ARE RTC PENALTIES ENFORCEABLE?

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Synopsis of this article

The Requirement to correct regime is backed up by substantial penalties. But the question remains as to whether the penalties are enforceable.

There is no reduction to reflect degrees of culpability. This presents problems for a taxpayer who is carelessly unaware that there are matters which were required to be corrected.

It may therefore be the case that the penalties contravene either EU law or the European Convention on Human Rights.

An obligation was introduced in Finance (No.2) Act 2018 requiring anyone with offshore tax non-compliance to correct it on or before 30 September 2018 ("the RTC regime"). This obligation was backed up by substantial penalties. Although it seems likely that the RTC regime was a success in its primary aim of driving tax compliance and disclosure, its continuing relevance lies in its application to persons who for one reason or another now face the threat of penalties. The legislative basis for such penalties doing so is relatively clear. Nevertheless a question remains: are those penalties enforceable?

There are two particular features of the RTC regime which are objectionable and which lead to questions as to enforceability of penalties. Firstly, the regime targets offshore matters only. That leads to a question of whether such an approach is consistent with the UK's obligations under the Treaty on the Functioning of the European Union ("TFEU") as in force on 30 September 2018. Secondly, the practical effect of the regime is to punish tax non-compliance which predated the entry into force of the RTC regime. That in turn raises an issue as to whether such a regime is compliant with the prohibition on retrospective penalisation in Article 7 of the European Convention on Human Rights ("Article 7 ECHR").

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In this article I consider some of the potential arguments which arise around these issues and which are of relevance to the question of whether RTC penalties are enforceable. Before getting into those particular arguments, however, is necessary to look at the application of the RTC regime.

Application of the RTC regime

The purpose of the RTC regime is stated to be "to require those with undeclared offshore tax liabilities (relating to Income Tax, Capital Gains Tax or Inheritance Tax for the relevant periods) to disclose those to HMRC on or before 30 September 2018" (HMRC Guidance on Requirement to Correct tax due on offshore assets of 16 November 2017). It targets past non-compliance but does so by creating a 'new' obligation on tax payers to correct it.

A penalty applies to anyone who (i) has "relevant offshore tax non-compliance" at 5 April 2017; and (ii) fails to correct that "relevant offshore tax non-compliance" by 30 September 2018 (para 1, Sch.18 F(No.2)A 2017). As such, it can be seen that there is both a retrospective element (past non-compliance) and prospective element to the penalty (failure to correct).

Non-compliance is widely drawn and includes an inaccuracy in a return or a failure to notify HMRC of a liability (para 8, Sch.18 F(No.2)A 2017). There is a degree of overlap with Sch.24 FA 2007 which penalises inaccuracies in a return and imposes a penalty where HMRC are not notified after an inaccuracy in a return is discovered (para 3, Sch. 24, FA 2007).

The offshore element requires that the non-compliance involves either (i) an offshore matter (which includes income arising from a source outside the UK or anything having effect as if it were such income), or (ii) an offshore transfer (broadly income or gains subject to UK tax received or transferred offshore) (paras 7 and 9 to 11, Sch.18 F(No.2)A 2017). The focus of the regime is therefore specifically an offshore one. Broadly the only thing which is not covered are purely domestic matters where, notably there is no equivalent obligation for non-compliance.

The non-compliance becomes relevant offshore tax non-compliance if it has not been corrected by 6 April 2017 (para 4, Sch.18 F(No.2)A 2017), it involved a potential loss of revenue (para 5, Sch.18 F(No.2)A 2017) and HMRC could have lawfully assessed the liability on 6 April 2017 if they were aware of the information missing as a result of any failure to correct non-compliance (para 6, Sch.18 F(No.2)A 2017). Offshore tax non-compliance can be corrected in a number of ways including: doing what should have been done in the first place; using the digital disclosure service or another service provided by HMRC; letting an officer of HMRC know in the course of an enquiry; or another method agreed with HMRC (para 13, Sch.18 F(No.2)A 2017).

Where non-compliance has not been corrected or HMRC consider that it has not been corrected, HMRC have until the later of the normal assessment date or 5 April 2021 to raise an assessment in respect of any tax that is subject to the requirement to correct (para 26, Sch.18 F(No.2)A 2017).

The quantum of the penalty

The standard penalty for failure to correct is a maximum of 200% and a minimum of 100% of the 'potential lost revenue' attributable to the offshore non-compliance (paras 14 and 16, Sch.18 F(No.2)A 2017). Potential lost revenue is broadly the unpaid tax. This compares to a penalty under Schedule 24 FA 2007 for careless behaviour at 30% of the lost tax for domestic matters rising to 100% for deliberate and concealed behaviour. That regime includes higher penalties for offshore matters depending on the relevant territory, rising to a maximum of 60% for careless behaviour and 200% for deliberate and concealed behaviour (para 4, Sch.24 FA 2007). There is, however, a clear and obvious disparity in the level of penalties being applied as between the two regimes.

A maximum reduction in the penalty to 100% of the potential lost revenue can be obtained where disclosure is made to HMRC (para 16, Sch.18 F(No.2)A 2017). There is also provision that the penalty can be stayed or compromised because of "special circumstances" (para 17, Sch.18 F(No.2)A 2017). There is no distinction between levels of penalties based on culpability.

Indeed, there is no fault requirement for the penalty to apply at all. There is, however, a defence of reasonable excuse, albeit one that is limited in certain circumstances (para 24, Sch.18 F(No.2)A 2017), most relevantly that reliance on advice will not be grounds for a reasonable excuse if it is disqualified. This is in effect reverses the burden of proof: requiring the taxpayer to show that he was not careless, rather than placing the onus on HMRC to show that he was.

A lot of time and effort was spent in the weeks and months leading up to 30 September 2018 either preparing for disclosure or taking further advice on whether there was non-compliance in order to ensure that there was a reasonable excuse. To that extent the RTC regime was presumably counted a success. Nevertheless, such diligence was not achieved in every case raising the possibility of the unwary finding themselves in a situation of facing potentially very significant penalties for behaviour that may have been at most careless. In those circumstances questions it is very much open to question as to whether the penalties are necessary or justified to give effect to the aim of the provisions. Taxpayers in that position will also be concerned as to potential defences. Two possibilities – on top of the question of reasonable excuse – which I discuss below are:

(i) that the penalty is in breach of EU law (as in place on 30 September 2018); and

(ii) that the penalty breaches the prohibition on retrospective penalisation under Article 7 ECHR.

Does the penalty breach EU law?

It is notable that the RTC regime targets purely offshore matters. It imposes three requirements which do not apply to UK matters:

(i) the obligation to correct non-compliance by a specified date;

(ii) an extended time limit to assess offshore matters; and

(iii) a penalty for failure to correct offshore non-compliance.

There is thus a clear difference between the treatment of overseas matters subject to the RTC regime and purely domestic matters. An immediate issue is whether this is lawful.

On penalties it is also notable that the RTC regime goes significantly further than the regime in Sch.24 FA 2007. That regime imposes varying levels of penalty for offshore matters but by reference to both culpability and the level of difficulty in obtaining information from the offshore jurisdiction. That is to say it is designed to address specific behaviours and issues. In contrast the RTC regime penalty applies without differentiation and at a level equivalent to what Parliament has prescribed under Schedule 24 FA 2007 for deliberate and concealed behaviour (i.e. the most culpable behaviour) involving those territories in which the non-payment of tax is most difficult for HMRC to identify (para 4A Sch.24 FA 2007). That difference in approach is difficult to understand and as discussed raises real questions as to the legality of the RTC penalties.

In many cases where the RTC regime is engaged there will have been an exercise of an EU law right, such as the right to free movement of capital in Article 63 of theTreaty on the Functioning of the European Union (‘TFEU’) which notably applies not only in relation to member states but also third countries. Whether such a right has been exercised and is engaged will be a question of fact, but where for example the penalty applies by income or gains on assets held offshore it would be unusual for that not to be the case. That then raises a question as to whether the legislation operates in a discriminatory fashion.

It seems relatively clear that the RTC regime does operate in a discriminatory manner. It applies only to those situations where there is an offshore element. There is a clear difference in treatment between onshore tax non-compliance and offshore tax non-compliance. A failure to declare taxes in relation to UK source income is in comparable to a failure to declare taxes in relation to non-UK source income. As such, the difference in treatment will only be lawful if it is justified by overriding reasons in the public interest.

One possible justification for the legislation which might be raised by HMRC that it is more difficult to detect a failure to pay tax in relation to overseas matters. The relevance of this point can be seen from a number of cases which have considered the issue of different penalties for offshore matters.

Drexl and Commission v France

The starting point for any discussion on the lawfulness of penalties under EU law is Case C299-86 Drexl which concerned with different penalties for offshore matters in the VAT context. The Court of Justice of The European Union ('CJEU') held that the penalties were unlawful:

> *"… the national court seeks to ascertain whether a system of penalties under which offences concerning value-added tax on importation are penalized more severely than those concerning value-added tax on domestic transactions is contrary to Article 95 of the Treaty, the principle of equal treatment and the principle of proportionality.*
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> *… Although it is true that criminal legislation and the laying down of penalties, even in the field of taxation, are matters for which the Member States are responsible, Community law sets certain limits in cases where national legislation may have an impact on the neutrality of internal taxation with regard to intra-Community trade, as required by Article 95 of the Treaty, and on the proper functioning of the common system of value-added tax laid down by Community directives.*
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> *18. As the Court has already held in another context concerning the free movement of persons, a system of penalties should not have the effect of jeopardizing the freedoms provided for by the EEC Treaty. That would be the case if a penalty were so disproportionate to the gravity of the offence that it became an obstacle to the freedom guaranteed by Community law.*
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> *…*
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> *22. It must be stated in that regard that the two categories of offences in question are distinguished by different circumstances concerning both the constituent elements of the offence and the greater or lesser extent of the difficulty of discovering it. Value-added tax on importation is charged simply when the goods actually enter the territory of the Member State concerned, rather than on a transaction. Those differences mean, in particular, that the Member States are not required to have the same system of rules for the two categories of offences.*

> *23. However, those differences cannot justify a manifest disproportion in the severity of the penalties laid down for the two categories of offences. Such a disproportion exists where the penalty provided for in the case of importation involves, as a general rule, a term of imprisonment and the confiscation of the goods pursuant to the rules laid down to combat smuggling whereas comparable penalties are not provided for, or are not generally imposed, in the case of offences concerning the payment of value-added tax on domestic transactions. A situation of that kind could in fact have the effect of jeopardizing the free movement of goods within the Community and would thus be incompatible with Article 95 of the Treaty.*
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> *…*
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> *25. The answer to the third question must therefore be that national legislation which penalizes offences concerning the payment of value-added tax on importation more severely than those concerning the payment of value-added tax on domestic sales of goods is incompatible with Article 95 of the Treaty in so far as that difference is disproportionate to the dissimilarity between the two categories of offences."*

It can be seen that the CJEU accepted that there were differences in the situation of domestic VAT supplies as compared to importation and that this could justify a difference in approach. Nevertheless, while it was lawful to have a different approach to penalties with an offshore element, but that the difference between onshore and offshore matters could not justify a manifest disproportion in the severity of penalties.

The same point was confirmed and adopted in Case C-276/91 EC Commission v French Republic [1997] STC 584:

> *14. On this point it must be confirmed that the member states are not required to have the same system of rules for the two categories of offence since they cannot be equally easily detected.*
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> *15. However, as the court stressed in the Drexl judgment the degree of difficulty in detecting an offence cannot justify a manifest disproportion in the severity of the penalties laid down for the two categories of offence.*
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> *…*
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> *23. The comparison shows that the provision for confiscation of the goods in respect of which the offence was committed does not exist in the case of the corresponding internal offence. Furthermore, the fine which is automatically imposed in addition to confiscation is equivalent to the value of the undeclared goods or up to twice that amount whereas, in the case of the corresponding internal offence, it is proportionate to the amount of the tax evaded. The disproportion between the severity of the penalties applicable to offences concerning the VAT payable on importation, on the one hand, and those relating to the VAT payable on domestic transactions, on the other, is therefore manifest.*

Thus although some difference in approach is permitted, if there is a manifest disproportion in in the severity of penalties, there will be an unlawful breach of EU law rights.

As noted above, there are two regimes specifically targeting offshore transfers: in the RTC regime; and that under Schedule 24 FA 2007. The latter regime is linked to the regime penalising domestic non-compliance but with a greater level of penalty depending, among other things, on the culpability of the taxpayer and the offshore jurisdiction involved. This more nuanced approach appears suggests a genuine attempt to increase penalties to reflect the difficulties in collecting tax where an offshore matter is involved. It is a regime in which there has been an effort to reflect the difference in situation in a manner which is proportionate, that is to say precisely the sort of regime which the CJEU was at pains to make clear would be permitted.

In contrast, the higher level of penalties and the blanket approach to their application under the RTC regime as compared to the situation where there has been a similar failure to pay tax but in a domestic context, is much more difficult to justify.

Joined Cases C 155/08 and C 157/08 X and E.H.A. Passenheim-van Schoot

The issue of different penalties for offshore matters was addressed not by reference to whether there was discrimination but rather by reference to the question of whether a restriction on freedom of movement was justified was Joined Cases C 155/08 and C 157/08 X and E.H.A. Passenheim-van Schoot [2009] STC 2441. This raised the same questions as considered in the cases above.

The case concerned a regime which permitted an extended recovery period for tax on assets held outside of the Netherlands (as compared to domestic assets). There were two aspects to this: an increased time limit to issue assessments; and increased penalties which resulted from the delay in making assessments.

On the question of whether the regime was justified the CJEU held that the difference in treatment was justified by the need to maintain the effectiveness of fiscal supervision and also to prevent tax evasion (justifications equally in point in the context of the RTC regime). On the issue of proportionality the CJEU noted that:

> *66. When taxable items located in one member state have been concealed from the tax authorities of another member state and those authorities have no evidence of the items existence which would enable an investigation to be initiated, the question whether the application by the latter member state of an extended recovery period is a proportionate means of attaining the objective of ensuring compliance with tax legislation therefore in no way depends on whether that period corresponds to the time necessary to obtain information from the member state in which the taxable items are held.*
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> *...*

> *70. Accordingly, making taxable items which have been concealed from the tax authorities subject to an extended recovery period of 12 years does not go beyond what is necessary to guarantee the effectiveness of fiscal supervision and to prevent tax evasion.*
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> *…*
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> *72. Even though a taxpayer is subject to an identical obligation to make a declaration to the tax authorities in respect of both his domestic assets and income and his non-domestic assets and income, the fact remains that, in regard to assets and income which are not the subject of a system for the automatic exchange of information, the risk for a taxpayer that assets and income which have been concealed from the tax authorities of his member state of residence will be discovered is less in the case of assets and income in another member state than in the case of domestic assets and income.*
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> *73. Thus, in so far as a member state lays down a longer recovery period for taxable items of which the tax authorities had no knowledge, it cannot be reproached for applying that period only to taxable items not located in its territory.*
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> *74. The second situation is where the tax authorities of a member state have evidence concerning taxable items located in another member state which enables an investigation to be initiated. In that situation, the application by the first member state of an extended recovery period which is not specifically intended to permit the tax authorities of that member state to have effective recourse to mechanisms of mutual assistance between member states and which commences once the taxable items concerned are located in another member state cannot be justified.*
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> *…*
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> *76. It follows from all the foregoing that arts 49 EC and 56 EC must be interpreted as not precluding the application by a member state, where savings balances and income from those balances are concealed from the tax authorities of that member state and the latter have no evidence of their existence which would enable an investigation to be initiated, of a longer recovery period when the balances are held in another member state than when they are held in the first member state. The fact that that other member state applies banking secrecy is not relevant in that regard.*

Thus a distinction was drawn between circumstances in which the taxing authority was unaware of the circumstances giving rise to a tax charge and those where it was so aware. This was directly linked to the justification for the extended time limit and reflected that it was only engaged where it was in point. This is a distinction which is relevant in relation to the proportionality of the RTC regime insofar as it targets matters which have been the subject of a previous disclosure or excludes reliance on disqualified advice in circumstances where HMRC were aware of matters.

The difference in approach when it came to the issue of penalties was not objectionable on the grounds that this reflected the longer period of recovery (§84). As such, the difference in approach was not manifestly disproportionate. This reflected the approach in the earlier cases, albeit that the application of that approach to the legislation in question had a different outcome.

Google Ireland Ltd

The approach in Drexl was more recently confirmed by the CJEU in its judgment in C-482/18 Google Ireland Ltd at §37:

> *It should be noted that, although systems of penalties in the field of taxation fall within the competencies of the Member States in the absence of harmonisation at EU level, such systems should not have the effect of jeopardising the freedoms provided for by the FEU Treaty (see, to that effect, judgment of 25 February 1988, Drexl, 299/86, EU:C:1988:103, paragraph 17).*

The case involved penalties for a failure to register with the Hungarian tax authorities in circumstances where a person was liable to Hungarian tax which applied to anyone anywhere in the world advertising in Hungarian. The CJEU found that the difference in approach which applied to suppliers based in Hungary as compared to those outside of Hungary was a restriction on the freedom to provide services (§§43 and 44). This restriction was potentially justified by the need to ensure effectiveness of fiscal supervision and the need to collect taxes, albeit subject to the requirement that "amount of the penalty imposed is, in each individual case, proportionate to the gravity of the infringement which it is designed to penalise" (§47).

The fines in that case were held to be disproportionate because there was no link between increases in the penalty and the seriousness of the failure to comply. Further the fine was determined without regard to the turnover forming the basis of the assessment (§50). An additional point was that the taxpayer had little chance to correct matters between the first penalty and subsequent increases (§51).

The Court also held that the discretion to reduce the penalties was irrelevant given that a "fine is no less disproportionate merely because the authorities of a Member State may, at their sole discretion, reduce its amount" (§53). In that regard reference was made to Case C-48/15 NN (L) International where it had been stated that penalties were disproportionate because there was no provision "for the possibility of modifying it or of imposing other less restrictive penalties, depending on the seriousness of the infringement committed".

This raises a question as to whether reduction of penalties for disclosure under the RTC regime at HMRC's discretion is to be disregarded in assessing the lawfulness of those penalties. A discretionary approach appears less acceptable in that regard than one which provides for less restrictive penalties for less culpable behaviour (such as Sch.24 FA 2007).

Given the absence of any limitation on the quantum of fines by reference to culpability under the RTC regime it would seem doubtful that the penalties meet this proportionality threshold. There a high level of penalties regardless of culpability, a level which is far in excess of that which would apply under Sch.24 FA 2007. The former applies on a blanket basis whereas in the latter Parliament has set out a regime reflecting both culpability and the difficulties of identifying certain offshore tax evasion, that is to say, it has attempted to make the penalties proportionate. The difference in the two usefully highlights the distinction being drawn in CJEU case law. That in turn raises serious questions as to the enforceability of RTC penalties.

Article 7 ECHR

A separate issue with the penalty under the RTC is that has a clear retrospective element. Part of what is being punished is non-compliance which predated the introduction of the RTC regime. Further, even the prospective element overlaps with an existing obligation to inform HMRC of errors in returns (see para 3(2) Sch.24 FA 2007), but imposes a greater penalty for the failure to do so. This potentially engages Article 7 of the European Convention on Human Rights ('ECHR'):

> *1. No one shall be held guilty of any criminal offence on account of any act or omission which did not constitute a criminal offence under national or international law at the time when it was committed. Nor shall a heavier penalty be imposed than the one that was applicable at the time the criminal offence was committed.*

Although this refers to 'criminal offence' it covers the penal elements of the RTC regime. It is well established that the term "criminal law" in this article has an autonomous meaning which extends to tax penalties. In Österlund v. Finland (Application no. 53197/13) the ECHR echoed what it has said on a number of occasions in setting out the position in the following terms:

> *"The Court has taken a stand on the criminal nature of tax surcharges, in the context of Article 6 of the Convention ... The Court observed [in Jussila v. Finland] that the tax surcharges were imposed by general legal provisions applying to taxpayers generally. Further ... the tax surcharges were not intended as pecuniary compensation for damage but as a punishment to deter re-offending. The surcharges were thus imposed by a rule, the purpose of which was deterrent and punitive. The Court considered that this established the criminal nature of the offence. Regarding the third Engel criterion, the minor nature of the penalty did not remove the matter from the scope of Article 6."*

The main argument against the relevance of Article 7 ECHR is that the RTC regime is not retrospective because it creates a new offence of failing to correct non-compliance rather than retrospectively penalising existing non-compliance. It is open to question whether that is what the penalty is really directed at. There is an ongoing obligation to comply with tax legislation whether involving domestic matters or foreign matters. The legislation crystallises that breach in relation to foreign matters on a particular date, but it is somewhat artificial to suggest that the failure to correct is the focus of HMRC's concerns. Rather it is underlying non-compliance.

It is well established that the protections offered under the ECHR should be practical and effective, not theoretical and illusory (see *Human Rights Law and Practice* (3rd. ed) Lester, Pannick & Herberg at 3-08). That suggests the prohibition against retrospectivity should be considered in a practical sense. It also raises a question as to whether the prohibition on retrospective penalisation can be circumvented by creating a new offence which is in substance punishing past behaviour on the ostensible basis that the past behaviour has not been corrected. If substantive effect of Schedule 18 F(No.2)A 2017 is not to penalise a new transgression but to increase the penalty for previous behaviour, can that be lawful?

Another way of looking at the issue is by reference to the proportionality of the penalty having regard to the nature of the offence. If it is the failure to correct rather than the original non-compliance which is being penalised, is the penalty proportionate given that it is only the latter and not the former which is being penalised?

There are two separate elements to the culpable behaviour being punished, and notably two penalty provisions which are engaged for each.

(i) The failure to pay tax when due (and possibly also the failure to correct errors). This is penalised under Sch.24 FA 2007, but it would seem to be a breach Article 7 ECHR to penalise this behaviour under the RTC regime.

(ii) The failure to correct non-compliance by 30 September 2018. This is the prospective element of what is penalised under the RTC regime, that is to say the part which would seem to be compliant with Article 7 ECHR.

The proportionality of the penalty for this second element needs to be addressed in the context of what is and what is not being penalised. If it is really the case that it is only the failure to correct and not the original non-payment of tax which is being penalised then it follows that the wrongdoing is much more limited in scope and a lesser penalty would be expected. The penalty is not for a failure to comply with a substantive tax obligation, it is for a failure to address an administrative requirement to make disclosure. As a failure to meet an administrative obligation, a lesser penalty would generally seem to be appropriate under the RTC regime. That the opposite is the case suggests that the penalty something very different than a penalty for a failure to disclose. It suggests that the reality is that it is the non-compliance (the failure to pay tax) which is being punished so that there is a breach of Article 7 ECHR.

Even if one limits the analysis to the prospective element of the penalty, it is problematic. Once retrospective element of the penalisation is stripped out the penalty appears to be disproportionate. Again that leaves compliance with Article 7 ECHR open to question.

Conclusion

A problematic feature of penalties under the RTC regime is their severity of the penalties combined with the absence of a reduction to reflect degrees of culpability. This presents particular problems for a taxpayer who is carelessly unaware that there are matters which were required to be corrected. The culpability is significantly less that that of a person who has deliberately concealed matters and continues to do so (perhaps in the UK) but the level of the penalty is not. It is doubtful whether this regime is sufficiently proportionate to meet the requirements of EU law. Those doubts which are strengthened by the presence within Sch.24 FA 2007 of a regime which addresses offshore tax matters in a way which is clearly more proportionate.

The severity of the penalty might be considered justified as it is targeting an ongoing failure, but that in turn raises other issues. The new penalty for a previous failure amounts to retrospective penalisation which is prohibited under Article 7 ECHR. It is doubtful whether that prohibition can be circumvented by the artificial mechanism of a prospective obligation to correct past failures. Viewed solely in that context the penalty again appears disproportionate.

Bearing these points in mind, in cases where HMRC are intent on applying penalties for breach of the RTC regime there are real issues of enforceability in point.