU) 2018/822 (DAC6)

DAC6 has been a major development in relation to tax compliance in the EU. DAC6 refers to an amendment to an existing EU Directive 2011/16/EU, which seeks to introduce an EU regime requiring mandatory disclosure of certain cross-border transactions that demonstrate certain 'hallmarks' of tax avoidance.

The disclosure obligation applies primarily to persons classified as intermediaries, which in turn is broadly defined to include 'a person that designs, markets, organizes or makes available for implementation or manages the implementation of a reportable cross-border transaction' and also 'any person … [that] knows or could be reasonably expected to know that they have undertaken to provide, directly or by means of other persons, aid, assistance or advice with respect to designing, marketing, organizing, making available for implementation or managing the implementation of a reportable cross-border arrangement'.

Such intermediaries would be required to have an EU nexus as provided for in the Directive. Based on this definition, lawyers, accountants, tax advisers, banks, financial advisors and others, depending on their role in the transaction, may be considered intermediaries. It is also important to highlight that there is a secondary reporting obligation on taxpayers.

The first filing of information in relation to reportable cross-border arrangements is due by 31 August 2020 in relation to cross-border transactions implemented between 25 June 2018 and 1 July 2020. This will apply even though the UK has not domestically implemented DAC6.

There is some uncertainty as to whether the implementation of DAC6 will be consistent across the EU countries and if there may be different reporting obligations in different jurisdictions. By way of example, Poland has already introduced an amendment to its Tax Ordinance, which in effect implemented part of DAC6. Poland adopted a wide approach to the implementation of DAC6 and effectively extended reporting obligations to certain domestic tax arrangements, as well as cross-border schemes. There are concerns that this amended legislation might imply that reporting may be regularly required in Poland.

By way of contrast, jurisdictions like Ireland (and the UK) have not implemented DAC6 yet, but this is currently being considered by the Irish Revenue Commissioners.

Ireland already has a mandatory reporting regime under domestic legislation which requires tax advisors to notify the Irish Revenue Commissioners when they promote or implement certain tax planning arrangements that meet the hallmarks of aggressive tax planning. The individual users of such schemes may themselves, in certain circumstances, have reporting obligations under this scheme – when, for example, the promoter of the scheme is outside Ireland, the promoter cannot make a disclosure due to legal professional privilege; or when there is no promoter and the scheme is limited to a specific group of users for its own use.

It is anticipated that the existing mandatory regime will be amended in this year's Finance Bill to ensure compliance with DAC6 by 31 December 2019. However, the exact changes are uncertain and it is also uncertain whether there will be consistency between the implementation of DAC6 in Ireland and other jurisdictions like Poland. The lack of consistency between jurisdictions creates further complexity in relation to the international tax compliance landscape.

Where does this leave us?

The tax compliance landscape has become increasingly complicated, and this is a function of globalisation, domestic measures (often with extraterritorial reach) and international measures. In the given climate, it does not appear that there will be any abatement in relation to the introduction of such measures. On the contrary, with the shifting focus domestically and internationally to the digital economy, it is likely that countries will introduce more measures relating to this sector, particularly in relation to digital marketplaces.

Businesses will need to devote more resources to this tax compliance function and assess the risks in all the jurisdictions they operate. A key risk will be for businesses to ensure awareness and compliance with laws in these jurisdictions. With some of the sanctions getting onerous (e.g. criminal liability under the CCOs), this is now essential. ■

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