



# Tax penalties

A recent Court of Appeal ruling would change the nature of financial penalties in tax cases, writes *Laurence Li*

A recent court ruling has changed the nature of insider dealing penalties from civil to criminal and called into question whether the Commissioner of Inland Revenue can continue to levy tax penalties under section 82A of the Inland Revenue Ordinance.

The case of *Koon Wing Yee v. Insider Dealing Tribunal and the Financial Secretary* (CACV 358 of 2005, 30 May 2007) concerns fines for insider dealing, but its reasoning applies

equally to penalties for tax violations. It will likely become a landmark case in Hong Kong. This article focuses on what the judgment means for the practice of the commissioner to negotiate and levy additional tax by way of administrative penalty.

## The judgment

The Court of Appeal ruled that because of the Insider Dealing Tribunal's power to impose financial penalties up to three times the profits gained or losses

avoided by insider dealers, such cases should be treated as criminal in nature and defendants should enjoy the same protection as those facing criminal prosecution. The court held that:

- Evidence obtained from a person under compulsion is inadmissible.
- The person cannot be required to testify.
- The criminal standard of proof applies.

The first and second points are matters of human rights protected

by Article 39 of the Basic Law and Articles 10 and 11 of the Bill of Rights Ordinance (Cap. 383).

The court made its ruling despite the fact that the legislature had clearly intended insider dealing to be a civil matter and the tribunal to be a civil court applying the civil standard of proof. The court based this ruling on English and European jurisprudence developed under the European Convention of Human Rights, where there are many cases treating civil matters as criminal in nature to protect human rights.

The court cited the following broad principles:

- The starting point of analysis is how the legislature labels an infraction (whether civil or criminal).
- What carries substantially more weight than the legislative label are:
  - The nature of the offence (whether disciplinary or criminal).
  - The nature and degree of severity of the penalty.

Applying these principles, the court decided that the insider dealing offences are criminal in nature.

### English and European cases

In arriving at its decision, the court repeatedly referred to the case of *Han & Anr v. Customs and Excise Commission* [2001] 1 WLR 2253, where the English Court of Appeal considered the powers of the Customs and Excise Commissioners under section 60 of the Value Added Tax Act 1994 and section eight of the Finance Act 1994 to levy civil penalties for dishonest tax evasion. Those provisions empower the commissioners to impose a penalty of up to the amount of the tax (or excise duty) evaded or sought to be evaded.

“The implications of the court’s recent decision in the *Koon Wing Yee* case to tax law enforcement are far-reaching. It calls into question the long-established regime under section 82A allowing the Commissioner of Inland Revenue to levy administrative penalties.”

The English court held that since the offences apply to the public at large, the fines are substantial and their purpose is punitive and deterrent, they are criminal in nature. The court recognized the policy behind empowering the commissioners to levy civil fines for tax violations. But the law is the law. The court was bound by it to conclude that the purportedly “civil” tax fines were, in fact, criminal in nature and the process of imposition of which should have been subject to human rights protection.

In a parallel case, *King v. Walden (Inspector of Taxes)* [2001] STC 822, the English court again reached the same conclusion for penalties imposed under section 95 of the Taxes Management Act 1970.

Three other European Court of Human Rights cases are also of interest. In *Bendenoun v. France* (1994) 18 EHRR 54, the court ruled that a case in the French administrative court to impose civil fines for tax evasion is a criminal matter for human rights purposes. In *AP, MP and TP v. Switzerland* (1997) 26 EHRR 541, the court again held that tax fines are criminal matters. In *Georgiou (trading*

*as Marios Chippery) v. United Kingdom* [2001] STC 80, the court ruled that a fine for dishonest evasion of value added tax, although labeled as a civil sanction by the legislature, should be regarded as a criminal matter for human rights purposes.

Commentators had raised the possibility that the legal principles in these cases should apply in Hong Kong. The court’s recent decision in the *Koon Wing Yee* case confirmed this.

### Implications on tax penalties

What does this mean for the practice of the Commissioner of Inland Revenue to levy administrative penalties instead of prosecuting tax violations?

The commissioner’s power under the Inland Revenue Ordinance should be regarded as criminal in nature, thus attracting human rights protection to the taxpayer. This is because it applies to the public at large and because the potential penalty is severe and aimed at deterrence and punishment.

This implies:

*Power to levy penalties*  
Article 10 of the Bill of Rights Ordinance guarantees that a person

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facing a criminal charge is entitled to a “fair and public hearing by a competent, independent and impartial tribunal established by law.”

This raises a serious issue on whether the commissioner is an “independent and impartial tribunal” because his or her department conducted the investigation against the taxpayer. This issue did not arise in the *Han* or *King* cases, possibly because the English tax authorities had some kind of internal separation between the tax and penalty assessment functions, and because any subsequent review was *de novo* – a rehearing of the case where the authorities have the burden of proof.

In short, the commissioner’s power to levy penalties might be unconstitutional.

### *Compelled evidence*

Article 39 of the Basic Law and Articles 10 and 11 of the Bill of Rights Ordinance curtails the use of statements obtained by compulsion and prohibits any requirement to testify. The court in the *Koon Wing Yee* case left open for law enforcement authorities to compel suspects to answer questions. But the answers cannot be used in the decision-making process.

Applying these principles to the tax context, the commissioner cannot rely on or consider any statements obtained by compulsion from the taxpayer. That is, the information that an assessor or inspector obtains from a taxpayer under section 51(4) (or other provisions) of the Inland Revenue Ordinance cannot be placed before the commissioner for his or her decision to levy penalties under section 82A. The commissioner also cannot require the taxpayer to give evidence.

Consequently, the commissioner might have to promulgate an arrangement similar to that in the *Han* case, where the English tax authorities do not require taxpayers to answer questions or provide information. Instead they encourage cooperation by promising a reduction in penalties and by implicitly threatening potential criminal prosecution. The commissioner is already doing this to some extent, but an official procedure may be necessary.

### *Burden and standard of proof*

Article 11 of the Bill of Rights Ordinance guarantees that a person facing a criminal charge is presumed innocent until proven guilty and it is the law enforcement authorities who have to establish guilt.

This raises a serious issue on whether section 68(4) is still valid in purporting to shift the burden of proving an assessment appealed against to be excessive or incorrect to the taxpayer. The law permits a shifting of the burden of proof in some circumstances, but it is beyond the scope of this article to analyze.

The court in the *Koon Wing Yee* case also ruled that since common law requires criminal offences to be proved beyond reasonable doubt, this standard should apply when a civil matter is to be regarded as a criminal offence for human rights purposes.

Under this principle, the commissioner and the Board of Review would have to follow the criminal standard of proof when adjudicating tax penalty cases.

### *Death and tax penalties*

In the *AP*, *MP* and *TP* case, the European Court held that tax fines are criminal matters and authorities cannot impose the penalties on a deceased taxpayer because criminal liability does not survive the criminal. (You cannot prosecute a dead person.)

This raises an issue of whether section 82A(6) of the Inland Revenue Ordinance, which allows the commissioner to impose penalties on a deceased taxpayer’s estate, is effective.

## Conclusion

The implications of the court’s recent decision in the *Koon Wing Yee* case to tax law enforcement are far-reaching. It calls into question the long-established regime under section 82A allowing the Commissioner of Inland Revenue to levy administrative penalties. Given the importance of this matter, hopefully the Inland Revenue Department will clarify its position soon. In any event, we can expect to see a test case in the future.

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