January 12, 2014

Is there a justification for imposing criminal liability on corporate managers in tax legislation?

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1. Abstract

Company's Directors and managers are subjects for two types of criminal responsibility: on one hand, they are subject to individual criminal responsibility when their actions are having the elements of the offense and the other is a kind of vicarious criminal liability for acts of the Company and / or its employees.

The problem with imposing a vicarious liability relies on the fact that such a liability, violates the fundamental principles of criminal law, such as "guilt". Vicarious liability is also violating the balance of forces in Criminal procedure as it will usually entail the transfer of the burden of proof upon the director to prove that he did everything possible or took all reasonable steps to prevent the offense. Such a transfer of the burden of proof violates the fundamental presumption of innocence and the balance of power in the criminal process.

2. Uniqueness of criminal tax law:

Obedience to tax laws is critical in societies which base their members’ social benefits primarily upon tax collection. Tax evasion committed by any member of such a society creates a feeling of deprivation, bitterness and inequality among taxpayers. A criminal tax laws and punishment in such countries express the deterrence which the legislature is seeking to achieve in order to prevent harm to state funds.¹

The severity of punishment imposed on those planning and committing tax offenses reflects the seriousness with which such offenses should be regarded, all because these offenses are extremely easy to commit but at the same time very difficult to discover.²

Enforcement of tax laws is substantially based on trust the system provides the taxpayer.

¹ Permission to crimA 512/04 Abu Obeid v. State of Israel 2004 PD 58(4) 381.
Consequently, when the taxpayer abuses that trust in combination with the fact that discovering tax offenses is quite difficult; the court will impose a severe penalty on him in order to deter both him as an individual and the general public from committing similar offenses in the future. However, due to the harmful and destructive consequences of using criminal law, it must be applied with care only where there is no other suitable alternative\(^3\) while maintaining its residual nature.

3. **Possible justifications for imposing such liability in the Israeli law:**

It is difficult to justify the extension of criminal responsibility to directors and representatives in tax legislation as part of the common goal of punishment. For example, the principle of reward, or as known by the "Goldberg Committee"\(^4\) - "The principle of compatibility" seeks to bring to a criminal reward by punishing him according to the severity of his actions. Criminal liability of directors and consultants, however, is a "vicarious" liability. It does not reflect the principle of compatibility as it imposes on manager's responsibility for offenses committed by the corporation or its employees, merely due to the nature of the manager's role in a company.

Most tax laws which cast criminal liability on directors usually do not require proof of guilt or the presence of a mental element. All that the prosecution is required to prove is that the defendant held a managerial position in the corporation which theoretically granted him both the authority and the means for preventing such violations. This is enough to pass the burden of proof onto the defendant who will need to prove that he "had taken all reasonable steps for prevention of the offense" and he had no knowledge of it.

In the writer's opinion, knowledge is indeed proof of culpability and guilt. Therefore, whenever evidence of the defendant's knowledge of the offense exists in combination with the possession of a managerial position which enables the prevention of such an offense; it is possible to infer the manager's guilt and impose criminal liability upon him. In contrast, when the manager proves that he had no knowledge of the violation, criminal liability should not be imposed.


\(^4\) Ministry of Justice *The Committee for examine ways of Retribution of judicial discretion imposing sentence* (1997).
However, the legislature didn't accept just the proof of absence of knowledge. It presented another obstacle by requiring the manager to prove that he had taken all reasonable steps to prevent the offense. "All reasonable measures" is often interpreted much too broadly by the court.

4. The nature of manager's liability:

A criminal tax laws impose severe punishments, including imprisonment on managers based on their vicarious liability which derives purely from their managerial role in the corporation. If we see the criminal law as designed to reward the offender depending on the severity of the violation committed, it is difficult to justify criminal liability on directors and officers as there is no correlation between the severity of the offense and the penalty.

Even if we see the criminal law as a tool for creating deterrence, it is still difficult to justify casting such broad criminal liability over directors and officers for several reasons: First, deterrence can only be effective when the optimal degree of deterrence is achieved. Such a deterrent would prevent the individual from repeating the offense and others from consideration of committing such an offense.

When considering the criminal liability of directors, it seems that vague legislation and the expansion of the circle of liability by the Israeli court's ruling may lead to excessive deterrence. This means that many might deny managerial positions out of concern that they could be significantly exposed to criminal liability for violations committed by the company.

Second, based upon the conclusions of the "Goldberg Committee" which underline the importance of the principle of congruence in criminal law and the enactment of Basic Law: Human Dignity and Liberty, deterrence of the public is subject to the principle of compatibility (proportionality) and by giving a harsher sentence than what is called for by

5 It's important to note that, certainty of punishment than the deterrent effect than severity of punishment in itself (see Cesare Beccaria, On Crimes and Punishments, 21 ON CRIMES AND PUNISHMENTS AND OTHER WRITINGS (Richard Bellamy ed., Richard Davids trans. 1995)).

6 Which was adopted as part of Amendment 113 of the Penal Code, Htsha"b - 2012, Sefer Huqim 102.
the nature of the offense, the legislature will constitute a violation of human dignity and liberty and would not meet the requirement of proportionality.\(^7\)

There are problematic aspects to imposing criminal liability on directors stemming from a number of terminologies in tax laws. For example, the law assigns criminal responsibility to whom it considers an "active manager" without providing a clear definition of corporate positions falling under that definition. Therefore it remains unclear which of the managerial positions exposes a manager to criminal liability based on that definition.

This definition is broader than the definition of the term "officer" found in the settings section of Companies Law. Therefore, an officer can become criminally liable according to tax legislation even if he is not an "officer" by definition of Corporate Law.\(^8\)

Circular 90/45 of the Israeli Tax Authority,\(^9\) issued by the Income Tax Commission, supposedly clarified the term. In fact it only deepened the uncertainty with regards to the question of who are the officers who should be exposed to criminal liability. According to the circular, the term "active manager" was meant to expand the circle of the bearers of criminal responsibility within the corporation. The definition also applied to a director who was not registered as having a managerial position in the company’s documents but in fact played a managerial role.\(^10\) Moreover, it was determined that the term "administrator" on section 117 of the Income Tax Command contained a broader definition and also will apply to the informal manager who had no practical managerial role in the company.\(^11\)

Tax laws expanded the scope of the term "active manager" in practice as it is ultimately applied to any manager - registered or not, technical or professional and did not confine the definition to financial or administrative managers only.\(^12\)

Many writers of academic literature criticize this broad definition. For example, according to Giora Amir, we are dealing with a norm that is too general, since by law "any officer is

\(^7\) Ruth Kannai 'constructing the judge's discretion in determining the sentence following the Goldberg Commission Report' (1998) Mehkarei Mishpat 15, 147, 164.
\(^8\) Haim Gabay 'managers responsibility in tax offenses' (2005) Corporations 2/5 40.
\(^9\) Income Tax Guidelines circular 45/90 'Section 224 of the Ordinance - who is an active manager?' (1991) Taxes 5/1 c-25.
\(^10\) Section 4.1 of the circular.
\(^11\) Section 4.2 of the circular.
\(^12\) CrimA 9902/05 State of Israel v. Ben- Abu Wood Ltd 2006 Taxes c/2 e-63.
presumed guilty of corporate malfeasance regardless of the type of responsibility or the extent of authority he holds within the corporation".  

Another criticism is pointed out by the words of David Tadmor, who was formerly in charge of the Antitrust Authority: "The Israeli legislature is infatuated with the imposition of criminal liability on directors of companies. It's its hobby [...] There is harsh punishment. The judges become sterner by the years with regards to financial punishment. There is also a clear trend of punitive measures against directors of a corporation even when there is no evidence linking them to acts committed within the corporation".

Another problem lies in transferring the burden of proof to the manager. The manager needs to prove that he was unaware of the crime and that he had taken all reasonable steps to prevent it.

Literal examination of the legislation leads to the conclusion that the legislature wanted to reduce the burden imposed upon the defendant in tax fraud by determining that he must prove "all reasonable measures" were taken to prevent an offense. This is unlike strict liability offenses where legislation demanded that the defendant proved "every possible measure" was taken to prevent the offense.

However, by using the principle of purposive interpretation, the Israeli courts interpreted the term "reasonable measures" broadly in relation to tax fraud. In fact, the Israeli courts granted the term "reasonable measures" such a broad interpretation that it rendered the term more severe than "every possible measure" in the context of strict liability offenses, even though strict liability offenses (such as directors violating Environmental Law) should be regarded as graver offenses.

It is well known that raising suspicions against one or worse – putting one through criminal trial - can be very harmful or even detrimental to one’s reputation and social future. Protecting the presumption of innocence is crucial as a tool for maintaining human dignity. I therefore think, that transferring the burden of proof with regards to lack of knowledge and ability to prevent an offense to the manager, violates the Basic Law:

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14 David Tadmor, ex Antitrust Commissioner, a conference on antitrust reform, conducted by the the College of Administration 1.18.2007 www.globes.co.il/serve/globes/printwindow.asp?did=1000174098
15 Rinat Kitai 'The importance of positive presumption of innocence, it's role and nature of the criminal proceedings prior legal determination' (2003-2004) Alei Mishpat 3(2) 405, 446.
Human Dignity and Liberty and does not stand the test of constitutionality as it is anchored in the restrictive clause.

It is important to note that only by being as a director in a corporation (even when acting a purely technical function) not necessarily indicate the ability and the access to information which might assist in denying the presumption of guilt made by the Law. In addition, unlike subjective defenses to criminal liability which are known to the defendant himself, it is questionable whether "reasonable steps", as widely defined by the Israeli court, cannot be verified by the prosecution since these are objective criteria.

This alone pulls the rug under the decision to transfer the burden of proof to the defendant at least as far as reasonable measures are concerned. Moreover, the protections offered to officials under tax laws do not correspond with the meaning of Section 34,(22) of the Israeli Penal Code. Therefore the official has to stand the test of probabilities in addition to going through the burden of proof of reasonable doubt.16

Raising the standard of proof, mentioned above, also raises quite a few questions.

Even if the justification for transferring the heavy burden of proof onto the defendant can be found, it is enough for the defendant to prove a reasonable doubt. Proving all reasonable steps were taken while demanding a balance of probabilities is too heavy a burden on the shoulders of the defendant. It undermines both balances of power in criminal law and the presumption of innocence.

The question of criminal responsibility of directors and officers is not regulated properly by Israeli tax legislation and case law. The legislation provides a vague definition to the question who is the officer who should be exposed to criminal liability for tax crimes committed by the company. The Israeli courts have also failed in answering that question. They refrained from providing a general and a clear definition of who can be considered a member in the “circle of responsibility”. Instead, courts continued to rule on a case-by-case basis while relying on the specific circumstances and facts of each case they came across.

16 CrimA (TA) 1825/95 A.Z Baranovich and his Sons building contracting company Ltd. v. State of Israel, Taxes 13/ 1 41, 303 (1999).
It appears that the Israeli courts have also avoided unequivocally stating which tax offenses should be considered strict liability offenses and which would only require the proof of a mental element for the purpose of convicting the manager.

To date, the section in tax laws which casts criminal liability upon directors is satisfied with the mere proof of possession of a managerial position for the purpose of transferring the burden of proof onto that defendant. The manager is required to prove that he had taken “all reasonable steps” to prevent the offense. In practice, the Israeli courts require much more than such proof, often requirements which stand against any constitutional logic.

As part of my doctoral research I conducted two quantitative studies of the Israeli court. One of the studies examined court rulings in cases dealing with criminal responsibility of directors and officers during the years 1990-2010. The study indicated that there had been a sharp rise in the quantity of cases and of indictments against company managers since 2004 as well as in the imposition of prison sentences.

Another important fact indicated by the study was that fines imposed on the company were significantly lower than those imposed on company directors. This comes in contrast to the American legislation which imposes the higher penalty on the company itself. Furthermore, most of American tax laws define a maximum limit to fines imposed on managers. The maximum fine generally equals half of the maximum fine imposed on the company. 17 My study showed however that only in two cases, managers were fined less than 1,000 Israeli Shekels while a symbolic fine was imposed on companies in 49 other cases.

Another interesting finding was that the court convicted the company and acquitted the manager of all charges in two cases only. On the other hand, there were 64 cases where the manager alone was deemed responsible while the company was acquitted of all charges (or not even put on trial).

The second study compared the ruling of the courts in cases concerning tax legislation in rulings concerning environmental legislation in the years 1991-2010. The purpose of this study was to examine if in fact the actual rulings of the court reflect the legislative policy and the courts’ general policy in context of these laws.

17 See for example, the offense of the lack of giving notice of pollution, 18 USC section 3571.
In theory, both legislature and court, maintained that environmental violations are considered some of the most severe of violations. In practice, the study showed that ruling in tax-related cases were stricter. For example, the court convicted the company and acquitted its manager of all charges in 9.3% of environmental cases examined versus 0.8% of tax-related cases. Moreover, the fine imposed on the company was considerably higher than the one imposed on the manager in the environmental cases. This came in complete contrast to the situation in tax-related cases.

The study clearly indicated that even though the legislator wished to apply strict liability to directors and officers under environmental legislation and ask that the manager proves "he did everything possible to prevent an offense", the Israeli court's ruling was stricter towards tax violators in practice. This was despite legislature’s milder demands that the manager would only prove he "had taken all reasonable steps to prevent the offense" as required in the tax laws.

5. Managers' liability- The desired law:

Ultimately, tax legislation concerning imposition of criminal liability on directors and officers is vague. The term "active manager" is inconclusive and subject to the interpretation of the courts. The court’s interpretation depends on the circumstances of each particular case and the judge's point of view.

There is no doubt it is important to deter managers from misuse their power for the purpose of tax evasion. Nevertheless, tax violation should be applied with regard to basic constitutional principles and with consideration of the cost of criminal proceedings to the individual and to society.

Since criminal law should be regarded as a last resort, it is important to use alternative procedures before referring to it. Apart from the civil proceedings, there are two main alternatives which can be applied to tax violations: Administrative fine under the Administrative Offenses Act\(^\text{18}\) and "Ransom" under the tax legislation.

Although “Ransom” is a punitive element, it differs from criminal conviction in many manners. There is an old debate over the question whether ransom should be considered a

\(^{18}\) Administrative Offenses Act, 1985, Sefer Huqim 31.
criminal punishment.\textsuperscript{19} In the matter of the Movement for Freedom of Information\textsuperscript{20} the Israeli court states "there is no dispute that despite of the penalty nature of the ransom procedure, it is not equal to a criminal conviction and therefore, in accordance with the Criminal Records Act, is also not registered in the criminal record". The dominant view is that ransom is a penalty payment. In other words: payment of ransom removes the criminal responsibility of the taxpayer.\textsuperscript{21} Although there are quite a few objections to the ransom alternative, it seems that it is a preferable procedure than criminal proceedings which can be more destructive and harmful.

It should be noted though that using any of the aforementioned alternatives does not solve all the problems related to imposing criminal liability on directors. Decisions of the ransom committees are made known to the public, therefore, the social stigma may carry a similar effect as criminal proceedings. Furthermore, the second alternative - administrative fine under the Administrative Offenses Act - can only be applied to offenses which may impose an administrative fine by definition.

It is necessary to limit the use of criminal law to one of the following circumstances: When the prosecution can prove director’s knowledge of the offense or alternatively when the director was negligent in preventing the committal of the offense. It should be emphasized that in case legislature wishes to apply strict liability with regards to tax offenses, it needs to define which offenses may be considered as strict liability offenses. In addition, the legislature should align the definition of the term "active manager" with the general definition of an officer under the Companies Law.

I think that as far as tax violations within a company is concerned, it is necessary to focus all resources towards the application of civil liability of directors. The imposition of criminal liability does not ultimately serve the end purpose of tax authorities which is collecting taxes to state funds. The legislature should impose heavy civil fines on the managers of the highest levels and save criminal proceedings to circumstances which "shake the very foundation" of the Law i.e. only when the manager’s deliberate intention of evading tax payment can be proven. (Proof of a mental element can be provided).

\textsuperscript{19} Nellie Munin 'ransom in tax legislation - the current situation and proposals for changing' (1991) \textit{Rivon Lemisim} 20, journal 77 18.
\textsuperscript{20} AdminA 398/07 \textit{Freedom of Information Movement v. Tax Authority} 2008 Takdin Elyon 2008(3) 4066.
\textsuperscript{21} Haim Gabay 'ransom money - the desired against the practice' (2002) \textit{Taxes} 16/ 5 A -93.
As mentioned previously, tax laws burden the officer with the requirement to prove that he did not know of the violation and that he had taken all reasonable steps to prevent it.

In the author's opinion, that when the legislature will seek to shift the burden of proof onto the manager, it shall only remain a burden of adducing evidence. This will carry effect only on the right to remain silent and not on the Presumption of innocence. That way the prosecution will still need to prove the manager's guilt, i.e. establish a reasonable doubt in the question of the manager knowledge of the violation and whether measures have been implemented to prevent it.\textsuperscript{22}

The defense “Mistake of Law” which has been adopted as an accepted defense strategy against the imposition of criminal liability on managers who are accused of tax fraud also raises a number of problems:

The Israeli courts have created a list, albeit incomplete of requirements when “Mistake of Law” defense might be applicable. One of the requirements when using this strategy of defense is getting a written expertise with preference to tax authority’s ruling. The problem with such a requirement is that the tax authorities are a party matter and have institutional partiality;\textsuperscript{23} Therefore, as long as the professional who provides the taxpayer with a written opinion is considered an expert in the subject matter, we cannot require the taxpayer to verify his expertise because it pulls the rug out from under the need for referral to specialists.\textsuperscript{24} Moreover, the ruling of the Israeli court in the \textit{Tnuva} case was given in the antitrust Act. Under this law the antitrust commissioner has a role of a regulator. This is unlike the tax authority chief who does not function as a regulator and whose ruling does not obligate the taxpayer.\textsuperscript{25}

6. Conclusion:

\textsuperscript{22} Professor Dan Bain argued that the burden of persuasion on the question of proving a defense lies on the shoulders of the prosecution and even when the legislature imposes a positive obligation on the defense to prove the defense, the Claim needs to prove in the end the defendant guilt accused and raise reasonable doubt, as there is, in the existence of defense. See, Dan Bain 'Constitutional protection of the presumption of innocence’ (1999) \textit{Eyonei Mishpat} 11, 18-19.


\textsuperscript{24} Giora Amir, \textit{Tax offenses}, supra note 13, 263.

\textsuperscript{25} Dan Bain 'The thin line between civil and criminal liability in tax: anti-planning norms, interpretation mistake and reliance on expert opinion' (2009) \textit{Taxes} 23/ 1, A-16.
Socrates\textsuperscript{26} imprinted the phrase "Nothing is to be preferred before justice." This claim could not be truer with regards to the imposition of criminal liability on managers without any requirement of proving a mental element of the manager in the case of tax offenses committed by the company.

It is well known that a person’s responsibility for his own actions is a cornerstone-rule of criminal law. In contrast, the criminal liability of managers is in fact a vicarious liability (Per se) and thus has no place under criminal law. Nevertheless, due to the importance of deterring managers from misuse of power for veiling tax offenses, there is room to impose criminal liability on managers only when it can be proven they had a deliberate intent. In these cases prosecution needs to prove manager’s knowledge including replacement of awareness.

\textsuperscript{26} The ethics of the Greek philosophers, Socrates, Plato & Aristotle (Edited by Chas. M Higgins New York, 1903).