The UK Criminal Finances Act 2017: tax evasion implications for franchisors – action steps

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15 NOV 2017

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The Criminal Finances Act 2017, now in force in the United Kingdom, introduces two new criminal offenses in respect of the facilitation of tax evasion. The new offenses will be committed where a corporate entity or partnership fails to prevent an associated person from criminally facilitating the evasion of tax, whether the tax evaded is owed in the UK or in a foreign country where there is a connection to the UK.

The legislation does not seek to amend what is criminal – rather, it widens the net as to who can be held accountable so that corporate entities and partnerships may be held criminally liable for the acts of their associated persons who criminally facilitate the evasion of tax.

The new offenses are strict liability offenses – *ie*, there is no need for the prosecution to establish that the entity being charged knew about the tax evasion.

Notably, however, when the entity has put in place reasonable procedures designed to prevent the criminal facilitation of tax evasion by an association person, the entity has a defense. That is, where a relevant body's **associated person** criminally facilitates the evasion of tax and the entity has failed to prevent such person from committing the offense (of criminal tax evasion), the entity will itself be guilty of a criminal offense carrying unlimited fines, unless it can show that it put in place reasonable prevention procedures.

Another factor in the mix: revenue investigators in the UK are sometimes remunerated on a commission basis on the amount of unpaid tax they are able to recover, thus incentivizing them to pursue corporate entities who may be perceived as having "deep pockets."

While there is nothing in the Act that relates specifically to a franchise relationship, franchisors should be aware of a few key issues that may affect them, in particular:

- the definition of "associated person"
- the nature of non-UK tax evasion and
- the concept of reasonable prevention procedures.

"Associated person"

The key question for any franchisor is whether a franchisee or sub-franchisee could be considered an "associated person." The Act defines an associated person widely, to include an employee, an agent or any other person performing services on behalf of a relevant entity. Each scenario will turn on its facts; the key question will be whether the franchisee is performing services on behalf of a franchisor or is doing something for the franchisor that it is obliged to do. Despite the fact that many franchise agreements explicitly state that the franchisee is not an agent or employee of the franchisor, the Act, like many others, requires assessing the actual nature of the relationship between the franchisor and the franchisee or sub-franchisee, rather than how the contractual agreement characterizes the nature of the relationship between the parties.

It will be important therefore to assess the degree of control the franchisor has over the franchisee or sub-franchisee; whether it could be said that the franchisee or sub-franchisee is acting as the franchisor's *de facto* agent; or whether the franchisee or sub-franchisee is doing something *on behalf of* the franchisor, which may not always be obvious.

In the context of tax evasion, if a franchisee is charged with criminal tax evasion – for example, because of accepting cash payments for the provision of services supplied as part of the franchised business while failing to declare that income for corporation or income tax purposes − then the franchisor would be well advised to consider the components of the "reasonable procedures" defense. Prudent franchisors should look to protect themselves against the risk of prosecution by making modifications to the franchise system and training provided to franchisees to ensure that the franchisor is able to rely on the "reasonable prevention procedures" defense.

Non-UK tax evasion

The Act also creates an offense of failure to prevent the facilitation of foreign tax evasion. However, unlike the domestic UK offense, this offense can only be committed where:

- the corporate body or partnership is established under UK law
- the relevant entity carries on part of its business from the UK or
- the associated person carries out the facilitating criminal act in the UK.

Therefore, when a franchisor incorporated outside the UK conducts no business from or within the UK, but has an associated person who carries out a criminal act of tax evasion outside the UK, the offense will not be caught by the Act. The Act also requires "dual criminality" – which, put simply, means the act of tax evasion must be criminal both in the UK and in the overseas jurisdiction. If the overseas jurisdiction does not have an equivalent tax evasion offense at the taxpayer level and facilitator level, then under the Act, no crime has been committed.

Again, in order to make out the offense, the question of whether a franchisee or sub-franchisee is an associated person will have to be established. For the reasons mentioned above, under a typical franchise relationship, the franchisee or sub-franchisee will likely not satisfy the test of an associated person. Despite this, a franchisor would nevertheless be well advised to consider the components of the "reasonable procedures" defense and to make the necessary modifications to ensure that it is able to rely on this defense, if necessary.

Reasonable prevention procedures defense

On September 1, 2017, the UK Inland Revenue Service (Her Majesty's Revenue and Customs - HMRC), published guidance on the use of the defense and some guiding principles to help relevant entities understand what may constitute reasonable prevention procedures. The following are the six principles as applied to a franchisor:

1. **Carrying out risk assessments** – Franchisors should assess the nature and extent of their exposure to the risk of franchisees or sub-franchisees criminally facilitating tax evasion offenses. Exposure to risk may vary based on the country, sector, transaction type, product or customer.
2. **Implementing procedures proportionate to the risks** – Procedures implemented by a franchisor should be proportionate to the risk the franchisor faces of franchisees or sub-franchisees committing tax fraud. This will depend on the degree of control and supervision the franchisor is able to exercise over a franchisee, and the proximity of the franchisee to the franchisor. For a franchisor who has less control over the franchisee or sub-franchisee either contractually or from a day-to-day perspective, this means that fewer procedures will likely be required. Despite this, at the very least a franchisor should be conducting a risk assessment, keeping the main risks under review and be able to articulate the outcome of the risk assessment and the active decision not to implement any procedures, should they be challenged at a later stage.
3. **Performing due diligence** – The franchisor should apply due diligence procedures proportionate to the identified risk, taking into consideration the level of control and supervision the franchisor is able to exercise over a franchisee or sub-franchisee. Given the nature of the franchise relationship, the level of due diligence required is unlikely to be high. Despite this, following the risk assessment, a franchisor may assess the risks as being substantial in relation to a particular franchisee due to unique circumstances – for example, concerns specific to a particular location or region – and so should apply greater scrutiny to franchisees in that location.
4. **Ensuring there is top level commitment to preventing tax evasion** – At the top level, franchisors should foster a culture within their organization in which activity intended to facilitate tax evasion is never acceptable. This could include communication and endorsement of the franchisor's stance on preventing criminal facilitation of tax evasion and involvement in the development and review of preventative procedures.
5. **Communication (including training)** – The franchisor should ensure that prevention policies and procedures are communicated, embedded and understood throughout the organization through internal and external communications, including training. This could include tax evasion and general fraud training which covers the franchisor's policies and procedures, an explanation of when and how to seek advice, and whistleblowing procedures for reporting any concerns or suspicions.
6. **Carrying out ongoing monitoring/reviews** – Franchisors should monitor and review their preventative procedures and make improvements where necessary. This could be done through formal periodic reviews or by seeking feedback from staff members and franchisees.

Next steps

Prudent franchisors are taking steps now to implement prevention procedures. This can be done by:

- carrying out risk assessments and due diligence to assess exposure to risk
- ensuring there is a documented top-level commitment to preventing tax evasion, and demonstrating this commitment on an enterprise-wide basis through training franchisees and sub-franchisees on tax evasion and preventative measures
- carrying out ongoing monitoring and reviewing of processes
- Closing any gaps found in the system which may expose the franchisor to an unacceptable level of risk of prosecution.

Find out more about the implications of the Criminal Finance Act for your franchise by contacting the author or any member of our Franchise team.