FAILURE TO PREVENT – THE FUTURE OF ADVISER OBLIGATIONS

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INTRODUCTION

Between F.A.T.C.A., C.R.S., the Panama Papers, and the Paradise Papers, taxpayer information has become increasingly transparent and available to authorities in many countries. Banks were once paradigms of confidentiality. Now, they are beholden to compliance and reporting obligations imposed by the O.E.C.D. and European Commission directives. Documents thought to be confidential are regularly hacked for "bad" reasons such as ransom and "good" reasons. The risk of embarrassing public disclosures incentivizes acceptable tax planning behavior.

The quantum of data that is in the public domain has stimulated a debate on the ethics of those who make a living advising others on tax reduction schemes. When clients commit a bad act, should tax and financial advisers be responsible? Should responsibility be eliminated if information is provided after the close of the tax year? Or do advisers have a duty to prevent the evasion or improper reduction of tax or to report the activity in advance?

This article looks at the history of liability exposure for failing to prevent a wrongful act. Starting with efforts to combat corporate bribery, it addresses the evolution of the failure-to-prevent standard of ethical behavior, highlighting recent U.K., U.S., and Dutch initiatives placing obligations on advisers.

THE EVOLUTION OF FAILURE TO PREVENT

Anti-Bribery Legislation

> The millions and – sometimes billions – in settlement and fines in anti-bribery cases is just a beginning! The rules which are implemented in anti-bribery legislation in many countries are here to stay – and are, as noted below, expanding to other areas of (corporate) compliance.

The failure-to-prevent standard of ethical behavior that now exists in many countries has its roots in U.S. Foreign Corrupt Practices Act ("F.C.P.A."). The F.C.P.A. was designed to prevent bribery of foreign government officials with the power to issue or approve contracts.

The F.C.P.A. applies to U.S. entities as well as foreign that have a legal tie to the U.S. (*e.g.*, by U.S. direct or indirect ownership), or foreign companies with publicly traded shares on a U.S. securities market. U.S. jurisdiction may also be invoked where a bribe has been facilitated by use of a U.S. bank or financial institution, the U.S. Postal Service, or a U.S. telecommunication service (including the use of U.S. servers). Companies caught by this legislation have found that turning a blind eye

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to bad acts and actors often leads to untold expenses and harmful public relations that drag down share value. Monetary penalties to the Department of Justice and to the Securities and Exchange Commission are to be expected as a part of a possible settlement, and the risk of individuals serving time in jail is imminent. The cases of very expensive settlements are many, and many U.S. and foreign international businesses have implemented ethical policies and procedures to prevent incompliant actions by the companies, their employees, and their agents. Equally important, ethical investor groups, including many universities and public pensions, have policies in place that limit shareholdings to corporations that meet a "good citizen" standard. Companies caught violating F.C.P.A. rules tend to be "sadder but wiser" concerning ethical behavior.

As a consequence of litigation, or an in effort to avoid it and to mitigate the consequences many international companies have introduced codes of ethics and business conduct as well as the necessary processes to implement, train and follow up such programs and policies that apply to all members of the multinational group, their employees, and their agents. Best practices have been adopted and are updated periodically as new exposure areas are identified. Employees are trained to adhere to these codes as well as to international and local legislation that attacks bribery and corruption. Monitoring systems have been implemented to track compliance. Companies have introduced due diligence procedures with business partners – customers as well as suppliers – mandating adoption of best practice policies. Today, it is impossible for many multinational companies to sell or buy products from a new or existing customers or suppliers without having performed proper due diligence as to the business practices of the counterparty to a transaction.

In most jurisdictions, the traditional view has been to look at the board of directors and hold the board responsible. The managing director is responsible only in very specific and identified cases. When bad acts are discovered, the perpetrator is described as a "rogue employee," suggesting that the act is isolated and reflects hidden behavior. Adoption of failure-to-prevent standards will change this. The board of directors typically establishes policy, but operating management is responsible for day-to-day operations. To influence operating management, anti-bribery statutes must have an enforcement mechanism. Otherwise, the anti-bribery rules are more of a wish than a mandate.

Failure-to-prevent rules in the U.S. and the U.K. are enforced by the U.S. Department of Justice and the U.K. Serious Fraud Office, governmental agencies that have a mandate to monitor compliance and punish noncompliance. However, not all countries have such stringent tools to incentivize ethical business practices.

In Sweden, modifications were made to the anti-bribery legislation in 2012 to define a new crime: gross negligent financing of bribery. In principle, management must secure that a due diligence system exists to control counterparties to a transaction. Any agent who receives corporate funds must be vetted, and management must be able to show that all reasonable steps were taken to prevent any risk of improper use of the funds. However, the Swedish rules have been designed to be relatively weak. In comparison to other countries, Swedish law does not require the implementation of concrete steps such as training programs and monitoring after-training behavior. A high burden of proof is not placed on Swedish companies to demonstrate compliance. Consequently, Swedish companies do not face an upward battle to demonstrate compliance with ethical standards.

Data Privacy

Recently, failure-to-prevent standards have migrated to other areas of law, including finance, anti-trust, anti-money laundering, and tax. The most recent example relates to the E.U.'s General Data Privacy Regulation ("G.D.P.R."), which takes effect for corporations on May 25, 2018. The G.D.P.R. is directed to the data protection and privacy of individuals and consumers. Organizational accountability is mandated by requiring organizations to implement robust privacy governance policies and procedures that among other things require risk assessment for data collected on E.U. individuals. Data collectors will be held responsible regardless of their location and the existence of an actual data breach. The penalty for failure to comply is a fine of up to 4% of group turnover. The G.D.P.R. is similar to the anti-bribery legislation in that management is incentivized to give attention because the penalty is enormous and painful.

Gender Equality

In some countries, the failure-to-prevent standard has also been applied to combat gender discrimination. Iceland has introduced legislation calling upon companies to show the reason for pay disparities between employees who perform essentially the same work and to be responsible for damages if management failed to have in place a policy on gender equality in workforce compensation.

Tax Evasion

In the tax area we see a trend in this direction with respect to tax planning and the role of the tax adviser – most recently in the B.E.P.S Action Plan adopted by the O.E.C.D. Some actions focus on transparency, putting a burden on the taxpayer to report information and actions to the tax authorities beyond what is reported in the annual report and/or tax return. In European countries, tax advisers and their clients must report "aggressive tax planning" to give the tax authorities advance warning of abusive tax planning. Obligations are imposed on the outside tax adviser and internal management. These are recent examples of the expansion of the failure-to-prevent principle. Other examples are discussed in detail below.

U.K. FAILURE TO PREVENT TAX EVASION

U.K. attacks on abusive tax planning provide a real-life example of the expansion of the failure-to-prevent principle in the context of cross-border tax planning. The new offences for failure to prevent the facilitation of tax evasion reflect the government's frustration at the difficulty encountered in successfully prosecuting large institutions when a criminal act has been carried out by a "rogue employee." The offences are "strict liability" so that they do not require proof of the involvement of senior management.

There are two offences identified in the legislation: (i) failure to prevent U.K. tax evasion and (ii) failure to prevent tax evasion in other countries. The offences extend to corporations, limited partnerships, and other structures located in the U.K. or outside that have failed to prevent the facilitation of tax evasion. In the case of foreign tax evasion, one of the following conditions must be met for the act to be punishable in the U.K.:

- One of the advisers is incorporated or formed in the U.K.

- The adviser conducts business in the U.K.

- The conduct that constitutes foreign tax evasion facilitation takes place in the U.K.

This means that overseas advisers that visit the U.K. in connection with an advisery or financial business activity fall within the scope of the legislation.

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The new offences carry the threat of unlimited fines. Fortunately, as with many other failure-to-prevent offences, entities have opportunities to protect themselves under the U.K. legislation. The key defense is that the entity has reasonable "preventative procedures" in place. H.M.R.C. issued guidance in October 2016 to help entities establish appropriate procedures. Those procedures are focused on five guiding principles:

- Risk assessment

- Proportionately of risk-based prevention procedures

- Top level commitment

- Due diligence and communication (including training)

- Monitoring and review

These are the same guiding principles used in connection with the anti-bribery statutes previously discussed. They are similar to principles that have been adopted by financial organizations required to manage anti-money laundering ("A.M.L.") risk within a large organization. While it is apparent that A.M.L. encompasses tax evasion matters, H.M.R.C. has made it clear that A.M.L. procedures, *per se*, will provide an entity with all the procedures it needs to make a complete defense against the new offences.

As mentioned above, acts of associated persons can result in liability under the offences. An associated person can be an employee or a contractor or subcontractor that can be seen to represent the entity. This risk of responsibility for the acts of others leads to the adoption of codes of ethical conduct in tax planning that are rigorously enforced. It follows that the organization must require each contractor or subcontractor to demonstrate that it has in place similar procedures that are rigorously enforced. On the other hand, it is expected that liability would not reach a corporation or partnership if it refers a client to a local adviser who then has an independent relationship with the client that leads to a prohibited act. In sum, management likely will face greater risk exposure if the company cannot prove that it has the necessary processes in place to secure proper and reasonable behavior by employees and third-party representatives that interface with taxpayers. Again, processes likely are not sufficient if they fail to include regular monitoring of behavior.

Another new development in the area of avoidance in the U.K. is the recent change to the penalties for compliance errors related to an avoidance arrangement. These changes seek to deem all behavior linked to tax avoidance arrangements as careless or deliberate for penalty purposes. These rules introduce the concept of disqualified advice, a significant and worrying development. Where a penalty is being considered and a taxpayer raises the defense of reliance on an adviser, no account is taken of advice that is disqualified. As a result, disqualified advice is treated as the absence of advice. Disqualified advice generally is the advice provided by the person who designed the plan – not one who independently evaluated the effectiveness of the plan for the taxpayer – or the person who was involved in implementing the plan based on the advice. In a sense, if the adviser fails to prevent the tax avoidance transaction from occurring, the underlying advice is not reliable. This may incentivize clients to bring malpractice actions against advisers who bring pre-packaged plans to a client or to file complaints against advisers with professional licensing bodies.

U.S. SWISS BANK PROGRAM

The United States does not criminalize the failure to prevent the facilitation or commission of a tax offense as of yet. It does, however, criminalize offshore acts that facilitate U.S. tax evasion. In addition, failure to prevent specified conduct is embodied in non-prosecution agreements and plea agreements resulting from these efforts.

The Swiss Bank Program, announced in August 2013, enabled Swiss financial institutions to avoid criminal prosecution for facilitating offshore tax evasion by U.S. taxpayers. Banks already under criminal investigations for Swiss activities were excluded from the program. However, a Swiss bank was eligible to receive a non-prosecution agreement if it fulfilled all the following conditions:

- It made a complete disclosure of cross-border activities.
- It provided detailed information on an account-by-account basis for accounts in which U.S. taxpayers had a direct or indirect interest.
- It cooperated in treaty requests for account information.
- It provided detailed information as to other banks that transferred funds into secret accounts or that accepted funds when secret accounts were closed.
- It agreed to close accounts belonging to account holders who failed to come into compliance with U.S. reporting obligations.
- It paid appropriate penalties.

There were four program categories based on the nature of the crime which determined the sort of agreement that would be available to a bank:

- Banks already under investigation were excluded from the program and generally entered a deferred prosecution agreement.
- Banks that were not yet under investigation and had reason to believe that they committed tax-related offenses sought non-prosecution agreements.
- Banks that did not believe they engaged in activities against the U.S. needed an independent examiner to verify the fact and sought non-target letters.
- Banks with a local client base, as defined under F.A.T.C.A., sought non-target letters as well.

Under the program, the U.S. government executed non-prosecution agreements with 80 Swiss banks and imposed more than $1.36 billion in penalties.

Once the Swiss Bank Program was terminated, F.A.T.C.A. became the policing measure in the U.S. Currently, F.A.T.C.A. requires U.S. persons living offshore to report their foreign financial accounts to the Financial Crimes Enforcement Network annually. Simultaneously, foreign banks now request their U.S. clients to complete forms declaring their citizenship and residency for tax purposes. This imposes a duty upon both the taxpayer to report its accounts and the financial institution to disclose its U.S. clients to ensure assets are not being concealed.

DUTCH DUTY OF CARE

Not all failure-to-prevent matters are handled by passing new law. Dutch trust companies have been targeted since the publication of the Panama Papers. Recently, the civil-law division of the Court of Amsterdam rendered an interesting judgment on a trust office's liability for the tax debts of a number of its clients.

In the case referred to as *Tradman v. Dutch Tax Administration*, clients used the trust office's advice to conceal companies that were liable to pay tax in the Netherlands. According to the Dutch Tax and Customs Administration, the trust office contributed to the fact that the tax authorities were unable to collect tax or to do so in good time. The court accepted this argument and ruled that the trust office should have borne the interests of the Tax and Customs Administration in mind when it provided assistance to its clients.

This is a remarkable judgment – in large part because a duty to the Tax and Customs Administration does not exist under Dutch law. In principle, the Tax and Customs Administration had sufficient powers under tax administrative law to safeguard its rights against the taxpayers in respect of a tax assessment. It has the power to raise an estimated assessment, which it failed to do. However, this point was not raised in the case. Instead, it seemed to rely on a concept that the trust office is an "insurer" for payment of Dutch tax by customers. Guilt by association would be a good description of the position of the Tax and Customs Administration.

The civil-law division of the Court of Amsterdam does not generally address tax matters, and certain conclusions of law do not appear to be widely accepted in tax jurisprudence. The court was correct to find that, in general, a trust office cannot be expected to weigh the interests of its client against the interests of third parties (*i.e.*, the Tax and Customs Administration). However, the court subsequently swept this consideration aside with the platitude that essentially applies to every adviser, namely that given its "social position in financial transactions and professional expertise" it should "to a certain extent" take the interests of third parties into consideration in the performance of its assignment. The court considered this to be a trust office's duty of care. Thus, if the trust office fails to perform its duty, standards of due care have been violated.

The court added to this that the directors and employees of the trust office may also be held personally liable if they can be "attributed serious blame" for the relevant trust office's actions and omissions. According to the court, this is the case if the directors and employees are personally involved in giving advice to the taxpayer. The court expressed the view that the trust office's duty of care implies that it is the trust office's task to investigate whether the service provided could be used for tax evasion.

The open issue, should the case be appealed, is whether the court's pronouncements are based on tax law that exists or simply on general views that are not found in tax practice.

Part of the court's ruling was favorable for the taxpayer. The tax authority argued that once fraud is asserted, no defense is available to the trust company. This is consistent with the view that the trust company is an insurer of the tax which would otherwise be due. Thus, resorting to a court amounted to an additional abusive act. The court disagreed. It found that a trust office may use legal process to defend itself without being viewed as further obstructing the Tax and Customs Administration. The trust company did nothing wrong when it sought legal protection for the benefit of its other clients and for its own interest. This implies that in future cases trust companies can defend their own position.

As a final point, the case dealt only with the trust office's legal liability. It did not address damages. With regard to the extent of the loss and the extent to which the Tax and Customs Administration is to blame for that loss, as well as whether the unlawful act is causally related to the loss at all, the court deferred any decision, preferring the matter to be the subject of follow-up proceedings. Consequently, the amount for which the trust office would be liable is yet to be determined. Undoubtedly, there will be more to report as this case develops.

CONCLUSION

"Advisers may no longer be able to claim a defense based on lack of knowledge or awareness of the results of a client's activity."

Recent developments show that there has been a change in attitude regarding the adviser's role. Advisers are being held accountable for their services and the consequences of actions carried out by clients. There is a movement in government, nongovernmental organizations, and the press to shift the loyalties of advisers from strict focus on interests of the client. Instead, the movement is towards putting the public interest ahead of loyalty to the client. When this approach is carried to its ultimate conclusion, advisers may no longer be able to claim a defense based on lack of knowledge or awareness of the results of a client's activity. Simple disclaimers may no longer shield an adviser from risk. Sophisticated advisers providing aggressive but arguably justifiable plans to a client may be held civilly or criminally liable for their plans. Client confidentiality is in the cross-hairs, and it is not clear that the ultimate answer will be the same in Europe and the U.S.