Guidelines for Effectively Auditing Tax Evasion Controls

CAMS Audit Whitepaper

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Executive Summary

Globally, over the past two decades, there has been increasing sensitivity around tax evasion and facilitation thereof by financial institutions (FIs). This eventually led to the categorization of tax evasion as a money laundering predicate offense by the Financial Action Task Force (FATF) in 2012.

Most jurisdictions, as a result, introduced legal and regulatory changes to put this requirement into effect and have mandated that FIs incorporate tax evasion controls in their anti-money laundering (AML) framework. International financial centers have been extremely sensitive to being perceived as tax havens. Regulators in such centers have mandated their FIs to ensure robust tax evasion related controls so that the jurisdiction is not exposed to reputational risk. Concurrently, due to severe enforcement actions, FIs are expected to drastically strengthen their AML controls framework. Lack of appropriate tax evasion controls would obviously tantamount to inadequate AML controls.

It is in this backdrop that AML frameworks have developed into serious models that use analytical techniques to identify and quantify risk indicators, process information from various data sources and use statistical methods to develop risk profiles and identify anomalous behavior. It is hence important to treat the AML controls framework as a risk model and incumbent on internal audit to deploy model validation methodologies to review these frameworks.

This white paper first traces the development of regulations governing FIs in respect to countering tax evasion. It then studies the model validation methodology that can be used by internal audit to review the AML controls framework.

This white paper discusses the various elements involved in model validation, the primary objective of which is to provide assurance that the model risk management framework is able to address the risk of errors in model construction and incorrect or inappropriate use of a model.

Finally, this white paper goes on to discuss how these model validation techniques can be used by internal audit to review tax evasion controls embedded in the AML controls framework. The elements discussed are:

- Evaluation of conceptual soundness – Assessment of model design including theoretical construction, key assumptions, variables selected, methods used and limitations.
- Ongoing monitoring – Assessment of ongoing testing and evaluation of model performance by the model owners.
- Outcomes analysis – Assessment of how model output compares with corresponding actual outcomes.
- Governance and documentation – Assessment of the model governance framework, associated policies and procedures and documentation.
In the light of aggressive regulatory enforcement in recent years, only such rigor in conduct of audits will provide the assurance that regulators seek from internal audit.

**Introduction**

Tax evasion refers to the use of illegal schemes to evade lawfully due taxes. In contrast, tax avoidance refers to the legal use of provisions in tax laws to reduce the amount of tax payable. Tax evasion may relate to taxes on income or wealth or inheritance, customs duty, value added tax, sales tax, etc. While there are numerous tax evasion strategies, most entail the use of offshore jurisdictions to conceal income or wealth from tax authorities. These offshore jurisdictions are variously referred to as tax havens or financial privacy jurisdictions or offshore financial centers.

There is no universally accepted definition of a tax haven and hence there is no authoritative list of tax havens. The following are some of the characteristics identified as indicative of tax havens (US General Accountability Office (GAO), 2008):

- Nil or nominal taxes;
- Lack of effective exchange of tax information with foreign tax authorities;
- Lack of transparency in the operation of legislative, legal or administrative provisions;
- No requirement for a substantive local presence; and
- Self-promotion as an offshore financial center.

In 2000, the Organisation for Economic Cooperation and Development (OECD) published a list of jurisdictions it considered as tax havens and the list included jurisdictions that one would typically associate with that term (please see Appendix 1 for OECD’s list of tax haven jurisdictions).

However, it has been argued that this conventional list of havens is misleading and that these fiscal paradises only serve as intermediate pit stops. Tax evaders ultimately want access to all the benefits of sophisticated capital markets, relatively efficient and regulated securities markets, financial institutions back stopped by large populations of taxpayers, well developed legal codes, competent attorneys, independent judiciaries, and the rule of law. Generally, these conditions can only be found in first world countries, which serve as destination havens and are hence equally susceptible to hosting tax evaded wealth (Tax Justice Network, James S Henry, 2012).

In 2012, the Tax Justice Network, an international nonprofit advocacy group combating tax evasion, estimated that about $12 trillion in offshore financial assets was being managed by the 50 largest international banks (Tax Justice Network, James S Henry, 2012). Of course there are many different reasons for holding assets offshore and not all of the offshore financial assets represent tax evaded monies.
Guidelines for effectively auditing tax evasion controls

Regulatory Requirements Governing Financial Institutions

How We Got Here – Facilitation of Tax Evasion as a Revenue Model

To understand tax evasion related regulatory guidelines governing FIs, it is helpful to understand the developments that led to these regulations (Appendix 2 lists some of the key events that have contributed to these developments).

For decades, tax haven jurisdictions have used banking secrecy to facilitate global tax evasion as an easy means to attract money. FIs in these jurisdictions used facilitation of tax evasion as a business model. Some international banking groups used their global footprint to funnel wealth to their private banking units in tax haven jurisdictions. In some instances, while FIs themselves did not systematically facilitate tax evasion, they turned a blind eye to such facilitation by their staff.

Disquiet over national deficits and debts has contributed to growing public and political concern about tax evasion. Some governments even paid large amounts to obtain information on tax evaders, stolen from banks in tax haven jurisdictions (Reuters, 2013). These events culminated in the following key developments:

- In 2010, the U.S. enacted the Foreign Account Tax Compliance Act (FATCA) to detect foreign financial accounts held by U.S. persons.
- In 2012, the FATF amended its recommendations to include tax crimes in the designated list of money laundering predicate offenses.
- In 2014, the OECD introduced the Common Reporting Standard for automatic exchange of financial account information between participating jurisdictions, thus dealing banking secrecy a serious blow (albeit with many loopholes).

Tax Evasion Related Regulations Governing Financial Institutions

Pursuant to the revised 2012 FATF Recommendations, most jurisdictions have amended their AML laws to make tax evasion a predicate offense. International financial centers are now extremely sensitive about being perceived as tax havens and such labels are usually met with strong rebuttals (TOI, 2012) (Economist, 2015).

While there are differences between regulatory requirements in various jurisdictions, in general, these regulatory developments require FIs to:

- Ensure there is adequate senior management commitment to prevent facilitation of tax evasion being pursued as a business model and to foster a culture where facilitation of tax evasion is not tolerated;
- Ensure that tax evasion-related risks are adequately assessed through the AML risk assessment process;
• Ensure that a fit-for-purpose AML controls framework, in line with the complexity of the FIs operations, is implemented to mitigate any identified tax evasion related risks; and

• Monitor staff behavior to identify rogue employees who attempt to subvert controls in order to facilitate tax evasion through the FI;

Clearly, FIs are now required to implement controls to positively demonstrate their commitment to prevent the facilitation of tax evasion. FIs will need to implement suitable control frameworks to detect and report suspected cases of tax evasion. These controls will also need to demonstrate that FIs have not turned a blind eye to rogue employees who facilitate tax evasion. Therefore, it is of even greater importance that internal audit use appropriate techniques to review controls designed to prevent the facilitation of tax evasion.

Role of Internal Audit in Model Governance

The term “model” refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A model consists of three components: an information input component, which delivers assumptions and data to the model; a processing component, which transforms inputs into estimates; and a reporting component, which translates the estimates into useful business information (Federal Reserve and OCC, United States, 2011).

AML controls framework employed by FIs encompass the following:

• Use of analytical and statistical techniques to identify and quantify risk factors that contribute to money laundering (ML) or terrorist financing (TF) risk.

• Use of methods (including risk scoring methods) to process information from various data sources, to assess whether or not a client is a high, medium or low risk from an ML/TF risk perspective. This in turn determines the extent of CDD that would be applicable to the client.

• Statistical techniques are also used to determine the rules and thresholds for ongoing risk-based monitoring of accounts with a view to identify anomalous behavior based on risk indicators, peer group comparisons, deviation from historical behavior, deviation from anticipated behavior, etc.

As such, the AML controls framework (which includes tax evasion monitoring controls) qualifies to be called a “model.” Authoritative guidance on the matter of internal audit’s role in model governance is provided by the U.S. Federal Reserve’s Supervisory and Regulation Letter SR 11-7 dated April 4, 2011. In the following sections, the framework suggested in this guidance is explored in detail.
The role of the internal audit (IA) function in model governance is outlined as below:

1. Assess the overall effectiveness of the model risk management framework to provide assurance that the governance framework is able to address the following two risks associated with models:
   a. Errors in the Model: A model may suffer from design flaws and provide inaccurate output in the context of its design objective and intended use. Errors can also creep in at any stage between design and implementation. Shortcuts, simplifications or approximations used to deal with complicated issues may compromise the integrity of a model. Errors in inputs or incorrect assumptions may also affect the output.
   b. Incorrect or Inappropriate use of a model: Even a sound model if misapplied or misused will produce inaccurate results. This typically happens when existing models are applied to new products or markets or continue to be used even when the underlying assumptions change. Limitations of a model, typically due to assumptions used, should be fully understood to ensure a model is not misapplied or misused.

2. Review of model validations commissioned by model developers – The foregoing does not mean that IA should duplicate model risk management activities. Rather, IA should assess whether model risk management is comprehensive and effective. This can be achieved by reviewing model validations commissioned by the model developers and may require IA to perform some degree of model validation of its own.

3. Review of model governance – Model governance framework provides support and structure to risk management functions by defining policies and procedures for relevant risk management activities and mechanisms for evaluating whether policies and procedures are being carried out as specified. IA should assess whether:
   a. Acceptable policies are in place for adequate governance of the model and relevant parties comply with these policies;
   b. Clearly documented procedures are in place for updating the model and are being carried out as specified.

Key Elements of Model Validation

Model validation is a set of processes and activities intended to verify that models are performing as expected in line with their design objectives and business uses. All model components, including input, processing and reporting, should be subject to validation and this applies to both models developed in-house and to those purchased from or developed by vendors or consultants (Federal Reserve and OCC, United States, 2011).

Effective model validation should at least include the following three core elements:
- Evaluation of conceptual soundness
- Ongoing monitoring
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- Outcomes analysis

1. Evaluation of Conceptual Soundness

This activity entails assessment of the quality of model design. It involves the review of documentation and empirical evidence to assess the theoretical construction, key assumptions, variables selected and methods used.

Validation should assess whether model limitations and assumptions are clearly understood and documented and whether the model design is logical and consistent with published research and industry best practices.

Validation may also include sensitivity analysis, if applicable, to understand the impact of changes in inputs on the model output. Model stress testing may also be considered to check performance over a wide range of inputs and parameter values, including extreme values, to verify that the model is robust (Federal Reserve and OCC, United States, 2011).

2. Ongoing Monitoring

This element seeks to ensure that the model is appropriately implemented and is being used and is performing effectively and as per design. Such monitoring is critical to assess whether changes in model assumptions necessitate adjustment, redevelopment or replacement of the model (Federal Reserve and OCC, United States, 2011).

There should be a program for ongoing testing and evaluation of model performance. The frequency should be appropriate to the nature of the model, the availability of new data and/or methods and the magnitude of risk involved.

Ongoing testing should include the following:

- Tests used in the initial validation of the model may be repeated periodically to assess the need to incorporate additional information, use new methods etc.

- Process verification: This is intended to check whether all model components are functioning as designed. It includes:
  - Verifying that the data inputs continue to be accurate and as per design
  - Supporting systems are correctly configured and are subject to stringent change control procedures to prevent unauthorized changes and to ensure that necessary changes are indeed identified and implemented.
  - Model outputs remain accurate and are being used as per design.

- Analysis of overrides – This involves the assessment of cases where model output has been overridden, to ensure that such overrides are adequately documented and the reasons for such overrides evaluated. Override performance should be analyzed to assess the need for the model to be revised.
3. Outcomes Analysis

This element involves comparison of model output to corresponding actual outcomes. The comparison helps evaluate model performance and assess the reasons for any observed variation between the two. The objective is to determine whether the variation stems from omission of material factors or some other aspects of the model.

The nature of comparison would depend on the objective of the model and may include assessing the accuracy of estimates, evaluation of rank-ordering ability, etc. Outcomes analysis may involve a combination of quantitative and qualitative testing and analytical techniques and the choice of technique depends on the model’s objective, methodology, complexity and the magnitude of model risk.

Back testing is one form of outcomes analysis that involves comparing the model forecasts with actual outcomes during a sample time period not used in the model’s development.

When models are revised to incorporate new data or techniques, parallel outcomes analysis may be conducted using the original and adjusted models. The revision would not be effective if the adjusted model does not outperform the original model.

Outcomes analysis may also enhance awareness about the limitations of a model.

**Audit of Tax Evasion Monitoring Framework – Model Validation Approach**

Based on the model validation methods discussed in the foregoing section, this chapter discusses an illustrative list of aspects that IAs should review as part of audit of the AML framework for tax evasion monitoring.

**Evaluation of Conceptual Soundness**

**A. Model construction – basic aspects**

- Prior to the AML framework being changed to include tax evasion-related aspects, was there an assessment to identify tax evasion-related risks faced by the FI?

Before amending the AML framework to incorporate tax evasion-related aspects, it is critical to understand what elements of the business expose it to tax evasion risk. Different business models are exposed to different types of risks. For example:

- Appendix 2 lists several instances where private banks were found to have facilitated tax evasion on a massive scale for their clients.
- Commercial banks in Australia were found to be used as a conduit by a criminal syndicate to help manufacturing companies to evade taxes using shell companies and ‘round-robin’ type schemes (please refer to case 1 in Appendix 3).
- A bank in the EU was investigated for their role in a Value Added Tax (VAT) fraud involving manipulation of the EU’s carbon emissions trading scheme (please refer to case 2 in Appendix 3).
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- Commercial banks have been found to have misused the interbank payments network to help select clients evade withholding taxes on banking transactions (The Express Tribune, 2015).

➤ Have the model elements addressing tax evasion risk been customized for the various lines of business covered?

As is apparent from the examples cited above, different lines of businesses are exposed to different types of vulnerabilities based on their products, client profile, etc. FIs may commit the error of tailoring their model to cater to the most dominant line of business. However, ancillary lines of business can expose FIs to significant regulatory and reputational risk. IAs should assess whether model elements have been customized to address risks arising from all relevant lines of businesses covered.

B. Screening against negative lists

➤ Does the model incorporate results of screening against negative lists?

In published cases of tax evasion, FIs (mostly in the private banking space) have been found to have actively provided services (to hide wealth) to individuals (or their proxies), who they knew were being investigated for tax evasion and other serious crimes in their home jurisdictions. Even unknowingly facilitating the actions of known tax evaders would suggest lack of adequate controls.

While FIs may conduct screening against lists of sanctioned names and politically exposed persons (PEPs), IAs should assess whether lists used for screening include other negative lists that cover persons being investigated/charged for tax evasion.

➤ Do negative lists used reflect the geographic footprint of the FI's client base?

Negative lists can be voluminous and result in lengthy processing times and large number of false positives (if the name matching method is basic or inadequately tuned). In such cases, FIs may restrict the jurisdictions for which negative lists are used for screening (e.g., an FI based in Singapore may limit negative lists to those relating to Singapore, Malaysia and Indonesia because most of its clients are from these jurisdictions). However, if the FI's client base is international, this may not be the most appropriate solution to the problem.

C. Risk profiling

➤ Does the model include risk profiling of clients?

It is now acknowledged that profiling clients based on various contributing risk factors is one of the key methods to monitor AML risk and this is mandated by most, if not all, regulators.

➤ Has the model been suitably amended to incorporate tax evasion-related risk factors identified as part of the risk assessment exercise?

Tax evasion-related risk factors should be identified through the risk assessment exercise referred in (A) above. Some of the important risk factors are discussed below.

Customer Risk indicators

➤ Customer's business/occupation

As with other ML/TF predicate offenses, the client's business/occupation remains a very important indicator of risk.
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- **Type of corporate structure (for legal entities) and lack of reliable information regarding ownership structure and beneficial ownership**

In several private banking-related tax evasion cases, FIs were found to have aggressively marketed schemes to enable clients to conceal wealth through sham corporations and trusts. FIs were also found to have knowingly accepted (and actually advised clients to provide) false declarations of beneficial ownership. Complex legal structures (bearer share corporations, complex trust or corporate structures set up in tax havens) are usually designed to conceal ownership information.

- **Client fails to disclose dual nationality or tax domicile**
- **Client fails to provide declaration of tax compliance**
- **Client fails to provide consent for tax reporting requirements**
- **Client is considered as recalcitrant under FATCA**

These are very important indicators of tax evasion risk and can indicate very high risk from a tax evasion perspective.

- **Quality of client information and the frequency at which it is updated**

The best of models can fail if the data inputs are outdated. It is important that all relevant client information is updated periodically. The model should incorporate assessment of the currency of the client data and increase risk scores if data being relied on is dated.

**Country Risk Indicators**

- **Country of incorporation of trusts and other corporate vehicles**
- **Country of nationality/residence of the client (natural person)/beneficial owner**
- **Jurisdiction to/from which the client sends or receives monies**

Clearly, known tax haven jurisdictions are high risk from a tax evasion perspective. There is also published research that persons from certain countries are more prone to engage in tax evasion. Where persons from such countries route monies through trust/corporate vehicles set up in known tax havens, this may be considered as even higher risk. Also, frequent dealings with known tax havens may be considered as high risk.

**Product Risk Indicators**

- **Products that conceal beneficial ownership of income or assets**

FIs have, in the past, been found to have aggressively marketed schemes designed to enable clients to conceal wealth. Such products include anonymous numbered accounts, insurance wrappers, irrevocable life insurance products, etc. There should be robust risk assessment of products as part of the product approval process, to identify products that are high risk from a tax evasion perspective.

**Channel Risk Indicators**

- **Non-face-to-face business relationships**

Relationships where for example, the FI only interacts with professional intermediaries and establishes non-face-to-face business relationships, would be higher risk as such relationships make it easier for clients to conceal their identity.
Special instructions that no contact be made unless initiated by the client (possibly on temporary visits to the FI's jurisdiction) or that contact only be made with a representative in a third country (possibly a secrecy jurisdiction)

Use of hold mail facility

In some published cases, FIs were found to have actively colluded with clients to conceal undeclared accounts from their domestic tax authorities by providing hold mail facilities so that information relating to these accounts is not accessible to domestic authorities. Indications that the client does not want authorities in the home jurisdictions to become aware of an account/service, reflects high tax evasion risk.

Transactional Risk Indicators

The model should identify transaction indicators that suggest high tax evasion risk. Some examples include:
- Splitting transactions (usually cash transactions) just below reporting thresholds
- Wire transfers to/from high tax risk jurisdictions
- Under or over valuation of invoices (for trade transactions)
- Inadequately explained large cash withdrawals or deposits
- Round-tripping (i.e., funds are sent back to originating jurisdiction after being routed through a foreign entity [usually in a tax haven])
- Account turnover much in excess of initially indicated amount
- Account closure after being requested for additional information on tax-related matters or beneficial ownership

In some published cases of tax evasion, FIs were found to actively provide advice to their clients to “stay below the radar” so their tax evasion would not be discovered.
- FIs structured transactions below the reporting/monitoring thresholds used by clients' domestic authorities.
- FIs permitted their clients to routinely withdraw large amounts of cash which could be transported to their home jurisdictions for use there.
- FIs gave their clients hard to trace prepaid cards that did not have a name on them.

The model should have a suitable transaction monitoring framework that detects all high-risk transaction patterns and adjusts the client's risk profile accordingly.

Behavioral Risk Indicators

The model should include assessment of the client's tax evasion risk by the relationship manager (RM), based on behavioral risk indicators such as:
- Use of a large number of personal investment companies
- Use of nominee directors/shareholders without reasonable justification
- Enquiries about hold mail facility
- Veiled threats of account closure in response to requests for additional information on tax related matters or beneficial ownership
- Verbal disclosure of tax-related non-compliance seeking the RM’s collusion
- Verbal disclosure about incorrect ownership or other declarations to the FI
- Enquiries about products or services that help conceal beneficial ownership
- Queries about the exact manner in which domestic or overseas tax reporting is conducted by the FI and concerns about such reporting
- Any other factor that may suggest high tax evasion risk
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Most published cases reveal that clients usually discuss their objectives with their RMs and seek advice to “stay below the radar.” Usually, RMs know their clients much more than what can possibly be gleaned from data elements in the FI’s core systems. Another point to note is that most published cases of large-scale tax evasion facilitation by FIs, have been triggered by employees turned whistleblowers. For any model to be effective, it is critical that RMs are required to declare their own knowledge and assessment of the client’s tax evasion risk.

Staff Behavior

➤ Assessment of employee risk

RM’s, being the first line of control, can be one of the strongest controls in the AML risk management framework by exercising adequately due diligence and acting with integrity. On the flip side, RMs can also work to undermine controls and facilitate tax evasion. Typical issues to be considered are:
- Is there a suitable code of conduct that sets out the standards of behavior (including those relating to tax evasion)? Are code of conduct certifications obtained periodically with appropriate tracking mechanism to ensure timely completion?
- Have any RMs introduced an unusual number of high tax risk clients?
- Have any RMs managing an unusual number/proportion of high tax risk clients?
- Is there surveillance of the RM’s activities such as cross-border client visits, advice provided on email, etc.

Outcomes Analysis

Review of outcomes analysis may cover the following:

➤ Comparison of cases of high tax evasion risk as indicated by the model with any actual cases of tax evasion detected to assess the predictive quality of the model.

➤ Review of back testing conducted by the model developers to assess the quality of testing by the model developers as also to assess the predictive quality of the model.

➤ Review of documented limitations identified based on outcomes analysis conducted by the model developers and the actions taken to mitigate these limitations.

Ongoing Maintenance

Review of the ongoing maintenance of the model may include the following:

➤ Process verification – Assess whether the data inputs for various elements of the model, continue to remain accurate and the software implementing the model remains correct.

➤ Testing – Assess whether the ongoing testing of the model is in line with documented governance procedures.

➤ Maintenance – Assess steps taken to keep the model current based on ongoing testing results—either by introducing new risk factors or changes in weightage of risk factors or changes in sources used for scoring of risk factors, etc.

➤ Analysis of overrides – Assess cases where risk as suggested by the model has been overridden, with a view to ascertain reasons thereof and to review the process followed. Also, assess whether overrides suggest any limitations in the model and assess steps taken to mitigate the same.
Validating the Validation

Model validations commissioned by the model owners either before deployment of the model or on an ongoing basis, may be reviewed based on the following aspects:

- Was model validation conducted in a timely manner?
- Were all relevant components (including input, processing and reporting) validated?
- Is the rigor of the validation consistent with the potential risk presented by use of the model?
- Was validation done by an independent party who was not involved in model development?
- If any aspect of the model validation work was done by model developers because it is most effectively done by them, was such work subjected to critical review?
- Was model validation conducted by someone who has requisite knowledge, skills, expertise and a significant degree of familiarity with the line of business using the model?
- Did the person(s) conducting the model validation have explicit authority to challenge developers and users and obtain necessary responses?
- Have the results of the model validation been adequately documented? Does the documentation of results reveal sufficient critical review of the model?
- Have issues identified in the validation been sufficiently reported to relevant stakeholders?
- Have timely actions been taken to address issues identified in the validation?

Governance, Roles and Responsibilities, and Documentation

- Are there documented policies and procedures for the model under review and are these policies and procedures consistent with the broader model risk management framework?
- Do the documented policies and procedures cover the following: model and model risk definitions; assessment of model risk; acceptable practices for model development, implementation and use; appropriate model validation activities; and governance and controls over the model risk management process? (Federal Reserve and OCC, United States, 2011)
Conclusion

An increasing number of financial institutions are being subject to enforcement actions due to lack of a robust AML control framework. Lack of appropriate tax evasion controls would indicate inadequate AML controls. Regulators in international financial centers are keen to send a message that inadequate AML controls will not be accepted and that they will not hesitate to use penalties and other severe actions when controls are found to be lacking. This underlines the fact that IA has a critical task of validating and testing the AML controls framework in use.

Stricter regulation and stringent enforcement have resulted in developing more robust AML controls (which include tax evasion controls). AML control frameworks now use analytical techniques to identify and quantify risk indicators, process information from various data sources and use statistical methods to develop risk profiles and identify anomalous behavior.

Given these developments, it is critical that IA redesigns its audit approach to recognize the AML controls framework as a risk model that needs to be subject to model validation methodologies.

Based on regulatory guidance, this white paper identifies the following to be critical elements while deploying model validation methodologies, and discusses these elements in the context of a review of tax evasion controls by IA:

- Evaluation of conceptual soundness – Assessment of model design including theoretical construction, key assumptions, variables selected, methods used and limitations.
- Ongoing monitoring – Assessment of ongoing testing and evaluation of model performance by the model owners.
- Outcomes analysis – Assessment of how model output compares with corresponding actual outcomes.
- Governance and documentation – Assessment of the model governance framework, associated policies and procedures and documentation.

The use of model validation methodologies by IA would yield the following benefits:

- Model validation methodologies provide a cogent framework for comprehensive coverage of all possible aspects of an AML program that could expose it to weaknesses.
- Most regulators now follow a risk-based inspection and surveillance program. A thorough review of the AML controls framework by IA would provide the necessary assurance to regulators. An FI may in turn benefit from being rated lower risk on account of its superior assurance program.
Appendices

Appendix 1 – OECD List of Tax Haven Jurisdictions

In a report issued in 2000, the Organisation for Economic Cooperation and Development (OECD) identified the following jurisdictions as tax havens according to criteria it had established.

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<th>Andorra</th>
<th>Cook Islands</th>
<th>Malta</th>
<th>San Marino</th>
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<td>Anguilla</td>
<td>Cyprus</td>
<td>Marshall Islands</td>
<td>Seychelles</td>
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<td>Antigua and Barbuda</td>
<td>Dominica</td>
<td>Mauritius</td>
<td>St. Kitts and Nevis</td>
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<td>Montserrat</td>
<td>St. Vincent and the Grenadines</td>
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<td>Cayman Islands</td>
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Luxembourg and Switzerland are members of the OECD and hence obviously were not considered for inclusion in this list.

All the above jurisdictions have since made commitments to implement the OECD standards of transparency and effective exchange of information and the timetable they set for the implementation. As a result, no jurisdiction is currently listed as an uncooperative tax haven by the OECD.
## Appendix 2 – Key Milestones in Tax Evasion-Related Developments

The following table highlights some of the key events that have contributed to regulatory developments governing tax evasion.

<table>
<thead>
<tr>
<th>Year</th>
<th>Significant enforcement related developments</th>
<th>Significant events shaping regulatory changes</th>
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| 2006 | • January - Germany agrees to pay ~EUR 5 million to an ex-LGT Bank (Liechtenstein) employee for stolen confidential client data. | • From the 35 jurisdictions named in the Tax Havens list published in 2000 by the OECD, 31 have already made formal commitments to implement the OECD’s standards of transparency and exchange of information. Only four countries remain uncooperative: Marshall Islands, Andorra, Liechtenstein and Monaco.  
• August – The U.S. Senate Permanent Subcommittee on Investigations release a detailed report on tax havens.  
• December – The U.S. passes a law that would permit the U.S. Internal Revenue Service (IRS) to offer awards (up to 30 percent of the recovery) to those who help recover sizable tax evasion amounts. |
| 2007 | • April - Bradley Birkenfeld, an ex-UBS employee, blows the whistle about UBS facilitating tax evasion by U.S. clients. | • Marshall Islands exits OECD uncooperative tax havens list after making commitment to implement OECD standards. |
| 2008 | • February - Germany announces large-scale tax evasion probe based on stolen LGT bank information it purchased and police conduct raids across the country.  
• February - The U.K. joins Germany in tax evasion probes and confirms it paid for data stolen from LGT bank. The Netherlands, Canada, France, Sweden, Italy, U.S., Australia and New Zealand join search into tax evasion by its citizens through LGT Bank.  
• December - Herve Falciani, an employee of the HSBC Private Bank in Switzerland (HSBC Suisse) is arrested in Geneva for surreptitiously copying client data during 2006-07. Falciani jumps bail and flee to France. |
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| 2009 | o January – France starts investigation using HSBC data obtained from Falciani.  
o February – Pursuant to disclosures by Bradley Birkenfeld, UBS pays $780 million to the U.S. IRS to resolve a criminal tax avoidance investigation. UBS also admits to assisting 17,000 clients evade taxes with offshore accounts, from 2000 to 2007.  
o August – To avoid additional fines, UBS agrees to provide the names of 4,450 Americans with offshore UBS accounts. | o Andorra, Liechtenstein and Monaco exit the OECD uncooperative tax havens list after making commitment to implement OECD standards. As a result, no jurisdiction is currently listed as an uncooperative tax haven.  
o G20 heads of state issue a joint communique declaring: “The era of bank secrecy is over.” |
| 2010 | o French Finance Minister passes HSBC Suisse data to the U.S. and some EU countries | o Based on lessons learnt from UBS, LGT Bank and other cases, US Congress enacts the Foreign Account Tax Compliance Act (FATCA) to collect information about foreign financial accounts held by US persons. |
| 2012 | February – The U.S. Justice Department indicts Wegelin & Co., Switzerland’s oldest private bank, on charges that it enabled wealthy Americans to evade taxes. | o FATF includes tax crimes in the designated list of offenses in its revised set of recommendations (a move that was considered in 2003 but was put off at that time).  
o U.S. IRS awards Birkenfeld $104 Million, as award based on the tax recovered pursuant to his disclosures. |
| 2013 | o January – Wegelin & Co announces that it will shut down.  
o October – Belgian prosecutors dawn raids on Antwerp diamond dealers based on the HSBC Suisse data passed on to it by the French Finance Minister. | o G20 endorses Automatic exchange of information involving the systematic and annual transmission of “bulk” taxpayer information by the source jurisdiction to the residence jurisdiction of the taxpayer. |
### Significant enforcement related developments

#### 2014
- May – Credit Suisse pleads guilty to criminal charges that it helped Americans evade taxes (becoming the first bank to do so) and is penalized $2.5 billion.
- November – France, Belgium and Argentina charge HSBC with aiding tax evasion through its Swiss business.

### Significant events shaping regulatory changes

#### 2014
- On July 1, 2017, the U.S. withholding tax becomes applicable to payments of certain U.S. source income (e.g., dividends, interest, insurance premiums) made to non-U.S. financial institutions (FFIs) UNLESS FFIs have registered under FATCA.
- Switzerland commits to participate in OECD’s automatic exchange of financial account information, beginning in 2018.
- Switzerland enacts law to make qualified tax fraud an ML predicate offense.

#### 2015
- February – More details of the Falciani leaks are published by media organizations across the world. HSBC apologizes in a full page advert taken out in national newspapers.
Appendix 3 – Some Tax Evasion-Related ML Typologies

Case 1 - The use of shell companies and ‘round-robin’ type schemes to evade tax. (AUSTRAC, Australia) (Egmont Group of Financial Intelligence Units, 2015)

Based on suspicious activity reports filed by banks and further analysis, the Australian Transaction and Reporting Centre (AUSTRAC) identified a case where certain clothing manufacturers engaged in scheme that enabled them to avoid paying a significant amount of tax. The method used by the syndicate to facilitate tax evasion is as follows:

- A legitimate clothing retail company paid a clothing manufacturing company for the production of garments. These payments related to a legitimate business activity and the retail companies were not complicit in the scheme.

- The promoters of the scheme made approaches to the garment makers and offered to reduce the amount of tax they were paying, less a commission to the promoters of between 5 and 10 percent.

- A series of shell companies were set up using the details of members of the community who had been approached by the promoters and paid a small amount of money for their personal details. These details were then used to register the companies, obtain workers compensation insurance and bank accounts in order to create a façade of legitimacy.

- With the assistance of the promoters, invoices were created and issued to the clothing manufacturers purportedly for the provision of (fictitious) goods and services. These false invoices enabled the manufacturer to claim tax deductions for subcontracting expenses that were never incurred.

- The manufacturers made cheques payable to the shell companies to pay the false invoices.

- Members of the syndicate deposited the cheques into the accounts of the shell companies.

- Once the cheques had cleared, the syndicate members withdrew the funds from the accounts via multiple cash withdrawals with debit cards obtained for each shell company account. These withdrawals were undertaken across various bank branches.

- The syndicate returned the cash to the manufacturer, minus a commission.

- The manufacturers used the cash to fund their lifestyles and paid cash wages to their employees, thereby avoiding income tax obligations.

- It was established that bank employees conspired with the criminal syndicate to commit the money laundering and fraud activity.
Case 2 – Carousel fraud – EU CO2 Emissions Trading Scheme (Reuters)

The EU Emissions Trading System, the bloc’s chief weapon against climate change, caps the emissions of factories and power plants, forcing them to buy carbon permits for additional emissions if needed while also allowing them to sell surpluses.

The carbon trading scandal emerged when authorities identified certain suspicious deals, known as "carousel fraud," designed to generate tax refunds when no tax had been paid.

The cases involved buyers importing contracts for CO2 emissions rights into one EU member state from another, free of VAT. The buyers then did not sell them for use in that market but sold them on to an untraceable series of companies in an agreed chain, which ultimately re-exported them, pocketing a rebate from tax authorities.

A ring of commodity traders was accused of participating in a conspiracy to evade around 300 million euros ($390 million) in value-added tax (VAT) on carbon permits between August 2009 and April 2010.

A bank in the EU was investigated for its role in this scheme.
Glossary

**AML**: Anti-Money Laundering

**AUSTRAC**: Australian Transaction Reports and Analysis Centre (AUSTRAC) is Australia's financial intelligence unit to counter money laundering, organised crime, tax evasion, welfare fraud and terrorism.

**CO2**: Carbon Dioxide

**EU**: European Union

**FATCA**: The Foreign Account Tax Compliance Act (FATCA) is a United States federal law whose intent is to enforce the requirement for United States persons (including those living outside the U.S.) to file yearly reports on their non-U.S. financial accounts to the Financial Crimes Enforcement Network (FINCEN). The law requires all non-U.S. (foreign) financial institutions (FFI's) to search their records for indicia indicating U.S. person-status and to report the assets and identities of such persons to the U.S. Department of the Treasury.

**FATF**: The Financial Action Task Force (also known as Groupe d'action financiere or GAFI in French) is an intergovernmental organization founded in 1989 on the initiative of the G7 to develop policies to combat money laundering. In 2001 the purpose expanded to act on terrorism financing. It monitors countries' progress in implementing the FATF Recommendations by 'peer reviews' ('mutual evaluations') of member countries. The FATF Secretariat is housed at the headquarters of the OECD in Paris.

**FI**: Financial Institution

**G7**: The Group of 7 (G7) is a group consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. The European Union is also represented within the G7. These countries are the seven major advanced economies as reported by the International Monetary Fund.

**G20**: The Group of Twenty (also known as the G-20 or G20) is an international forum for the governments and central bank governors from 20 major economies. The members include 19 individual countries—Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom and the United States—along with the European Union (EU). The G-20 was founded in 1999 with the aim of studying, reviewing, and promoting high-level discussion of policy issues pertaining to the promotion of international financial stability. It seeks to address issues that go beyond the responsibilities of any one organization.

**GAO**: The US Government Accountability Office (GAO) is a government agency that provides auditing, evaluation, and investigative services for the United States Congress. It is the supreme audit institution of the federal government of the United States.
Guidelines for effectively auditing tax evasion controls

**IA:** Internal Audit

**ML:** Money Laundering

**OCC:** The Office of the Comptroller of the Currency (OCC) is an independent bureau within the United States Department of the Treasury that was established by the National Currency Act of 1863 and serves to charter, regulate, and supervise all national banks and thrift institutions and the federal branches and agencies of foreign banks in the United States.

**OECD:** The Organisation for Economic Co-operation and Development (OECD) is an international economic organisation of 34 countries, founded in 1961 to stimulate economic progress and world trade. It is a forum of countries describing themselves as committed to democracy and the market economy, providing a platform to compare policy experiences, seeking answers to common problems, identify good practices and coordinate domestic and international policies of its members.

**PEP:** Politically Exposed Person

**RM:** Relationship Manager

**SR:** Supervision and Regulation Letters, commonly known as SR Letters, address significant policy and procedural matters related to the US Federal Reserve System's supervisory responsibilities. Some recent SR Letters relate to external audit of internationally active U.S. Financial Institutions, capital planning for FIs, prudent risk management for commercial real estate lending etc.

**TF:** Terrorist Financing

**VAT:** A value-added tax (VAT) or goods and services tax (GST) is a popular way of implementing a consumption tax in Europe, Japan, and many other countries. It differs from the sales tax in that taxes are applied to the difference between the seller-purchased price and the resale price. This is accomplished by taking full tax on all sales, but refunding the tax difference to the sellers.
Guidelines for effectively auditing tax evasion controls
