

# Tax Foreclosure and Tax Liens: Where Lies the Line?–A Case Comment

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*Judicial judgment must take [d]eep account of the day before yesterday in order that yesterday may not paralyze today'*

Felix Frankfurter, *National Observer*, 1<sup>st</sup> March 1965

## Background

Whilst the Ethiopian tax system undergone a series of piecemeal reforms over decades,<sup>1</sup> a major overhaul occurred only in 2002. The 2002 tax law reform broadened tax bases, introduced new varieties of taxes, self-assessment procedures, and newer modalities of enforcing delinquent taxes. Of the later, incorporation of self-executing tax enforcement mechanisms was among the grand shifts in the country's tax system. Previously, the only means of collecting delinquent taxes<sup>2</sup> was through the costly and rather time consuming judicial execution. Alike ordinary creditors, the tax authority had just to queue before the office of judicial execution to have delinquent taxes enforced.<sup>3</sup> The

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<sup>1</sup> For a brief overview of tax reforms in Ethiopia, see generally, Alemayehu Geda and Abebe Shimeles, 'Taxes and Tax Reform in Ethiopia: 1993–2003,' UNU-WIDER and World Institute for Development Economics Research, *Research Paper No. 2005/65*, 2005.

<sup>2</sup> Delinquent taxes are taxes already due but not yet paid by the taxpayer; the defaulting taxpayer is referred to as a delinquent taxpayer.

<sup>3</sup> Articles 62–63, A Proclamation To Provide for Payment of Income Tax, 1963; Proc. No.173/1963, *Negarit Gazeta*, 20<sup>th</sup> Year, No. 13; see also, Bekelle Haileselassie, 'Salient Features of the Major Ethiopian Income Tax Laws', *Journal of Ethiopian Law*, Vol. 15, 1992, p.53.

disapproved judicial enforcement of delinquent taxes is now replaced by a set of self-executing enforcement schemes, namely ‘tax foreclosure’ and ‘tax liens’.<sup>4</sup>

Tax foreclosure is an out of court means of recovering delinquent taxes by seizing and selling the assets of delinquent taxpayers. It is “a public authority’s seizure and sale of the property for non-payment of taxes.”<sup>5</sup> It involves a series of procedures, e.g. notification, attachment, and seizure to sale.<sup>6</sup> Tax liens, on the other hand, represent a scheme of charging the asset of delinquent taxpayers until the tax already due is paid. Established by law, tax liens are simply securities the tax collector may avail himself of where taxpayers default.<sup>7</sup> Liens may also be established following procedures of notification and later registration of the security interest of the tax authority. Tax foreclosure and tax lien are uniformly recognized in almost all of Ethiopia’s tax legislations.<sup>8</sup> Despite

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<sup>4</sup> As shall be seen later, tax liens under Ethiopian law are however treated as legal mortgages which are enforced through judicial execution anyway; and this works against the original aim of the overall tax reform to eschew away all inefficiencies and inexpedien- cies court procedure entails in enforcing delinquent taxes.

<sup>5</sup> Garner, B. (ed.), *Black’s Law Dictionary*, 8<sup>th</sup> ed., West Publishing Co., St. Paul, 2004, s.v. “tax foreclosure” [Hereinafter Black’s Law Dictionary].

<sup>6</sup> Tax foreclosure may be compared with power of sale foreclosure that banks in Ethiopia are vested with since 1998. See, Property Pledged/Mortgaged with Banks Proclamation, 1998, Proclamation No.97/98, *Federal Negarit Gazeta*, 4<sup>th</sup> Year, No.16. For more on the Ethiopian tax foreclosure regime, see generally, Kinfu Micheal, *An Introduction to the Ethiopian Law of Tax Foreclosure: A Commentary*, 2009, available at:

<[http://www.abysinnialaw.com/uploads/The\\_Ethiopian\\_Tax\\_Foreclosure\\_Regime\\_\\_3\\_.pdf](http://www.abysinnialaw.com/uploads/The_Ethiopian_Tax_Foreclosure_Regime__3_.pdf)>.

<sup>7</sup> *Words and Phrases*, Vol. 41, Permanent Edition, West Publishing Co., St. Paul, 1965, p. 321. Black’s Law Dictionary, *supra* note 5 (p.2940), further defines tax liens as “liens on property, and all rights to property, imposed by the government for unpaid taxes.”

<sup>8</sup> See, for instance, Articles 77–80, Income Tax Proclamation, Proclamation No. 286/2002, *Federal Negarit Gazeta*, 8<sup>th</sup> Year, No.34 [Hereinafter ITP]; Articles 31–32, Value Added Tax Proclamation, Proclamation No.285/2002, *Federal Negarit Gazeta*, 8<sup>th</sup> Year, No.33; Article 17, the Value Added Tax Regulation, Regulation No.79/2002, *Federal Negarit Gazeta*, 9<sup>th</sup> Year, No.19; Articles 10–11 of the Excise Tax Proclamation, Proclamation No.307/2002,

the inclusion of these enforcement tools into our tax law statute book, a recent decision of the cassation bench of the Federal Supreme Court appears to mystify them.

This short critique comments on the decision of Cassation Division of the Federal Supreme Court in *Ethiopian Revenues & Customs Authority (ERCA) Jimma Branch v. Adale Seid and Firomsis Plc*<sup>9</sup> with a view to unravel how the court confused tax foreclosure with tax lien – two separate schemes of tax enforcement under the Ethiopian law. For the purposes of this piece, all references are to the Income Tax Proclamation No. 286/2002(ITP).

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*Federal Negarit Gazeta*, 9<sup>th</sup> Year, No.20; and Articles 13–14, Turnover Tax Proclamation, Proclamation No. 308/2002, *Federal Negarit Gazeta*, 9<sup>th</sup> Year, No.21; see also Articles 16(2(3)) and 18(2(h)), A Proclamation to Provide for the Establishment of the Ethiopian Revenues and Customs Authority, Proclamation No.587/2008, *Federal Negarit Gazeta*, 14<sup>th</sup> Year, No.44. Among regional laws, see for instance, Articles 14–15, the Southern Nations, Nationalities and Peoples Regional State Turnover Tax Proclamation, Proc. no. 57/2003, *Debub Negarit Gazeta*, 8<sup>th</sup> Year, No.6. Subsidiary legislations issued by the Ministry of Finance and Economic Development and the Ethiopian Revenues and Customs Authority further elaborate on tax foreclosure; see, “ግብር የመክፈል ግዴታቸውን ያልተወጡ ግብር ከፋዩችን ሀብት በመያዝና በመሸጥ የግብር አሰባሰብ የሚከናወንበትን ስርዓት ለመወሰን የወጣ መመሪያ” (የገንዘብና ኢኮኖሚ ልማት ሚኒስቴር፣1996E.C.), “የግብር አሰባሰብ እና ክትትል የሰራ ሂደት ማንዋል” (የኢትዮጵያ ገቢዎች እና ጉምሩክ ባለስልጣን፣ ሐምሌ 2000 E.C.). Disparate seizure rules are also included in Ethiopian customs law. Custom officers are empowered to detain a means of transport and [s]eize goods loaded where they have reasonable suspicion that customs formalities have not been met. Although not clearly articulated, such seizures would result in the ultimate sale of the goods where the owner of the good doesn’t report to the tax authority or fails to bring the case to court in 30 days from the notice of seizure. See Articles 82, 2(49), and 109, Customs Proclamation, Proclamation No.622/2009, *Federal Negarit Gazeta*, 15<sup>th</sup> Year, No. 27.

<sup>9</sup> *Ethiopian Revenues & Customs Authority (ERCA) Jimma Branch v. Adale Seid and Firomsis Plc*, Federal Supreme Court Cassation File Number 57100 [Ginbot 30/2003 E.C.].

## 1. Facts and Issues of the Case

Mr. Adal Seid lodged an execution proceeding against a clinic owned by Firomsis PLC, where he was a shareholder. The High Court of Jimma Zone in Oromia Regional State ordered the sale of the clinic so that Mr. Adal be paid his share in the plc. Nevertheless, bidders didn't appear in two consecutive auctions. As a result, the judgment creditor (Mr. Adal) requested to take possession of the assets of the plc.

Meanwhile, ERCA (Jimma Branch) intervened in the proceeding claiming that the plc owed it 508, 564.67 Birr in unpaid taxes and that the authority has *preferential claim to assets* under Article 80(1) of ITP. Nonetheless, the High Court declined ERCA's claim for seizure of delinquent taxpayer's property is allowed, as per Art 78(1) of the ITP, only when it is not subject to attachment or judicial execution and the assets of the plc are already under judicial execution proceedings. On appeal, the Supreme Court of Oromia Regional State agreed with the decision of the High Court.

Disagreeing with this decision, ERCA petitioned the Federal Supreme Court Cassation Division to review the decision of the lower courts for basic error of law. And the tax authority argued it enjoys preferential claim to assets next to other secured creditors such as banks under Article 80(1) of ITP, yet the regional courts denied its claims by relying on Article 78(1) instead. It maintained Article 78(1), which regulates surrender of property in the hands of third parties during tax seizures, is irrelevant to the circumstances of the case at hand.

The Cassation bench received the written responses of the respondents (Mr. Adal and Firomsis PLC) after identifying the existence of fundamental error law qualifying for cassation review.<sup>10</sup> The first respondent (Mr. Adal) stated in his

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<sup>10</sup> Before cassation review, decisions of lower courts appealed from would first be screened out by a panel of three judges; and, it is only when the panel is satisfied with existence of

submission that the appellant was very late in seeking enforcement for unpaid taxes against the property of the second respondent. Also, he generally argued that the appellant is not entitled to preferential claim on the assets (of the second respondent) over which he received temporary administration after failed attempts to auction off the same. Though not clearly articulated in the case report, the responses of the second respondent seemed to support the claims of the appellant. The appellant had also submitted a counter-reply, albeit its contents are not summarized in the case report.

The Bench framed the issue: does the appellant enjoy preferential claim to assets of the second respondent over which the first respondent received temporary administration? From the outset, the court also established the uncontested fact that the first respondent didn't have a secured right against the property of the second respondent.

## 2. Decision of the Bench

In defining the ambit of Article 80(1) of ITP, the court noted that a claim would precede the claims of the tax authority only where it is *secured*. As to whether Article 78 (1) of ITP is relevant to the case under consideration, the court ruled that the provision doesn't bar the preferential claim to assets of the tax authority. The main aim of the provision, according to the Bench, is just to regulate the procedure through which the property of the delinquent taxpayer could be collected or received by the tax authority should it become necessary.

Accordingly, the court reasoned the judgments of the regional courts rendered based on Article 78(1) constitute fundamental error of law. Consequently, they are quashed and the priority of the appellant's claim to the claims of the first respondent is upheld.

### 3. Tax Foreclosure and Tax Liens – Drawing the Lines

As noted above, the two important questions the Bench dealt with are: (1) “when does the tax authority enjoy preferential claim to assets of delinquent taxpayers under Article 80(1) of ITP?”<sup>11</sup> and (2) “what is the correlation between Article 78(1) and Article 80(1) of ITP?” In what follows, I shall treat these two issues separately and examine their disposition by the court. In doing so, an attempt is made to draw a line between foreclosure and lien under Ethiopian tax law.

In disposing the first issue the court held that no claim, unless secured, precedes the tax claims of the tax authority under Article 80(1). In other words, all creditors but secured creditors (e.g. banks, mortgagees or pledges) are ordinary creditors next in priority to the tax authority. Apparently, the tax authority becomes a secured creditor with senior lien rights as against all subsequent creditors from the day the tax becomes due and payable.<sup>12</sup> It is not however clear from the decision of the court if a secured creditor, say a bank, which becomes a mortgagee vis-à-vis the taxpayer on the morrow of the day the tax becomes due and payable on the same taxpayer would still be subordinate to the tax authority. According to a doctrine of property security, *first in time first in right*, one that registers the property of a debtor first is entitled to priority against all subsequent claims.

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<sup>11</sup> Article 80(1) reads as follows:

“From the date on which tax becomes due and payable under this Proclamation, subject to the prior secured claims of creditors, the Authority has a preferential claim over all other claims upon the assets of the person liable to pay the tax until the tax is paid.”

<sup>12</sup> Of course, this should not come as a surprise as it is generally recommend that tax law should provide for a charge or lien that constitutes a security interest in the taxpayer’s property in favor of the government. See, Gordon, R., Law of Tax Administration and Procedure, *in* Thuronyi, V. (ed.), *Tax Law Design and Drafting*, Kluwer Law International, the Hague, 2000, p.108.

The logical way of reading Article 80(1) would be that the tax claims of the tax authority would be superior as against all claims regardless of whether they are secured. Given the peculiar feature of tax liens in Ethiopia, this construction is nonetheless difficult to swallow. Though Article 80(1) appears *prima facie* to grant preferential claim to asset from the day the tax becomes due and payable, a closer look at subsequent sub-articles reveals that other requirements need to be met before the claims of the tax authority take priority. It can be argued that all what is provided under Article 80(1) is just the principle, and that other conditions stipulated under sub-articles 80(2)-(3) are still required to make the tax authority a complete secured creditor.<sup>13</sup>

As per the rules laid down in sub-article 80(2)-(3), where the taxpayer defaults on his payment of taxes,<sup>14</sup> the tax authority has to give a written notice to the delinquent taxpayer stating its intention to register a *security interest* on the assets of the defaulting taxpayer.<sup>15</sup> Secondly, where the taxpayer fails to pay up taxes due within 30 days of notice, the tax authority may direct the relevant authority to register its security interest for unpaid taxes on the property of the taxpayer.<sup>16</sup>

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<sup>13</sup> It is not uncommon to find similar sequencing of provisions in other pieces of legislation. Either the first provision in a given section of legislation or the first sub-article would be captioned as 'general' or 'principle' and the details are set out in subsequent articles or sub-articles.

<sup>14</sup> There are generally three conditions under which a taxpayer may be deemed to have defaulted under Article 73(2) of ITP. These are: "Where the taxpayer fails to pay the tax due within 30 days from the receipt of the assessment notice or from the date of the decision of the review committee; or where the period for lodging appeal on the decision of the tax appeal commission has expired; or where the court of appeal renders its final decision."

<sup>15</sup> Article 80(2), ITP.

<sup>16</sup> *Ibid*, Article 80(3); on another note, the notice that the tax authority may give to the property registering authority is literally a direction ordering registration of its security interests. The registering authority doesn't have a power to investigate the titles or the interests of the registrant. This approach seems to be guided by a view that 'tax liens are liens of sovereignty

It seems, therefore, cogent to state that though lien right of the tax authority arises from the moment taxes become due and payable, registration has to be sought before the registering authority enjoys preferential claim. *First in time first in right* rule ought to be read into the provisions of the law. This line of argument finds support from the very terms used in the provisions of the law. The terms *security interest* and *mortgage* under Articles 80(2)–(4) evince that the status of a secured creditor could only be secured in so far as the conditions thereunder are complied with; or else, the tax authority would be treated like an ordinary creditor.

In view of the foregoing, ERCA was bound to issue notice and seek registration of its security interest for it to raise preferential claim over the assets of Firomsis Plc. And, since it didn't, ERCA shouldn't have been given preferential claim to assets of the Plc. The Cassation Bench should have simply treated ERCA as an ordinary creditor for it did not comply with the statutory requirements of notice and registration. What is more, if the claims of Mr. Adal as against Firomsis Plc were to be regarded as secured,<sup>17</sup> the tax claims of ERCA would be next to the claims of the former in the hierarchy of claims notwithstanding the registration of the tax authority's security interest. It is thus unfortunate that the Bench subordinated Mr. Adal's security right to that of the tax authority's for the utter reason that ERCA has invoked Article 80(1).

Logic also accords with the above interpretation of the provisions of Articles 80 (1)–(3), ITP. If lien right of the tax authority were to be considered established from the moment taxes become due and payable without further steps of notification and registration, other secured creditors' rights would become redundant. This would particularly be true where sale proceeds of the

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and a sovereign can do no wrong'. See, Wolson, B., 'Federal Tax Liens—A Study in Confusion and Confiscation', *Marquette Law Review*, Vol. 43, 1959/60, pp.181–182.

<sup>17</sup> Whether a shareholder in private limited company has a secured claim to the extent of his share in the company is of itself an interesting topic separately.



taxpayer's assets are insufficient to cover the claims of all other creditors after having satisfied the tax claims.

In answering the question regarding the relationship between Articles 78(1) and 80(1) of ITP, the court seemed to hold that the former comes into play only where seizure of the taxpayer's property is deemed necessary under the provisions of the later. It is here that the court apparently conflated two separate schemes of tax enforcement, tax foreclosure (Articles 77-79) and tax liens (Article 80).<sup>18</sup>

Articles 77-79 of ITP generally deal with tax foreclosure – a procedure whereby the tax authority enforces unpaid taxes through unilateral seizure and sale of delinquent taxpayer's property. Particularly, Article 78 governs the situation where properties of the delinquent taxpayer are in the hands of third parties once a tax foreclosure process begins. It sets out the obligation (and rights) of these third parties vis-à-vis the tax authority and delinquent taxpayers. Article 80, on the other hand, deals with tax lien – a distinct notion in tax law. As noted earlier, tax foreclosure is essentially an out of court procedure carried out by the tax authority itself. Of course, tax liens are also theoretically self-executing procedures that do not directly involve courts. Nevertheless, as the Ethiopian law uniquely contemplates tax liens as legal mortgage, recourse to court is not avoided altogether.<sup>19</sup> As provided under Article 80(4) of the ITP,

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<sup>18</sup> The writer believes both the trial and appellate courts of Oromia Regional State were wrong in answering a question primarily related to tax liens based on Article 78, a provision dealing with tax foreclosure.

<sup>19</sup> Legal mortgage is a variant of mortgage. It is created by the operation of the *law* (as opposed to agreement). The most common instances under which a legal mortgage may arise includes, a legal mortgage that minors, interdicted persons and absentees have on the property of their tutors and curators as a security under the laws of some jurisdictions; see, Black's Law Dictionary, *supra* note 5, *s.v.* "legal mortgage". Ethiopian law sets forth four major instances of legal mortgage, namely, legal mortgage of co-partitioners (Article 3043, Civil Code), legal mortgage of sellers of an immovable (Article 3042, Civil Code), legal mortgage of a seller of a

“notice served to the property registering authority ordering the registration of the interest of the tax authority will serve *as an instrument of mortgage*, and such a registration *shall operate as a legal mortgage in all respects*.” This stipulation apparently defines tax liens as legal mortgage. And, legal mortgage, along with judicial mortgage and contractual mortgage, is a security device enforceable only through judicial execution.<sup>20</sup> In this sense, therefore, tax liens as legal mortgages are not self-executing under Ethiopian law.<sup>21</sup> Given this feature of tax liens, one would find hard to swallow the reasoning of the Cassation Bench that fixation of lien under Article 80 may necessarily lead to unilateral seizure of property of the taxpayer by the tax authority under Article 78.

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business and creditors of a bankrupt trader (Article 172, Commercial Code), and legal mortgage of the tax authority on the delinquent taxpayers property (Article 80(4), ITP). The fourth instance under which a legal mortgage arises is probably peculiar to the Ethiopian law for it deviates from comparable foreign laws on tax lien.

<sup>20</sup> Article 3058 (1), Civil Code. It is to be noted that ITP, under Article 2 mandates the cross-reference of terms defined in other laws of Ethiopia (including the Civil Code) save where different meanings are expressly provided in ITP itself. Absent any specific definition of *legal mortgage* in ITP, referring to the relevant provisions of the Civil Code for an understanding of legal mortgage appears appropriate.

<sup>21</sup> Indeed, there is a clear resemblance between ‘lien’ and ‘mortgage’. According to a common law theory of lien, what mortgagees acquire is a lien on the property, and the mortgagor retains the legal title over the same property up until foreclosure ultimately happens. Unlike tax foreclosure that enables direct seizure of property, (tax) liens and (legal) mortgages only encumber the tax payer’s property and give the tax authority priority if it properly complies with statutory requirements of lien or mortgage creation. And, the property, including legal titles to it, remains in the hands (and names) of the taxpayer until final judicial sale eventuates; see generally, Lloyd, W., ‘Mortgages – The Genesis of The Lien Theory’, *Yale Law Journal*, Vol. 32, 1923, p.233 *et seq.* See also, Gavitt, B., ‘Under the Lien Theory of Mortgages Is the Mortgage Only a Power of Sale?’, *Minnesota Law Review*, Vol. 15, No. 2, 1931, p.147 *et seq.*

Should a taxpayer fail to discharge his duties, what could happen under Article 80 is that the tax authority files a claim before a court of law as a creditor or a secured creditor if the requirements under Article 80(2)–(3) are fulfilled. Fixation of lien only helps to lift the authority to the status of a secured creditor. Still, claims secured by tax lien are subject to other prior secured claims; also, and more importantly, they are basically enforced judicially.

The writer believes the Bench's attempt to correlate provisions of Article 78(1) with Article 80(1) misses the salient feature of the Ethiopian tax lien regime. The provisions of Section VII (Collection Enforcement) do not only deal with tax foreclosure involving unilateral seizure and later sale of taxpayer's property. Some deal with tax lien. And, tax foreclosure and tax lien are twin enforcement tools, albeit they employ slightly different trajectories in achieving the same objective of recovering delinquent taxes. Put simply, tax lien is legal alternate to tax foreclosure under Ethiopian tax law.

Given that tax liens are just alternative means of enforcement, the tax authority may not nevertheless need to go through the procedure of tax lien creation in all instances. It can proceed with the unilateral tax foreclosure procedure – which also involves a series of procedures before property of the taxpayer is subjected to sale – where, for instance, the authority emerges as a lone creditor vis-à-vis non-registered properties of the delinquent taxpayer.

## **Concluding Remarks**

In the foregoing, we pointed out that the highest court has run into another error in rectifying an alleged fundamental error of law. The cassation bench mistakenly confused two separate schemes of tax enforcement and assumed the provisions of Article 80 generally deal with tax foreclosure. This piece underscores that tax foreclosure and tax lien are two separate schemes of tax enforcement under Ethiopian law. Although recovering delinquent taxes is

their shared ultimate goal, they follow different tracks in enforcing delinquent taxes; while tax foreclosure is self-executing and unilateral, tax liens are enforceable through judicial execution.<sup>22</sup> Considering tax lien as self-executing and unilateral procedure (as the Bench did in *ERCA vs Mr. Adal and Firomsis Plc*) would make Article 80 of ITP redundant. Also, it might seriously limit the rights and interests of other (than the tax authority) creditors' of the delinquent taxpayer.

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<sup>22</sup> No matter how inexpedient and costly judicial proceedings are, the involvement of courts in handling delicate matters like selling alleged debtors property adds sense of trust to the whole system. That being said, one may ask why the judiciary is brought back through tax lien while the initial goal was to eschew away the time consuming and inexpedient judicial enforcement. In this regard, I elsewhere put forward my hunch that this may have resulted from drafting problems. See generally, Kinfe Micheal, *The Basic Features of the Ethiopian Tax Lien Regime*, 2010 (Unpublished), available at: <[http://www.academia.edu/862727/The\\_Basic\\_Features\\_of\\_the\\_Ethiopian\\_Tax\\_Lien\\_Regime](http://www.academia.edu/862727/The_Basic_Features_of_the_Ethiopian_Tax_Lien_Regime)>.