GIORGI TSAGURIA*

A Critical Comparison of Georgian Corporate Income Tax Model with theEU Analogues (Primarily the Estonian Model)

1. Introduction

The changes that the CIT model adopted in 2016-17 was probably the most challenging in Georgian modern Tax Code, because it was solely based on the CIT of just one country – Estonia. Therefore, Georgian new CIT model, based on 2016-17 tax reform (GCITM) is almost unique and have a very poor practice in Georgia, as well as in Estonia. This fact also excludes observations of any court practice or of any other tax dispute platform effective in Georgia.

Although the GCITM has important strengths, based on its practical usage – number of important mismatches have been detected and discussed in this article. Based on the restrictions of the format – only problematic/unclear issues related to GCITM are observed. The article also proposes ways to improve GCITM, mainly adopting the approaches used in Dutch and Estonian CIT models. This analysis is not related to the economic consequences, but to the incentives and legal logics.

* Law student, New Vision University.

2. General Overview of GCITM

GCITM has taken all of the taxable objects that the Estonian Corporate Income Tax Model (ECITM) envisages, giving them slightly different formulation. The main document for the Georgian CIT base is a factual economic performance of the company, based on International Financial Reporting Standards.

However, substantial differences exist in the interpretations and further explanations, whether the specific transaction falls under the respective taxable object definition or not.

With such an approach the regulations on a thin capitalization, an accrual method of tax accounting, liquidation, reorganization and transfer of asset rules, numerous tax norms are eliminated as no more applicable for the persons subject to GCITM.

3. Unresolved Issues/Practical Negative Effects of the Existing Model. Proposed Ways of Solution

3.1. Legal Vehicles

Georgian Law on Entrepreneurs lists the types of entities defined as enterprises and there are no Collective Investment Funds (CIFs) and trusts. Therefore, most likely, this is the reason why regulation of Tax Code of Georgia (TCG) with respect to accumulated pensions and investment funds is very narrow and provides exemptions for operations related to investments and pensions provided by a legal entity which obtained a status of an international financial company only.[1]

Comparing to the EU Countries Classical CIT Model (EUCCCM) and ECITM, Georgian tax legislation lacks CIT regulation regarding the specific types of entities. Entities like CIFs ("funds for joint account"[2] as in the Netherlands) and trusts are widely used in the Western world for the specific investments and/or savings purposes. Such entities are mostly (in EUCCCM, as well as in Estonia[3]) exempt from CIT or have other specific tax regimes.

1 Tax Code of Georgia 2010 (Georgia) s99 (1.n).
2 Law on Corporate Taxation 1969 (Netherlands) s2 (1.f).
3 Income Tax Act 1999 (Estonia) s2 (5).

Additionally, according to the EU/Georgia Association Agreement,[4] Georgia has an obligation to regulate such investment vehicles as UCITS (Undertakings for Collective Investment in Transferable Securities) in accordance with a Directive N2009/65/EC of the European Parliament and of the Council of 13 July 2009. Respective regulatory changes shall be made before 2022.[5] This should most likely mean implementation of respective tax regulations as well.

If the respective amendments were done in TCG, as well as in the Law on Entrepreneurs, giving possibility for creation of the CIFs (including UCITS) and trusts, with respective CIT exemptions, it would create an incentive for creation of pension/saving funds, which would also have a huge impact on Georgian economic growth, which was the goal of the new CIT model.

In addition, it is noteworthy that the partnerships are not differentiated in GCITM for tax purposes, comparing to EUCCCM, where different kind of partnerships might be taxed differently. In case of GCITM, all the partnerships are taxed in the same manner; they are all inter alia CIT subjects in Georgia and taxed respectively.[6]

3.2. CIT on Profit Distribution of PE Acting in Georgia

TCG defines distributed profit of permanent establishment (PE) as a distribution (the profit attributable to PE taken away by the non-resident enterprise) either in monetary or non-monetary form made to the non-resident out of the profit gained as a result of the activity of the PE.[7] At the same time, distributed profit is a profit distributed by an enterprise to its partner as a dividend in a monetary or non-monetary form.[8]

Based on the definition of a dividend, it may be distributed only between two separate legal entities.[9] Thus, because a PE and its head office do not

4 Chapter D of Annex XV-A of EU/Georgia Association Agreement.
5 Ibid.
6 Tax Code of Georgia 2010 (Georgia) ss21 (1.c), 97 (1).
7 Tax Code of Georgia 2010 (Georgia) s98^1(3).
8 Tax Code of Georgia 2010 (Georgia) s98^1(1).
9 Article 8.12 of the TCG.

form distinct legal persons and represent a single legal entity,[10] PE is unable to distribute its profit in a form of dividend. Therefore, the moment and an exact transfer of funds that should be regarded as distribution of profit subject to CIT is unclear.

The Georgian Tax Authorities keep silence regarding this issue, whereas more than 1900 PEs[11] of non-residents are left with this uncertainty and each makes its own interpretation on the subject.

In order to make the abovementioned clear, TCG could choose an approach used in ECITM and Estonian Tax Board. The dividend distribution of PE could be directly connected to the tax period i.e. a fiscal month and the transfer of funds could be considered the moment when the assets are not under the control of a PE or a PE has not received a remuneration at a market price for its activities.

3.3. Uncertainties Related to Taxation of Specific Expenses

TCG specifies that expenses, which have been incurred without a purpose to gain profit, income or compensation, shall be deemed as expenses not related to economic activity, thus subject to CIT.[12]

The main issue related to this norm is connected to the penalties and fines. ECITM directly says that the fines and penalty payments (including payments in kind), imposed on the basis of law and interest paid for late payment of tax and bribes are subject to CIT,[13] GCITM lacks such provision, leaving space for taxpayer's interpretation. Additionally, most criminal fines and tax penalties are not deductible in EUCCCM,[14] as it is per today applicable in Georgia with respect to the companies not transitioned to GCITM yet.

Per my opinion, levying CIT on the penalties/fines should be subject to CIT, as not levying CIT might trigger unequal treatment of the taxpayers transitioned to GCITM and of not transitioned. Regarding the bribes, I do not think it

10 Law on Entrepreneurs of Georgia 1994 (Georgia) s16 (1).
11 Official web-site of National Agency of Public Registry < https://enreg.reestri.gov.ge>
12 Tax Code of Georgia 2010 (Georgia) s98[2] (1.b).
13 Income Tax Act 1999 (Estonia) ss51 – 52.
14 Marnix Schellekens, Netherlands Corporate Taxation Country Surveys, 17 May 2018, Amsterdam, 1.3.3.2. < https://online.ibfd.org> (accessed 16 July 2018).

is correct to levy CIT on giving a bribe – as the taxpayer giving a bribe will be charged in a form of penalty for such a bribe, which according to my previous argument should be subject to CIT.

In addition, I think that introducing assumption that the penalties/fines are deemed to be related to the economic activity, therefore not subject to CIT would not be correct from the perspective of GCITM general approach:

- GCITM's aim seems to be taxation of all the finances that leave the GCITM subject;
- Special assumptions are not provided for the expenses not related to the economic activity.

3.4. Determination of CPTRs

GCITM levies CIT on the specific transactions with entities registered in country with preferential tax regime (CPTR).

The rules determining the CPTRs and referring to the respective Ordinance of the Government of Georgia[15] is mentioned in the article regulating expenses not related to economic activity.[16] The first rule states that a country shall be considered as CPTR if under the tax legislation of the country and/or of separate territories of the country:

- a legal person is exempt from CIT[17]; or
- CIT is not imposed on profit gained and/or distributed by a legal person, or the CIT rate does not exceed 5%.[18]

The second rule states that if the tax legislation of foreign country or its separate territory envisages any of the abovementioned tax implications to a company registered on its territory – such country or its separate territory shall be deemed as CPTR with respect to such implication.[19]

[15] Ordinance of the Government No 615, 2016 (Georgia).
[16] Tax Code of Georgia 2010 (Georgia) ss98^{2} (5), 98^{2} (6), 98^{2} (10).
[17] Based on the current Georgian CIT rate (15%).
[18] Tax Code of Georgia 2010 (Georgia) s98^{2} (5).
[19] Tax Code of Georgia 2010 (Georgia) s98^{2} (6).

Further, TCG states that the list of countries and/or separate territories of countries that are considered as CPTRs for the purposes of TCG shall be determined based on the rules mentioned above by ordinance of the Government of Georgia.[20]

Therefore, we have three interconnected rules, which determine whether a country shall be considered as a CPTR. A company registered in UAE should fall under the first rule based on the fact that UAE does not impose CIT on supply of computers, however it might not fall under the second rule in case if we take a profit of oil company which is taxed in UAE, and therefore, it also does not fall under the third rule – as although UAE is in a list of CPTRs, but only for the purposes of the second rule. Thus, in this event, an oil company registered in UAE is a company registered in CPTR based on the first rule, but it is not a CPTR based on the second and the third rule.

Notably, some countries mentioned in the list do not exist anymore. This might be issue in some cases. For example – the Netherlands Antilles. This country is dissolved.

In order to avoid all the above mentioned, GCITM could take an approach used in the ECITM, where the rules for CPTRs are determined similarly to Georgian second rule only.[21]

Most importantly, EITA do not refer to the territories, which should be considered as CPTRs, but to the territories which should not be considered as CPTRs and moreover, this list do not prejudice the rules determining CPTR.[22] Thus, the CPTR in case of Estonia is the country satisfying the alternative to Georgian rule N2 mentioned above. Leaving only the second rule, GCITM would also be clearer and probably avoid uncertainties.

3.5. Possible Increase in a Burden of Tax as a Result of New CIT Model

According to the Constitution of Georgia, a new type of common-state tax may be adopted or the upper limit of the current rate may be increased

20 Tax Code of Georgia 2010 (Georgia) s98^2 (10) referring to Ordinance of the Government No 615, 2016 (Georgia).
21 Income Tax Act 1999 (Estonia) s10 (1).
22 Income Tax Act 1999 (Estonia) s10 (3).

only through a referendum, except for the cases provided for by the Organic Law.[23] Additionally, introduction or change of a tax shall not be deemed as introduction of a new type of common-state tax or an increase in the marginal rate if the introduced or changed tax represents an alternative to the current tax or replaces the current tax and at the same time does not increase the tax burden.[24]

The reforms of 2016-17 were not carried out based on the temporary increase of taxes, which could be legitimate in accordance with the Organic Law.[25] Therefore, the Government did not execute its right mentioned in the Organic Law. Thus, the referendum was required if the actual tax burden has raised based on GCITM changes.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of deductible temporary differences, the carryforward of unused tax losses, and the carryforward of unused tax credits.[26] Deferred tax assets might be deemed as the tax relief, as they are artificially created by the tax legislation and do not coincide with the real accounting situation of the company, thus creating a possibility for the company to delay payment of CIT.

Let's assume that a big international company providing taxi services has entered Georgia in 2014. It knew that TCG provides a tax relief in a form of deferred tax assets. It predicted that the tax relief would be applicable also in the future. The company has bought cars on amount of USD10mln. Company has a financial profit since its establishment in Georgia. It could deduct this amount at once or deduct an annual depreciation of cars (both represent a tax relief). The TCG envisaged 20% annual depreciation for cars. Thus, the company deducted USD2mln in the first year, USD1.6mln in the second year and intended to deduct USD1.28mln in the third year (2017). However, in 2017, the new GCITM has been enacted and the right of the company to deduct further 20% was cancelled. Furthermore, nor a right to correct/clarify declarations for previous years has been granted to the taxpayers that have used an annual depreciation method for tax purposes.

23 Constitution of Georgia 1995 (Georgia) s94 (4).
24 Constitution of Georgia 1995 (Georgia) s94 (5).
25 Organic Law of Georgia On Economic Freedom 2011 (Georgia) s1 (6).
26 International Accounting Standards 12: para. 5 — Income Taxes.

Alternatively, if the company chose a one-time deduction method and intended to carry loss incurred in 2014 – such a right is not applicable in 2017, based on the GCITM. As the result – a company is liable to pay CIT on the distribution of dividend in 2017 and it cannot carry loss anymore for further years.

As might be ascertained from the abovementioned arguments – transition to the new GCITM do represent a cancellation of tax relief. Cancellation of tax incentives according to tax scholars make the tax burden heavier and entail more tax risks.[27]

As the companies are no more allowed to carry loss incurred initially – transition to new GCITM might be considered as increase of a tax burden, especially for the big international companies making a long-term investment in Georgia, which require a purchase of expensive assets. Thus, the constitutional claim would at least have a solid based to be satisfied.

3.6. Lack of Effective Incentive to Reach the Aim of the Reform

GCITM was intended to create a new incentive – to reinvest sums in the enterprises. However, when we check the ECITM, which was the base of GCITM, it contains specific incentive, which is not provided in GCITM. The companies did not have an actual financial incentive to retain the profits within the company. As the result, the aim of the reforms carried out most likely was not reach. Furthermore, as discussed in previous chapters, many uncertainties take place, which certainly do not create an incentive to even enter the Georgian market.

One of the most interesting incentives that GCITM could take from ECITM is that in Estonia, a profit distributed in the calendar year, equal to or less than the income distributed in the previous three calendar years from the average profits distributed by the resident company, is taxed at the reduced rate.[28] Such a regulation shall most likely create an additional incentive for company to reinvest more and not to withdraw finances from the business for the years.

27 Causes of Tax Risks and Ways to Reduce Them, European Research Studies Journal, Volume XX, Issue 3B, 2017, p. 456.

28 Income Tax Act 1999 (Estonia) s50[1].

4. Conclusion

The aim of the work to show all the major problematic issues related to the GCITM is achieved. During the research, numerous complex issues have been detected and observed, comparing Georgian tax legislation with its analogues in EU.

Although there is almost no cases observing GCITM, the article has successfully provided the possible tax dispute subjects and proposed the ways of elimination of such issues (where applicable) before serious tax disputes has arisen. The main problems of the GCITM detected and discussed in this work are related to:

- Tax subjects;
- Distribution of profit by PE;
- Taxation of penalty/fine payments;
- Determination of CPTRs;
- Incentive to reach the aim of the reform;
- Increase in a burden of tax.

To summarize, I believe that this work will be useful, based on the fact that GCITM has been enacted recently and there are very few works related to the weaknesses of GCITM, especially from the perspective of its practical implications.