SPECIAL REPORT:
MONEY LAUNDERING LEGISLATION IN THE U.K.

THE U.K.'S ROLE AS INTERNATIONAL ENFORCEMENT OFFICER

by Richard Palmer, London, England

INTRODUCTION: On Wednesday, March 22, 2006, at 1:00 pm ET, the Tax Section together with ABA-CLE will sponsor its annual **Tax Link Live** member benefit teleconference. This special 90-minute ethics program will feature a discussion on "**Ethical Considerations for a U.S. Practitioner in Planning for a U.S. Multinational Client.**" Speakers will include: Joan C. Arnold, Pepper Hamilton LLP, Philadelphia, PA; Peter M. Cohen, Trident Trust, Atlanta, GA; Richard Palmer, Ashurst, London, England; H. David Rosenbloom, Caplin & Drysdale, Washington, DC, and Stanley C. Ruchelman, The Ruchelman Law Firm, New York, NY. This expert panel will discuss the U.S. practitioner's ethical considerations in planning for a U.S. multinational client when confronted with fraudulent avoidance of foreign law and examine whether US ethical principles may conflict with foreign rules. The panel also will explain the "Know Your Customer" (KYC) rules that are applicable to practitioners in the U.K., especially in light of the broad definition of money laundering that includes assisting persons who have committed tax fraud in another country and KYC requirements that apply to the offshore sector in response to the OECD challenge initiated several years ago. The following article is part of the program materials for the teleconference. For details on registering and obtaining CLE ethics credit, please see the ad on page 23 immediately following this Report.

Money laundering is the process by which the identity and ownership of the proceeds of crime are concealed so that the proceeds appear to originate from a legitimate source and can be retained permanently or recycled into further criminal enterprises. The scope of money laundering laws has broadened significantly over the last couple of years for four reasons. First is due to the second Money Laundering Directive and secondly, and crucially, the tracing of Islamic terrorist funds has become a very high priority for law enforcement agencies all over the world. Thirdly, the Government sees the Proceeds of Crime Act 2002 (**"POCA"**) as one of the key weapons in its armoury against criminal conduct. Fourthly, the police in the U.K. get to keep 50% of the recovered proceeds (but not in relation to evasion of foreign taxes where that is the crime).

Whilst the U.K. money laundering legislation applies principally to U.K. businesses and their U.K. advisers, advisers based outside the U.K. should be aware of the basic rules and reporting requirements for a number of reasons. If U.K. advice is required on any transaction, then the advisers (or their client) will need to provide sufficient proof of their identity (for example, copies of passports) to enable the U.K. adviser to meet its obligations to comply with formal identification procedures. In addition, the U.K. money laundering legislation is very widely drafted and (as discussed below) may require reporting of transactions which do not constitute criminal conduct where they are carried out but which would be criminal in the U.K. U.S. advisers should be aware that U.K. advisers may be obligated to report both their client and any overseas adviser engaged on any transaction which is reportable. The U.K. adviser is also prohibited from telling the US adviser or client that he has reported them. If a disclosure is made in respect of, say, foreign tax evasion, the U.K. revenue authorities have procedures for passing on details of any such disclosure to their counterparts in other jurisdictions.

The U.K. has, therefore, moved well ahead of its European colleagues in the scope and enforcement of its anti-money laundering laws. The two main sources of law in the U.K. are POCA and the Money Laundering Regulations 2003. The former has been supplemented by the Serious Organised Crimes and Police Act 2005 which provides a significant increase in the powers available to HM Revenue and Customs investigators.

POCA

The POCA establishes extremely broad powers in relation to the proceeds of crime, including the power to freeze assets, trace and seize assets, and make confiscation orders, but it goes further than this. It creates offences that enable those who facilitate money laundering to be prosecuted and it expands the scope of the crimes covered.

There are two different types of powers that are provided for. One is effectively a broad tracing type of power where the authorities go in and say "We know you nicked this money and bought this yacht with it so therefore we are going to take this yacht from you". The second power is akin to confiscation orders which derive after a person is convicted. In this case the court says "You've got no visible means of support, you're living a criminal lifestyle, we know you've been dealing in drugs, we believe that you

have made about £3m out of this illegal activity so you must pay us £3m and if you don't come up with the money then you'll serve extra time in prison".

But what does it mean for the tax practitioner and the lawyer? Well here the legislation establishes a series of money laundering offences some of which apply to both the regulated and unregulated sectors and some of which apply only to the regulated sector. The Money Laundering Regulations set out what businesses are within the regulated sector and these include businesses engaged in insolvency, tax, accountancy and legal services.

CRIMINAL PROPERTY AND **CRIMINAL CONDUCT**

The concept of criminal property is at the heart of money laundering law. It is a concept on which the POCA operates and it is very important to realise that the law on money laundering has moved beyond merely policing the proceeds of drug and terrorist offences and now is a very wide-ranging law indeed.

The starting point is the definition of criminal property which is contained within section 340 of POCA. Criminal property is property which constitutes a person's benefit from criminal conduct or represents a benefit either in whole or in part directly or indirectly. You cannot get much wider than that. In the typical tax evasion case, property will have been obtained as a result, say, of legitimate trading or disposal and a portion of it retained as a result of the non-payment of tax. The alleged offender has to know or suspect that it represents such a benefit but as this is very broad indeed the next question is what is criminal conduct?

Criminal conduct is defined in section 340(2) of POCA as conduct which constitutes an offence in any part of the United Kingdom (we would expect that) or (and this is the really shocking part) "would constitute an offence in any part of the United Kingdom if it occurred there". You don't need to have knowledge of the criminal law of any other country and, therefore, the place where the criminal conduct occurred is irrelevant. What matters is whether the conduct would have constituted an offence if it had been committed in the U.K. It is not clear whether you simply transpose the facts or consider the facts in the context of the relevant circumstances. This is what is known as the single criminality test. The conduct need not be unlawful in the place where it occurs but only in the "home" jurisdiction. Whilst this has the benefit of simplicity it can produce absurd results—viz the Spanish matador and the U.K. road haulier. It also means that many more U.K. disclosures are being made in circumstances where perhaps they shouldn't.

The more sensible interpretation, but one that is not technically correct, is the dual criminality test—namely the criminal conduct must be criminal in both the state of commission and the U.K., but that then means you need to know the criminal law of the foreign country. Further, it is immaterial whether the conduct occurred before or after the POCA came into force. This is a retrospective law which is pretty rare in constitutional terms under U.K. law. We'll come to what sort of tax offences are caught by criminal conduct shortly but in the meantime it is worth looking at the actual offences which POCA sets out and which could apply to advisers.

PRINCIPAL **OFFENCES**

There are three principal offences which apply to both the regulated and unregulated sector and they are set out in sections 327, 328 and 329 of POCA. It is worth noting that section 328 is particularly widely drafted and includes entering into or becoming concerned with an arrangement which a person knows or suspects (this is actual knowledge or an actual suspicion), facilitates the acquisition, retention, use or control of criminal property by or on behalf of another person. When providing tax advice, for example on property transactions, setting up trusts or creating offshore structures a lawyer/tax adviser should be aware of the need to consider whether the transaction on which he is advising facilitates the acquisition, retention or use of criminal property. If you go further and acquire, use or have possession of criminal property then you are also guilty of a criminal offence and in all these cases the maximum penalty is 14 years in prison. It should be pointed out that no offence is committed if you do not have actual knowledge or suspicion that the property represents a benefit from criminal conduct. Suspicion requires a degree of satisfaction (not necessarily belief) extending beyond mere speculation as to whether something has occurred or not. It is more than simply having a cause for concern. In that case you should ask the client more questions which may allay concerns, but that isn't always easy.

TAX EVASION AND AVOIDANCE

The question of whether or not fiscal offences and in particular evasion of foreign tax can be regarded as predicate offences for the purposes of U.K. anti-money laundering law has been much debated. Some commentators take the view that they are not, relying on the long-standing principle that the courts of one country will not enforce the revenue and penal laws of another. To apply the money laundering laws to foreign tax evasion would be to indirectly circumvent this rule and enforce foreign revenue laws. Furthermore, they point to the fact that the FATF (Financial Actions Task Force) makes no mention of fiscal offences as predicate offences in its Recommendations. This argument ignores the fact that U.K. parliament can make laws which derogate from this long-standing principle and provisions of tax treaties which allow for exchange of information. Much of the U.K.'s money laundering legislation is about collection of information which it is known will be shared between law enforcement agencies. If the matter came to the courts, the likely answer is that the court would uphold the POCA rather

than the common law principle. In short, if the foreign conduct amounts to what would be tax evasion in the U.K. (or a similar criminal offence such as cheating the Revenue) the U.K.'s anti-money laundering provisions will apply.

Tax evasion is a criminal offence in the U.K. and the financial benefit gained represents a person's benefit from criminal conduct even if the money or property on which tax should have been paid was legitimately earned. It is difficult to establish clear guidelines as to the difference between tax evasion and tax avoidance save that the consequences of the former are criminal convictions and the latter civil penalties. In essence though, tax avoidance is perhaps taking advantage of the fact that the tax system is not always joined up whereas tax evasion is really the illegal non-payment of tax rightfully due. The common thread in all cases of direct tax evasion is concealment or dishonesty. The distinction has not been helped by courts and judges often using the terms interchangeably, and occasionally embellishing them with phrases such as "unacceptable tax avoidance" or "innocent evasion". To the extent that the Revenue has any consistent practice it has indicated that there will be no criminal offence where there is no element of concealment of the true facts of arrangements for which there is a respectable technical case. A key question though is what level of disclosure is required to ensure there is honesty. It will be interesting to see whether a taxpayer who has entered into a tax avoidance scheme which he has not disclosed under the Tax Avoidance Disclosure Regulations and which is successfully challenged by the Revenue will face a criminal charge. Will such taxpayers find that although they haven't disclosed under the Disclosure Regulations their advisers have reported them under POCA?

In the U.K. at least, there is now a statutory offence of fraudulent evasion of tax in section 144 FA 2000 but, historically, tax evasion has been charged as the common law offence of cheating the Revenue. In both offences, dishonesty must be proved. It is interesting to note that for indirect tax (such as VAT) a criminal offence can be committed as a result of an innocent or accidental error.

PRIVILEGE AND CONFIDENTIALITY

A solicitor is under a professional and legal obligation to keep the affairs of clients confidential and that protection is provided by way of a privilege against disclosure.

This is a fundamental cornerstone of the legal system. But not everything that a lawyer has a duty to keep confidential is privileged. Only those confidential communications falling under the head "advice privilege" or "litigation privilege" are protected. In the current context it is advice privilege which will be relevant. That relates to communications between a lawyer acting in his capacity as a lawyer and a client if they are confidential and for the purpose of seeking legal advice from a lawyer or providing legal advice to a client. It is therefore only those communications that directly seek or provide advice which are privileged.

Legal professional privilege does not, however, exist in respect of documents which themselves form part of a criminal or fraudulent act or communications which take place in order to obtain advice with the intention of carrying out an offence. So, with regard to the principal offences, namely concealment, arrangement, acquisition, use, or possession, if the solicitor knows that the transaction on which he is acting will constitute a principal offence, not only does the solicitor risk committing such an offence (unless he makes an authorised disclosure) but the communications relating to the transaction are not privileged and can be disclosed.

Even if you suspect that a money laundering offence may be committed statute (POCA §338(4)) clearly states that an authorised disclosure does not breach any restriction on disclosure or the duty of confidentiality. That is true also where the solicitor receives information about another person (other than his client) whom he suspects is engaged in money laundering. Again the solicitor can make a suspicious activity report without breaching his professional obligations.

DEFENCES TO PRINCIPAL OFFENCES

It is a defence to the principal offences if a suspicious activity report has been filed with the National Criminal Intelligence Service (NCIS). If the report is made before completion of the suspicious transaction (ie. before any concealing, arranging or acquiring takes place) then the law enforcement agencies have a time period in which to provide or refuse appropriate consent. A solicitor should not take any further steps, having made a report, until he has either obtained NCIS consent or seven days have elapsed. A fast-track system has been put in place for urgent requests and consents can be faxed within 24 hours. This can still, however, leave solicitors in a difficult position. A report that concerns evasion of U.K. tax or NIC's and which is not linked to wider criminality will be forwarded by NCIS to the Inland Revenue and any enquiries they carry out will be in the same manner as any other enquiry. Proceeding with the transaction without appropriate consent can lead to criminal liability. Where the report concerns foreign tax evasion, U.K. tax legislation includes the authority for the Revenue to exchange information with other fiscal authorities. The legislation refers to "the exchange of information necessary for carrying out the domestic laws of the U.K. … including, in particular, provisions about the prevention of fiscal evasion …". These exchanges are supported by the extensive network of double tax agreements which often contain specific clauses relating to information exchange. Within the EU, further assistance is available to the respective revenue authorities under the Mutual

Assistance Directive. This process enables one EU country to ask another to use its domestic formal information powers to assist in an investigation. In addition, there are also two new programmes, Fiscalis 2007 and Customs 2007 which are designed to counter cross-border tax fraud by implementing improved electronic systems for information exchange, co-operation in investigations and the exchange of information between administrations. In the U.K. it is clear that the Government's objective is to attack tax fraud and evasion by exchange of information rather than supporting any network of withholding taxes. It is also worth noting that the introduction of the Anti-Terrorism Crime and Security Act 2001 allows the Revenue to breach taxpayer confidentiality under certain circumstances which include any criminal investigation or criminal proceedings whether in the U.K. or abroad.

REGULATED SECTOR – SECONDARY OFFENCES

If you are in the regulated sector then there are some "failure to disclose" offences. The first one is the failure to disclose knowledge or suspicion (actual or constructive) of money laundering to your firm's money laundering officer or to the NCIS. This applies to any employee in the regulated sector. Under the Money Laundering Regulations, all firms within a regulated sector must have a money laundering officer.

In relation to regulated sector offences actual knowledge and actual suspicion are certainly grounds upon which you might be committing a money laundering offence but the legislation also includes circumstances where you have reasonable grounds for knowing or suspecting that a person is involved in money laundering. Section 330 provides that it is an offence to fail to make the required disclosure when in the course of business in the regulated sector a person acquires knowledge or suspicion or there are reasonable grounds for knowledge or suspicion that another person is engaged in money laundering. In other words, the POCA imposes an objective test and that is because a higher standard is expected in the regulated sector. If a reasonable person in your position would have come to the conclusion that a person was involved in money laundering, the fact that you did not happen to spot it is no defence. This means that you can effectively commit this offence negligently. But what if you suspect that your client might commit an offence? An intention on the part of a client not to pay tax of itself is insufficient to amount to criminal conduct. But does the position change if he makes up his mind and decides not to include certain points on his tax return or do you need to wait until he files the misleading tax return or the deadline date has passed? These questions are important because they affect anyone who might be holding such proceeds/profit (a principal offence under section 328) or any adviser in the regulated sector who would be concerned about failing to report an offence. It is not clear. But what is clear is that you, as an adviser, might want to think twice before asking your client any questions, the answers to which would suggest he has or is committing an offence. It is also unclear whether it is enough to be suspicious in a general sense (what we would call the 'smell test') without any reference to the specifics of the tax scheme. In relation to foreign tax evasion or avoidance, schemes can often be complex so how would an adviser know or suspect if something is merely complex tax avoidance or is illegal tax evasion? Interestingly the Chartered Institute of Taxation's guidance notes give no indication as to what degree of knowledge, if any, a tax adviser is required to have of overseas tax systems. What is helpful, however, to the lawyer at least (but not the tax adviser who is only an accountant), is that if the information which gives rise to the suspicion is privileged then no disclosure needs to be made. One should note that many lawyers rely on this as a defence. Of course, as previously discussed, that cannot apply if the information was communicated with the intention of furthering a criminal purpose.

There is also a similar offence where the nominated money laundering officer fails to report suspicions to NCIS as soon as practical after he himself is informed.

In addition, there is an offence of tipping-off, that is tipping-off a person about an investigation being started or currently under way. Thus if you know or even suspect that a disclosure has been made you cannot go around telling people that they are the subject of an investigation or allow them to have information which leads them to that conclusion. As a lawyer you may want to make preliminary enquiries of a client or raise questions during a transaction to clarify various issues or to remove any suspicions. Nothing here prevents you from doing that and these enquiries will not amount to tipping off unless you know or suspect that a report has been made and you make enquiries in such a way which discloses those facts.

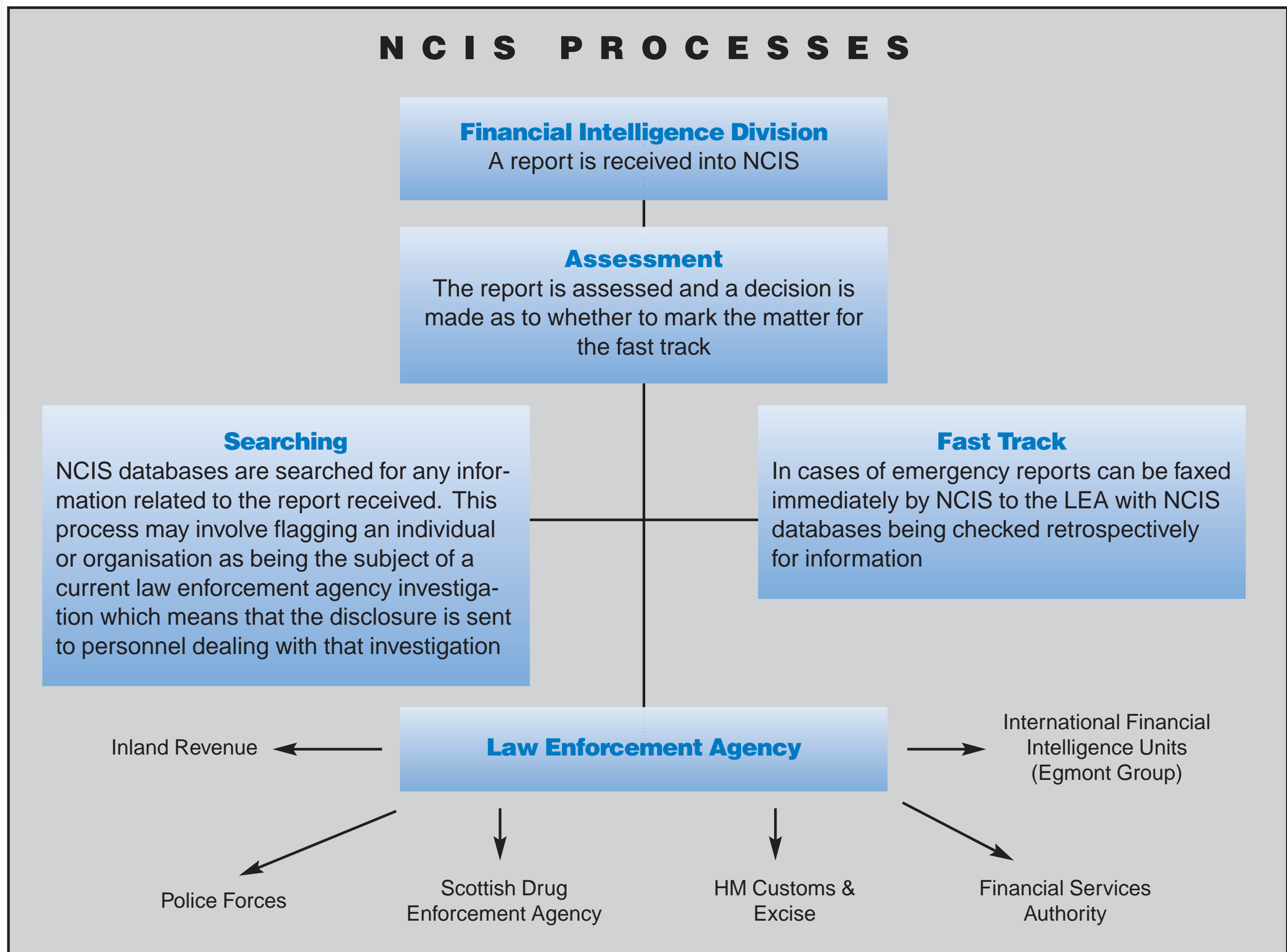
NCIS

Where a pre-transaction report is made to the NCIS, the solicitor must wait for NCIS consent or for the time limit to expire before proceeding with the transaction. The solicitor should separately determine whether to continue to act but will need to be careful that terminating the retainer does not amount to tipping off. Therefore, the manner in which the retainer is terminated will be important. If NCIS refuse consent then the solicitor cannot take any further steps for 31 days.

In very limited circumstances a legal advisor, having made an authorised disclosure, can tell others of that fact provided that it is necessary and appropriate in connection with the giving of legal advice (*P v. P* 2003 EWHC 2260). *(See NCIS Process illustration next page.)*

THE MONEY LAUNDERING REGULATIONS

The Money Laundering Regulations and the Joint Money Laundering Steering Group Guidance



Notes, which supplement those regulations and are in effect a "best practice," set out a number of obligations on relevant businesses. In essence they impose:

(i) identification procedures;

(ii) record-keeping procedures;

(iii) internal reporting procedures; and

(iv) money laundering awareness training.

Failure to comply with these obligations is a criminal offence.

Identification procedures must be followed where the client and the applicant for business form or agree to form a business relationship, where a payment of €15,000 or more is to be made by the applicant for business or where you, as the regulated business, know or suspect that the transaction involves money laundering whatever the amount.

The client identification procedures are perhaps the most significant part of the Money Laundering Regulations. Your identification procedures must require that as soon as reasonably practicable after contact is first made with the applicant for business that he produces satisfactory evidence of his identity. The test for satisfactory evidence is two-fold. First an initial objective test of what is reasonable and then the objective part of whether the lawyer/regulated adviser is satisfied. This should include copies of passports or identity cards and utility bills and physical inspection by the lawyer. It is worth noting that if satisfactory evidence cannot be obtained the business relationship must stop, otherwise a criminal offence is being committed. Potential clients need to understand that this inconvenience is necessary in the context of fighting money laundering.

As far as record-keeping obligations are concerned, you will need to keep a copy of evidence obtained for a five year period and detail all transactions carried out in the course of your acting for the client.

You will need to comply with internal reporting procedures which means nominating a money laundering officer (MLO) to receive disclosures from staff and who must then also determine whether the information received gives rise to knowledge, suspicion or reasonable grounds for knowledge or suspicion and whether a suspicious activity report should be made to NCIS. The nominated MLO is not a role actively cherished by many lawyers in a firm.

Finally, you must conduct anti-money laundering training with staff which must cover money laundering law and guidance on how to recognise and deal with transactions which may amount to money laundering. ■