Board liability for company's tax debts 3/14/22

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The State Revenue Service (SRS) is increasingly exercising its statutory power to have a company's board member pay an overdue tax liability if that debt cannot be collected from the company. For the board member this often means thousands of euros to pay, private accounts blocked, and properties seized. This article explores the legal grounds for such actions and outlines substantial errors in decisions made by the SRS.

Compensating the government for overdue tax liabilities

On 1 January 2015, Chapter XI, *Compensating the Government for an Entity's Overdue Tax Liabilities,* was inserted in the Taxes and Duties Act (TADA). It followed from an annotation for the draft amendments that *the current rules on performing the taxpayer's statutory obligations are inadequate and fail to motivate the entity's officers in charge to carry out their obligations as good stewards. Traders have no motivation to settle their debts because, as SRS officers have seen in practice, it is easier and more advantageous to form a new entity and divert the remaining cash and other assets to it. Having started proceedings to collect overdue tax liabilities, SRS officers often find that either the entity does not have any assets to target for collection or their value is substantially lower than the overdue tax liabilities.*

The new rules had been adopted, among other things, to determine a legal basis for collecting the entity's overdue tax liabilities from its officers in charge, to make the collection of overdue tax liabilities more effective, and to determine ways of having the responsible person perform the obligation to duly file for insolvency in the future. However, the annotation emphasised that *to observe the property rights guaranteed to a private person in section 105 of the Constitution, the bill has been prepared in such a way that a board member (private person) would be held liable for the entity's debts only in the exceptional case of having acted irresponsibly with respect to statutory debts and ignoring national interests (and those of each member of the public)*. This irresponsible action is treated as established if the criteria laid down by TADA section 60(1) are met.

According to this clause, which was in force before 2020, the SRS had the power to initiate proceedings for collecting the entity's overdue tax liabilities from the person that had served on its board during the period in which the overdue tax liabilities arose if all of the following criteria are met:

1. The overdue tax liabilities total more than 50 minimum monthly wages prescribed in Latvia.
2. The decision to collect the overdue tax liabilities has been notified to the entity.
3. It has been found that after the overdue tax liabilities arose, the entity disposed of its assets to a person that fits the definition of the board member's interested party within the meaning of the Insolvency Act.
4. There is a document stating that it is impossible to collect the debt from the entity.
5. The entity has failed to perform the obligation laid down by the Insolvency Act to file an insolvency petition in court.

In practice the SRS has largely failed to establish a fraudulent disposal of the company's assets to interested parties under TADA section 60(1)(3).

The definition of "interested party" in section 72(1) of the Insolvency Act recognises the following persons as the debtor's interested parties:

1. The debtor's members (shareholders), or partners in a partnership, and members of its governing bodies
2. The entity's procurator and commercial trustee
3. A person who is the spouse or a relation of the debtor's founder or member (shareholder), or of a partner in a partnership, or of a member of the governing body, by blood or marriage up to the second degree
4. A creditor in the same group with the debtor

Under section 72(2) of the Insolvency Act, the persons mentioned in this section are recognised as the debtor's interested parties if they had had this status within the last five years before the entity's insolvency proceedings were announced.

According to the case law, however, when it comes to identifying an interested party, it is their direct or indirect financial interest that matters. Thus, formal compliance with the listed range of persons is not relevant. For example, if the company's asset has been transferred to the board member's ex-wife, this does not mean she is automatically recognised as an interested party. All the persons mentioned in section 72(1) of the Insolvency Act share another feature – a direct or indirect financial interest that is part of the criterion of economic interest. Thus, having a financial interest is decisive in interpreting section 72 of the Insolvency Act. The case law states that while a company is solvent, the main persons interested in its financial operations are its members (shareholders); once the company becomes insolvent, the main persons financially interested in its operations are the creditors, who are at risk of loss if the debtor still carries on business unsuccessfully. This must be taken into account when assessing whether a person fits the definition of interested party in section 72(1) of the Insolvency Act.

Because the SRS had run into difficulties putting the lawmaker's intentions into practice and there were relatively few cases of such "compensatory" decisions being made, the rules continued to be improved. Amendments to the clause came into force on 1 January 2020, and it no longer matters what status the person to whom the entity transferred its assets has with respect to its board member. It is now sufficient to find that the board member's action or omission has led to a tax debt remaining unpaid.

With these amendments, the lawmaker has significantly changed the content of TADA section 60(1)(3) in order to authorise the SRS to initiate proceedings for collecting the entity's overdue tax liabilities from the person if, among other things, *it has been found that after it was decided to conduct a tax audit, a notice was sent detailing discrepancies that a data compliance review had found between the information filed by the taxpayer and the information available to the tax authority, a thematic review statement was drawn up if a thematic review had found substantial breaches pointing to tax evasion, and the entity disposed of its assets after the overdue tax liabilities arose, and as a result of the board member's action or omission, the entity's overdue tax liabilities were not fully paid within statutory time limits.*

In a recent case heard by the administrative court, the SRS made a mistake and applied the version of the clause that came into force on 1 January 2020 to events having occurred in an earlier period (the board member was accused of omission in paying a tax debt during the period from 2017 to 2018). The SRS had wrongly applied to past events a clause that had a substantially different set of legal conditions. The SRS was wrong in not assessing whether the company's assets were transferred to an interested party (which is a far more complicated task) and they confined themselves to a finding that assets have been disposed of but the tax debt remains unpaid.

However, neither the clause in its new version nor the TADA transition rules state that the newly adopted provision is to apply retrospectively. Therefore, in assessing whether all the preconditions are met for a "compensatory" decision to be made for the board member, the SRS should have followed the version of TADA section 60(1) that was in force when a potential breach was committed (from 2017 to 2018). If at least one of the criteria included in the clause is missing, there is no longer any basis for applying it and a "compensatory" decision cannot be made. This might release the board member from paying a large debt. We eagerly await the outcome of the case in the administrative court and will keep our MindLink subscribers posted.