Dutch Guidance on Tax Integrity Risk for Financial Institutions

Monique van Herksen and David Schreuders

Issue: Derivatives & Financial Instruments, 2019 (Volume 21), No. 2
Published online: 7 March 2019

Financial institutions serve a “gatekeeper” role when it comes to preventing and addressing money laundering conducted by (or through) their clients. The Dutch regulator is requiring Dutch banks to significantly improve their “know-your-customer” rules and test their clients much more thoroughly for aggressive tax planning. This article discusses the new guidance issued in the form of a consultation paper that was published on 7 February 2019 on what constitutes “good practice” when it comes to financial institutions screening their clients for aggressive tax planning structures.

1. Synopsis

On 7 February 2019, the Dutch regulator (De Nederlandsche Bank (DNB)) published guidance for financial institutions on how to investigate the fiscal motives of their clients (the Guidance).[1]

According to the published Guidance, the reason for its issuance is that financial institutions wish to avoid being engaged or involved in tax avoidance and evasion. Banks are legally required to take measures to guarantee business integrity and avoid getting involved with financial economic crimes, including money laundering related to tax evasion. Therefore, banks are required to investigate the fiscal motives of their clients for the requested financial services and determine whether there is any risk of tax evasion. If a bank does not (sufficiently) investigate this, it may be that the bank unwillingly facilitates money laundering.

Although tax avoidance is not illegal, the harmful effects thereof may affect the reputation of a bank and, in general, the trust in the Dutch financial sector. In any case, a bank may want to determine whether there is factually tax avoidance or tax evasion taking place. The Guidance, however, groups both avoidance and evasion under one label: fiscal integrity risk.

The Guidance shows how a bank can structure its systematic integrity risk analysis (SIRA) process, i.e. the client investigation and transaction monitoring, such that fiscal integrity risks related to clients can be identified and managed better. Although the brochure is labelled “guidance”, it does provide that the focus areas and examples serve as an addition to the applicable laws and regulations that were issued previously, including:

- the DNB guidance on the Act for the Avoidance of Money Laundering and Financing of Terrorism (Wet ter voorkoming van witwassen en financieren van terrorisme (WWFT)) and the Sanctions Act (Sanctiewet (SW)) of April 2015[2]
- the guidance on post-event transaction monitoring for banks[4]
- “Integrity risk analysis: More where required and less where possible”[5]
- “Q&A on the Determination Ongoing Due Diligence Process (WWFT and SW)”[6] and
- “Good practice Integrity Risk Appetite”.[7]

The Guidance focuses on the fiscal integrity risks of clients of a bank. It does not address fiscal integrity risk with regard to the bank’s own practices. Investigating the risk of tax avoidance of clients as a form of money laundering is not a new requirement, and supervision thereof is principle based. This means that the practical implementation thereof is not prescribed minutely by law; and there are no

---

2. NL: Money Laundering and Terrorist Financing (Prevention) Act (Wet ter voorkoming van witwassen en financieren van terrorisme), most recently amended by Stb. 2018, 42170 [hereinafter WWFT].

© Copyright 2019 IBFD: No part of this information may be reproduced or distributed without permission of IBFD.
Disclaimer: IBFD will not be liable for any damages arising from the use of this information.
regulations are issued by the regulator. A bank will make its own decisions on how to apply the rules, and the regulator will review the results thereof.

The Good Practices brochure provides real-life examples of how problems have been addressed in practice by banks based on findings resulting from aggressive tax planning and client anonymity investigations that were conducted by the Dutch regulator in 2017.

2. Legal Context and Reach

There may be a range of fiscal motives for clients to which fiscal integrity risk can be linked. At issue is that a bank will need to investigate the motives of its clients to prevent that the bank becomes involved with tax avoidance. Next, a bank will need to determine whether it considers the fiscal integrity risk of the clients acceptable. If it is determined that there is no tax avoidance or tax evasion, but (only) tax optimization, the (applicable) rules will be limited. A bank is not required to know all the tax consequences of each structure of each client, but it will need to have procedures in place that serve to adequately ensure that the fiscal integrity risks of its clients and related transactions are clear and acceptable.

3. Cross-Border Transactions

Cross-border transactions and clients with complex international business structures are particularly exposed to fiscal integrity risk. Therefore, the G20, OECD and Financial Action Task Force (FATF) have determined that the effective tackling of tax avoidance and evasion benefits from international rules, as well as the approaches to implementing those rules in national law and regulations. This has led to the Common Reporting Standards (CRS) and the BEPS Actions of the OECD, as well as recommendations by the FATF with regard to fiscal integrity risk. The international rules have also been included in European law and regulations. The 2012 FATF Recommendations define tax avoidance as a predicate offence to money laundering. Based on the revised EU Directive on Administrative Cooperation (DAC 6), which was updated in 2018 and will become effective as of 2020, banks that qualify as intermediaries will be required to report cross-border tax structures that meet predetermined hallmarks to tax authorities.

4. Dutch Law

Banks are required to take action to avoid becoming involved in money laundering. The relevant rules are included in the Act on Financial Supervision (Wet op het financieel toezicht (WFT)), the Decree on Prudential Rules (Besluit prudentiële regels) of the WFT and the WWFT. Measures taken by a bank to comply with the WWFT and the WFT may be integrated, as they largely serve the same purposes. Of key importance is that a bank “knows its customer” and knows the purpose for which the business relationship exists. If there is insufficient transparency, an unacceptable risk is presented that the bank will become involved in facilitating tax avoidance by the client, and for that reason, the bank may reject that client. To obtain adequate transparency of the integrity risks of clients, a bank is required to conduct a SIRA process. If the SIRA process leads to the identification of fiscal integrity risk, a bank is required to (i) develop a policy for fiscal integrity risk; (ii) implement procedures; and (iii) take adequate measures. In the SIRA process, the bank should list which structures are and are not (any longer) acceptable based on its own integrity risk appetite. The measures taken should be proportional to the nature and size of the financial institution. Not only is the bank required to investigate clients at the moment of establishing a relationship (acceptance), but also on an ongoing basis and with regard to future transactions. To this extent, adequate measures need to be implemented in order to obtain transparency with regard to the ownership and control structure of the client. In addition, an investigation of the source of the means/funds with which a transaction is conducted may be required. In the case of changes to laws and regulations, it is also expected that banks will conduct an adequate investigation when the client’s fiscal structure changes based on the changed laws.

Banks are required to intensify their monitoring when the identified risk increases. The SIRA process is required to support this approach. Banks can divide their client base into classes with different risk profiles and use their own indicators based on the client characteristics that may indicate increased fiscal integrity risk. These characteristics could be complex in terms of business structure, client activities, jurisdictions involved, types of transactions, etc. Similarly, banks are required to make sure their employees and staff are (periodically and) adequately trained to recognize fiscal integrity risk.

The Guidance is applicable to (i) all banks that are established in the Netherlands; (ii) branches of foreign banks that are established in the Netherlands; and (iii) internationally operating banks. The latter banks are defined as such in article 2 of the WWFT.

8. See supra n. 1.
11. NL: Decree on Prudential Rules WFT (Besluit prudentiële regels WFT), most recently amended by Stb. 2018, 33915 [hereinafter BPR].
12. Art. 10 BPR; and art. 2 WWFT.
13. Branches of such banks outside of the EU territory will be required to organize their client investigation systems to complement the WWFT requirements at group level. These banks will need to apply procedures and policies that can be implemented effectively by branches and subsidiaries established in an EU Member State.
5. Investigating Fiscal Integrity

Fiscal integrity investigation processes are described as (i) starting with the SIRA process; (ii) going through the integrity risk appetite; and (iii) clients either being accepted as having no risk or being assessed in a client tax assessment as presenting either unacceptably high risk or acceptable risk. Clients with unacceptable risk should be rejected as clients, possibly after reporting the financial institution to the Financial Intelligence Unit (FIU). Clients with no risk or acceptable risk can be accepted, but they should be subject to ongoing transaction and client monitoring.

Good practices (analysed during the 2017 review period) reported by the regulator in the Guidance include the following observations/actions:

- Scanning the client portfolio for fiscal integrity risk based on the complexity of the client structure. Complexity indicators include (i) a client having several layers of ownership; (ii) ownership structures including entities in offshore jurisdictions; (iii) the presence of doelvenootschappen (single/special purpose companies); (iv) the presence of special purpose entities; (v) the presence of a trust; (vi) the presence of legal entities such as foundations, trusts and limited liability partnerships (LLPs); (vii) the presence of a so-called stichting administratiekantoor (foundation); (viii) the presence of a commanditaire vennootschap (limited partnership); (ix) the presence of an investment and fund structure; and (x) recently altered ownership structures of the client.

- Unacceptable risks may be presented by (i) the presence of nominee shareholders in the group structure; and (ii) the presence of bearer shares in the structure.

- Risk indicators were developed by one bank for activities that may be considered unacceptable. These are related to (i) trade; (ii) natural resources; (iii) oil and gas; (iv) transportation; (v) medicine; (vi) sports; (vii) real estate; and (viii) the exploitation of intellectual property and services.

- Jurisdictions involved were listed as possibly presenting high risk. Those included jurisdictions in which (i) the client is incorporated; (ii) the client is established for tax purposes; (iii) the client is operationally active; (iv) the related holding companies are established; and (v) the ultimate beneficial owner (UBO) is based.

- Keeping track of service providers. Risk indicators relating to the service providers used by clients could include trust offices and certain tax advisers who introduced the bank to clients or represented clients as service providers or “feeders”. International publications on money laundering show that low-integrity advisers tend to use one and the same structure for several clients. By screening their entire client portfolio for the involvement of these advisers, a bank may achieve transparency with regard to fiscal integrity exposure that may be included in the broader client portfolio.

- Tracking banks that are involved. Involved banks that are established in jurisdictions with (former) client secrecy laws, such as Monaco, Liechtenstein and Switzerland, may present increased risk exposure. Foreign branches of banks in regions/countries with increased anti-money laundering risks, such as the Middle East or the former Soviet Union, have also been identified as risk indicators.

- Public sources of information and internal red flags. One bank makes use of information available in the client file, including investigating public information (open-source intelligence). This way, the bank checks on an automated basis, whether the client is involved in tax avoidance or evasion. Screening results of other client information (such as the company name, place of establishment, UBO information or representatives) from open sources such as the Panama Papers and Paradise Papers and public databases provide feedback for this risk assessment.

- One bank translated the outcomes of its risk scans into an impact analysis, which reflected which sectors, products and client groups may present the highest tax integrity risks for the bank. In addition, jurisdictions that were high risk were identified. The outcome of the scans was verified by the in-house and sector knowledge of account managers and of the compliance department. The impact analysis was subsequently transformed into a heat map reflecting different business lines and sectors in which the bank operates which provides guidance on the chance that tax integrity risk may materialize within a sector or client group and how many clients possibly are involved. In this respect, a bank with a real estate portfolio that consists of clients with complex offshore financing structures will likely end up having higher risk than a bank with mainly clients that are involved in the rental of (existing) Dutch real estate for which financing was obtained exclusively in the Netherlands.

6. Determining Fiscal Integrity

As regards general starting points to set the fiscal integrity level of the bank for its client portfolio, the following good practices are listed in the Guidance:

- One bank placed the ultimate responsibility for the risk profile of the bank at the board level. As a result, the board balances its choice to accept certain risks or not. This also means that there was congruence between the integrity risk appetite and the strategic goals of the bank in the short and long terms. In addition, it ensures the proper implementation of the integrity risk appetite within the entire
organization, as well as clear internal and external communication with regard to the integrity risk appetite. The board reports (also towards the supervisory board) with regard to the effectiveness of the integrity risk appetite. This makes clear as to how the determined risks compare to risk limits and in how many instances within a certain period there were actions taken that were outside of the risk appetite and how these situations were handled. A bank could also decide to publish its tax integrity risk appetite on its website and be transparent about its strategy and risk appetite.

– Another bank established a tax integrity risk appetite according to the same methodology used by the bank for credit risk. Periodically, a review takes place with regard to the integrity risk appetite as compared to the actual risk profile of the bank (including independent reviews thereof). The bank differentiates between risk appetite levels applicable to, for example, the entire bank, each business line, each sector or each jurisdiction. Objective limits have been set for each country in which the bank is active, and the bank differentiates between limits that apply in normal circumstances and limits that apply in stress scenarios. In the event of large incidents, such as the Panama Papers, a bank can temporary tighten those limits. The bank monitors the risk limits and application of the relevant conditions to the respective risk appetite levels. In the SIRA process, this bank determined, per client group, the different scenarios that indicate increased tax integrity risk.

– In a third case, a bank made the integrity risk appetite applicable in practice by translating the risk appetite of the fiscal integrity risks of clients into key risk indicators and risk limits. Key risk indicators and risk limits present a combination of quantitative and qualitative elements that allow the bank to measure whether it is operating within its own integrity risk appetite. Examples include a maximum percentage limit for the number of clients in a certain sector with increased fiscal integrity risk (clients with one or more risk indicators). This bank also formulated several qualitative key risk indicators, including naming key risk indicators of clients that would be unacceptable for the bank within its own risk appetite, namely offshore-based clients in high-risk sectors, structures with bearer shares or nominee shareholders and back-to-back loans.

The Dutch regulator acknowledges that the fiscal integrity risk appetite will be a learning process. Developments in relations with clients and changes in tax laws or in the expectations of external stakeholders or society at large will impact the integrity risk appetite and its relationship with the SIRA. A feedback loop will develop based on practice, review and monitoring. A high-risk appetite will generally require a higher level of control by the bank, as well as higher costs.

It should be noted that the risk appetite related to fiscal integrity may also be included in the Supervisory Review and Evaluation Process (SREP) by the regulator. This is the process in which the regulator identifies all risks, including reputation risk, of a bank. The Guidance provides that, based on the outcome of the SREP, the regulator determines how much capital and liquidity a bank must maintain. A high fiscal risk appetite may lead to prudential requirements being assigned to the bank, including having to maintain extra capital.

7. Client Screening

The Guidance also lists good practices observed with regard to individual client screening:

– One bank, as a matter of practice, establishes a fiscal risk profile of each (new) client, and certain information provided by the client is automatically included in the risk profile. The account manager subsequently completes the fiscal risk profile file based on information from the client file (in which no reporting fields may remain empty). Activities of the client, the structure, the transactions, the jurisdictions involved, the banks involved, the supply channels and tax opinion letters may all be included as relevant fiscal risk indicators. If it appears that the client presents a fiscal integrity risk, the case is escalated to the Compliance division and the tax department for a more in-depth analysis of the fiscal integrity risk.

– Another bank developed a step plan for investigating fiscal integrity, including the following steps:

1. obtaining insight into all relevant parts of the structure of all involved companies, including an explanation of the role of all companies involved and the ownership structure;

2. obtaining support for the structure with a tax opinion, requested by the bank;

3. testing whether the transactions of the client are in accordance with the obtained information on the purpose and structure. This is done by using structure drawings, flow-of-funds drawings and the transaction profile explained in the tax opinion. The bank may proceed to request credit information, trade financing documentation, rulings with the tax authorities, CRS/FATCA information, transfer pricing analyses, country-by-country reports and an overview of the effective tax rate of the group/UBOs;

4. researching public databases and sources to screen UBOs, professional relations, companies and possible information on actions that did not meet required tax integrity levels, such as the Panama Papers and Paradise Papers; and

5. comparing the client in its investigation with previous cases and related structures to identify risks expediently. This benchmark serves to support (earlier) analyses made of the client. Once the bank has identified a client with an unacceptable fiscal integrity risk, it uses this know-how for a re-evaluation of similar clients in its portfolio. The bank submits the results of the 5-step process to the individual client risk analysis (client tax assessment).

– In another case, a bank established high risk factors that it investigated at the level of individual clients related to the (i) structure and involved jurisdictions; (ii) operational activities of the client; and (iii) transactions. As regards the structure and involved jurisdictions,
the bank applies a risk-based country list with regard to fiscal integrity risk. Countries with low tax rates, elaborate tax exemptions, low/no tax transparency and/or low/no cooperation with international tax authorities were labelled as high risk. To establish this list, the IMF Organization of Economic Cooperation and Development list was used, as well as the OECD list of non-cooperative jurisdictions, the EU black and grey lists of tax havens and the financial secrecy index. Also as regards the structure, the bank considered scenarios in which ownership was separated (with nominee shares, bearer shares or other barriers to determining ultimate ownership) or hybrid structures were in place, both of which lead to high fiscal integrity risk. As regards operational activities, when a bank required clear reporting of what economic functions the client performs within the group, it was regarded as a good practice. Not only were operational activities reported and evidenced with annual reports and business reports, but in addition, the products that the client obtained from the bank and what those were used for were described. In a case in which a client was engaged in a business that carries a higher fiscal integrity risk, such as trade, natural resources, energy, transportation, pharmaceuticals, real estate or advisory services, the bank also checked whether the client actually performed services in those industries. In one situation, a client was found to exclusively serve as a reinvoicing entity, and as a result, the bank could not adequately assess the fiscal integrity risks with respect to this client. The client relationship was terminated as a result. In addition, the transaction was reported to the Dutch FIU because there was a presumption of tax avoidance and the shifting of profits and expenses by the client. With regard to transactions, a preparation of a transaction profile combined with a flow-of-funds drawing can provide insight into the expected money flows and the parties to the transaction. If transactions deviate from this profile, the bank can ask for additional information about the purpose and nature of the transactions.

- In a case in which a new prospect had its most relevant bank accounts in a non-European Economic Space (EER) bank and was part of a group that similarly only had a banking relationship with a non-EER bank, the bank informed the prospective client that it could only accept the company as a client if it would obtain more information on the financial flows of the prospective client, including within the group. This is identified as a good practice in the Guidance.

- Clients that receive payments on the basis of intangibles (such as ownership rights, patents and licences) may have higher fiscal integrity risk than others, as royalty payments may be fiscally driven. A bank that requires information on the economic rationale of these transactions and that proves that arm’s length valuations and rates are involved will be considered to engage in good practice.

- In the case that a client performs intra-group transactions, including financing, a bank can request how the transactions fit within the group structure, whether arm’s length rates are used for intercompany transactions and whether any tax motives are involved with regard to the intercompany transactions. The bank should check whether intra-group payments deviate from what is expected, whether they are linked to other intercompany transactions or whether there are significant value differences in the case of share transfers, (option) rights or other assets. If a client obtains external financing, the bank should determine how the client will use the external financing, whether that fits within the profile of the company and whether fiscal motives are involved. For example, interest deductions for foreign loans may be relevant. Back-to-back loans or guarantees on behalf of a client by third parties not belonging to the group structure require further investigation by the bank.

8. Conclusion

A review of the indicators mentioned in the Guidance can lead a bank to determine whether there are legitimate fiscal motives or risks that it will facilitate tax evasion. Such review should also help determine whether there are legal yet, for the bank, still undesirable fiscal avoidance motives involved.

In practice, it may be difficult to determine whether a bank comes across a situation of legal but undesirable fiscal avoidance or unlawful tax evasion. The international legal context makes it clear that tax crimes fall within the scope of “criminal activity” as defined in the Fourth Anti-Money Laundering Directive. Accordingly, the FATF Recommendations 2012, tax evasion is a predicate offence to money laundering (as the Dutch Supreme Court already quite clearly ruled in 2008). Further, cross-border aggressive tax structures will have to be reported by banks when they qualify as intermediaries once DAC 6 comes into effect in 2020. In the Dutch legal context, non-compliance could – under certain conditions – lead to criminal liability of a bank, as, for example, the Houston case against ING in September 2018 showed. This liability not only pertains to economic offences that are rather regulatory in nature, but also to the serious crime of culpable money laundering as well. Although the Guidance of the DNB relates to fiscal motives of the banks’ clients, financial institutions should always be aware of their own (criminal) liability risks at the same time.

The Dutch regulator realizes that not each and every bank may have the tax resources in house that are needed to make a detailed assessment of tax integrity risk. The Guidance provides that in such a case, external tax expertise may be required. Alternatively, a bank can choose to do away with clients that fall within a certain tax integrity risk profile because the tax risk cannot be managed by that financial institution. The regulator emphasizes that transaction monitoring and the training of staff are additional material steps to manage fiscal integrity risk. There is little doubt that the Dutch regulator aspires to take on a leading role in tackling tax avoidance and evasion, and with its Good Practices Guidance, it clearly sets the tone.

---


The Guidance is currently in the consultation stage, and comments are requested by 1 April 2019 at the latest. Banks, but also advisers and service providers that support banks, are requested to comment on the consultation draft.