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Directors' liability: directors can be liable for tax obligation breaches that preceded their appointment

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Introduction

Corporate law recognises a fundamental principle which is known as the 'organ theory' – that is, directors acting in their capacity as a company's corporate representative cannot be held personally liable for the corporate obligations arising from their position. This principle is reflected in Article 441-8 of the Companies Law.

Despite its fundamental importance, exceptions to this principle are allowed in certain circumstances, which have in common the wrongful nature of a director's given action (or omission).

A notable exception is brought by Luxembourg tax law.

Within the framework of direct income taxes (eg, the withholding tax on salaries and wages) and indirect taxes (eg, value added tax), the Luxembourg tax administration can hold directors personally liable for the payment of the company's own taxes under the following cumulative conditions:

- the company must have failed to comply with a tax obligation (eg, non-payment of taxes or default interest owed on taxes);
- the director must have had an obligation to take on the company's tax obligations (which is the case where a director has been entrusted with the day-to-day management of the company); and
- the failure to comply with tax obligations must have been due to a wrongful misconduct of the director.

In recent years, the Luxembourg tax administration – which is in a privileged situation with regard to the enforcement of its (tax) claims as it can create its own enforcement titles by issuing tax assessments – has increasingly been holding company directors liable for unpaid taxes of Luxembourg companies, especially in cases where such companies have been declared bankrupt. Luxembourg case law has applied the abovementioned conditions in manners that were sometimes described as more 'tax administration-friendly' than protective towards directors.

On 28 October 2020 the Administrative Court (43152) rendered a judgment which is a concrete example of the Luxembourg courts' approach.

Facts

On 5 October 2017 a French company (Company A) and a Luxembourg company (Company B) entered into a share purchase agreement, pursuant to which Company A acquired, from Company B, all of the shares of another Luxembourg company (Company C).

At the same time, Company A and the legal representative of Company C entered into a guarantee agreement, pursuant to which the latter explicitly guaranteed that Company C had always fully complied, within the legal deadlines, with all its tax and social security (reporting and payment) obligations.

On 13 December 2017, following the removal of the former legal representative of Company C, the claimant in the considered case was appointed as a director in charge of Company C's day-to-day management.

On 11 April 2018 Company C was declared bankrupt, a bankruptcy receiver was appointed and – consequently – the claimant was removed from his duties as director.

On 5 September 2018, following a verification of Company C's payroll books, the Luxembourg tax administration issued an *ex officio* tax assessment with regard to withholding taxes on salaries owed by Company C for the fiscal years 2014, 2015, 2017 and 2018.

These withholding taxes had effectively been deducted from the salaries paid to Company C's employees but had not been paid to the tax administration.

On 22 October 2018 the tax administration issued a guarantee call tax assessment requesting that the claimant (in his capacity as director in charge of Company C's day-to-day management from 13 December 2017 to 11 April 2018) personally pay the aforementioned withholding taxes on salaries owed by Company C.

On 21 December 2018 the claimant filed an objection with the tax administration's director, which the latter rejected on 28 March 2019.

On 20 June 2019 the claimant lodged an action for annulment against the tax administration director's rejection decision before the Administrative Court.

The claimant's main argument was that Company C's failure to pay to the tax administration the withholding taxes that had been deducted from salaries paid by Company C at a time when the claimant had not yet been appointed as Company C's director (ie, before 13 December 2017) could not be considered as due to any wrongful misconduct on his part, given the fact that:

- he had not been in charge when the withholding taxes should have been paid to the tax administration; and
- Company C's former legal representative had contractually guaranteed that Company C's past tax obligations had always been fully complied with.

Decision

The Administrative Court ruled in favour of the claimant with regard to the withholding taxes on salaries paid in 2014 and 2015; however, the court rejected his request with regard to the withholding taxes on salaries paid in 2017 and 2018.

While the claimant's success with regard to the withholding taxes on salaries paid in 2014 and 2015 stems from technical considerations, as the court found that the related tax debts had been formally established only on 5 September 2018 (ie, after the claimant's removal as a director), it is the rejection of the claimant's request with regard to the withholding taxes on salaries paid in 2017 and 2018 that is particularly noteworthy.

In order to reject the claimant's request, the court reaffirmed several principles that – despite their apparent harshness – can be considered as solidly enshrined in Luxembourg case law.

The court reasserted that once withholding taxes on salaries have effectively been deducted from employees' salaries, their non-payment to the tax administration is wrongful *per se* (which means that the tax administration need not prove the wrongfulness of the non-payment on top of proving the non-payment itself), as the fact that the taxes were deducted from

the salaries necessarily shows the director's awareness of the tax obligation.

The court underlined that the circumstance that a payment of taxes should have been performed prior to a director's appointment does not prevent the newly appointed director from having to remedy the tax obligation breach.

The court emphasised that the director should have been diligent and ensured that the company's tax obligations had been properly performed, even though the deadline to perform said tax obligations had already expired at the time of his appointment.

The court also reiterated that it is a general rule of tort law, which must also be applied in the context of directors' liabilities towards the tax administration, that the mere fact that a third party (eg, a former director) also contributed to the damage does not constitute a ground for exemption from liability. Further, the court held that in the situation where several persons have contributed to the damage through wrongful misconducts, all are severally liable towards the tax administration, which may freely choose to act against any one of them – regardless of the respective severity of each misconduct.

Finally, the court stressed that the provisions of the guarantee agreement pursuant to which the former legal representative of Company C had explicitly guaranteed that Company C had always fully complied with all its tax obligations could not be invoked against the tax administration, as such an agreement is binding only on the parties thereto.

Comment

While this judgment can seem harsh, it is worthy to highlight that the case's outcome was affected by the fact that the unpaid taxes were withholding taxes that had effectively been deducted from salaries paid to the company's employees. Therefore, this circumstance exempted the tax administration from having to prove the wrongfulness of the director's misconduct on top of the misconduct itself (ie, the failure to remedy the payment obligation breach) in accordance with well-established case law, which holds that the non-payment of withholding taxes to the tax administration is wrongful *per se*.

In most cases, the fulfilment of the three cumulative legal conditions to determine directors' personal liability towards the tax administration is reviewed carefully by the courts and directors who, in good faith, were unaware of the company's failure to comply with a tax obligation have good arguments for their defence.

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