

A Pig in a Poke: Tax Avoidance, Directors, Shareholders and a Company Life

1. Introduction

Variation of taxes and reducing them is the case when we need to be aware of some rules to stay away from jail and not to lose millions. While working on a specific transaction lawyers need to identify all the risks to clients and the company. So it is necessary to know the method of indication of risks. For example, the Supreme Court of Georgia has discussed the issue of liability of a director and a partner when they abuse tax reliefs. The aim of the present work is to research and detect the limit between tax avoidance and tax planning according to the decision of the Supreme Court of Georgia (6th May of 2015), also determine if there is enacted any kind of a special test by this decision. This includes liability of a company, its director and partners when they use tax reliefs, also criminal liability of them and the risks that appear on the local market because of the explanation formed by the court.

In order to reach the outlined aim perfectly, there are used the methods based on comparative analysis and synthesis, generalization, abstraction, analogy and system approach in the present work.

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Pay less taxes as it is possible – of course this is a legitimate goal. According to the 94th article of the Georgian constitution the payment of taxes shall be obligatory in the amount and in accordance with a procedure established by law.¹ In the organic law on economic liberty this wide issue turns specific: we read there that “the liberty is the main principle of the economic policy that is expressed in a small government, responsible macroeconomic policy and low taxes”². This means that if minimization is determined by law then it is possible to lobby with your taxes in such a way that allows you to undertake less tax obligation. Accordingly, the basic questions that shall be responded with the help of this research are:

1. Can we reduce taxes and how?
2. What is the difference among tax evasion, tax avoidance and tax planning?
3. What does the principle of abuse of law mean in tax law?
4. Is there any test that indicates whether the specific case is about tax avoidance or tax planning?
5. What kind of liability lies with companies, directors and partners if they decide to reduce taxes? Who is responsible for a concrete action and what is this liability based on legally?
6. What should a director do when he can reduce taxes – act in favor of company’s interests and be under the risk of criminal liability or pay more and be accountable to the partners personally?

The three key forms (terms) – tax evasion, tax avoidance and tax planning are not defined well in Georgian legislation. For example, Tax evasion – here we come across the cases when violation is obvious: a person does not use a cash machine, carries out illegal accounting and, accordingly, directly breaks the law. In this case not only does the person have to pay basic amount, but also fine and penalty. At the same time criminal liability lies with him.³

¹ Constitution of Georgia, 1995, Article 94;

² Organic Law of Georgia on Economic Freedom, 2011, Preamble;

³ International Tax Avoidance and Evasion, Four related studies (OECD, Paris, 1987), p.11; see *United States v. Terrel*, 754 F.2d 1139, 1144 (1985); *United States v. Grasso*, 629 F.2d. 805, 805 (1980).

Tax avoidance is an intermediary element, here a company does not violate written law and obeys formal demands, but activation of an illegal structure/scheme causes the results that have not been intended by the legislator.⁴ So, in order to understand the will of the legislator which the specific relief is based on, we should use legal texts, its history and explanatory notes.

Tax planning is when a taxpayer as a result of his legal actions reaches the aim of the legislator about enacting a certain relief and neither criminal nor administrative liability lies with him.⁵

At the moment when there are a lot of questions about the terms, Georgia does not have various judicial practice related to them. In Criminal Code of Georgia we meet a term “tax avoidance” in Georgian language and “evasion of taxes” in English language, so this leads to big problems on the local market.⁶ If we take into account the amount that is enough for the action to be considered as a crime⁷, every potential case may be recognized as a crime. Accordingly, every director and/or a partner is a potential accused, if his decision is not considered by tax authorities as tax planning.

2. Tax avoidance, Abuse of Law and Tax Planning – Limits of Law

Is the agreed transaction relevant to the performed action? Practically, this is a principle like one Georgian expression “I believe the oath but the tail amazes me”. For instance, if somebody has signed a rent agreement, is this a rent agreement really? Or is it property transfer in fact? The subject of the contract is a property that is depreciable and the term of the agreement is 60-70 years. It is a logical doubt that we see a rent agreement in the document, but essentially there is transfer of a property, because by the time the property goes back to the owner it may be devalued/destroyed.

⁴ Lord Nolan opinion on *Inland Revenue v. Willoughby* case (1997), p. 27.
<https://publications.parliament.uk/pa/ld199798/ldjudgmt/jd970710/willough.htm>

⁵ M. Paulus, *Tax Evasion, Tax Avoidance and Tax Planning*, Issue 5 (May 2006), pp. 272-281; P. Kavelaars, *EU and OECD: Fighting against Tax Avoidance*, Issue 10 (October 2013), pp. 507-515;

⁶ Criminal Code of Georgia, 1999, Article 218.

⁷ *Ibid.*

So, the relevance between the essence of the law and the transaction is the main problem in the present work. If they do not correspond each other, it is necessary to find out whether the form that was used by the person is illegal or not. In this case the most critical side of Georgian legislation is the fact that Georgian Criminal Code discusses “tax avoidance” word for word. This means that not only can it include hiding incomes and receiving reliefs illegally, but also tax avoidance, which is usually legal formally but does not correspond the direct will of the legislator. This example perfectly describes the decision⁸ of the Supreme Court of Georgia which was followed by a great response.

In this part a lawsuit about Halifax is worthwhile.⁹ There the court declared that the aim of the company of paying less taxes is legal when the law allows to do it. But it is vital to have a certain criterion that defines the relevance of persons’ economic activities to the essence of them.¹⁰ Halifax like other financial institutes was free of paying VAT without the right of deduction. So when Halifax would buy service/products for his basic business from the suppliers who paid VAT, it could not deduct VAT. Accordingly, its directors decided to plan their operations in the way that would let them do everything correspondingly to the formal legal standards and deduct VAT at the same time. They were going to build a call-center, for which they had to pay VAT in amount of several millions without the right of deduction. To carry out its plans, Halifax made a special transaction among several affiliated and related companies. That was formally legal in the whole, but certain actions annulled each other.¹¹ For example, if an affiliated company would become the owner of real estate, it would rent this property to Halifax. Halifax would hire two companies: one would build a building there and another would renovate. In this case VAT deduction was allowed by British legislation.¹² Finally, the company reached its aim and did everything legally (formally), but the revenue service became suspicious about this situation. Since British

⁸ Supreme Court of Georgia, Case Judgement #as-1158-1104-2014, 06 May 2015;

⁹ C-255/02 – Halifax and Others, 2006.

¹⁰ C-255/02 – Halifax and Others, 2006, paras. 12-30.

¹¹ Ibid, paras. 31-37.

¹² C-255/02 – Halifax and Others, 2006, paras. 1-11.

courts used to discuss the rights of tax payers conservatively and generally legislation did not allow to cancel transactions, the only way to punish Halifax was a general legal principle – abuse of law.¹³ When a tax payer uses law the aim of which is not giving such kind of reliefs and the person intended to get these reliefs, it can be recognized as abuse of law. The result of this was that according to the decision revenue services of EU countries were entitled to put in doubt such cases that could not have been discussed before. I think that this decision explains the origin of form-essence principle in Georgian tax law and allows tax authorities to change classification.¹⁴ Exactly in these articles correspondence of an action to a form is checked. Every transaction can be tested based on this. Usually the burden of proof lies with the tax authorities, but if a tax payer has to pass all three instances of the court, it will be clear that in fact the main part of the burden lies with him.

We can discuss this problem with the help of the decision of the Supreme Court.¹⁵ In this decision a special test is made which indicates the case when joint and several liability lies with a director and a founder and whether determining the guilt in criminal law causes personal material liability or not.

3. Directors and Shareholders Liabilities under Supreme Court of Georgia

3.1. Director's liability

In Supreme Court Case the company violated the rules of tax registration. He had a tax liability in amount of 233,636 GEL which he could not pay due to lack of assets. Due to non-payment of the amount incurred by the company within the term provided by the law investigation began in 2011 against the company's head and partners. According to the director's note, bankruptcy was not caused by his illegal activity, but the hard financial situation in the enterprise. A partner emphasized that he was the founder of the enterprise and had no obligation to make payments to the budget on behalf of the company, so his personal liability should not have been established.¹⁶

¹³ Ibid, paras. 62-86; 88-97;

¹⁴ Tax Code of Georgia, 2010, article 73(9.b)

¹⁵ Supreme Court of Georgia, Case Judgement #as-1158-1104-2014, 06 May 2015.

¹⁶ Supreme Court of Georgia, Case Judgement #as-1158-1104-2014, 06 May 2015, section 1;

The Court of Appeals decided that the company's partners and directors did not properly record trade operations in order to avoid taxes while importing/selling the product. These words were used by the Kutaisi Court of Appeals. The chamber was guided by articles of general torts and it reckoned that the actions of the parties were illegal and intentional, so – culprit, therefore, the chamber noted that obliged persons had to recover the damage.

The Court of Appeals declared that emphasizing by the director and the partners that the company was LLC was abuse of the legal form, accordingly, they were accountable to the creditors personally. The Court stated that if a creditor does not receive incomes due to the abuse of the right by partners, personal liability will lie with the partner. Though the Supreme Court said that the Court of Appeals had wrongly defined the fact of appealing the decision by a party as well as the circumstance of receipt of the tax notice.¹⁷

The criminal liability had been lied with the founders and the directors of the company by the previous courts on the grounds of avoiding taxes. As a result of this the tax authority had initiated a lawsuit based on general torts which states that “A person who unlawfully, intentionally or negligently causes damage to another person shall compensate the damage to the injured party”.¹⁸

The Supreme Court considered that in the light of the circumstances the case had to be regulated within the liability of the director and the partners under the Entrepreneurs Law of Georgia. It also noted that the legal nature of the circumstances presented in the case were based on the corporate law in fact and not on the general article of the Civil Code. The court declared that the main motivation for the establishment of the LLC is exactly the separation of property. In addition, it used a decision of the European Court of Justice which states that the member states of the European Union may indicate legitimate public interest when they use special measures to enforce their tax demands by creating additional guarantees for legal persons with limited liability.¹⁹

¹⁷ Supreme Court of Georgia, Case Judgement #as-1158-1104-2014, 06 May 2015, section 1;

¹⁸ Ibid.

¹⁹ Supreme Court of Georgia, Case Judgement #as-1158-1104-2014, 06 May 2015, section 1; see ECJ, Case C-212/97, March 9, 1999, note 37-Centros;

The court also noted that the Entrepreneurs Law of Georgia does not envisage personal liability except for specific cases.²⁰

Carrying out a scheme for tax avoidance leads to personal criminal liability according to the decision of the court. Also the financial consequences caused by tax avoidance may be catastrophic for the company and the standard for making a “valid business decision” obliges a director not to engage in illegal schemes for tax avoidance.²¹

3.2. Partner’s liability

The court in order to discuss liability of a company’s partner starts the judgement with the article 3 (VI) of the Entrepreneurs Law of Georgia, which enacts that a partner is personally accountable to creditors if he abuses the established legal form of limitation of liability.²²

After that the court discusses the problem of piercing the corporate veil and its use, since the above mentioned issue is based on this doctrine.²³

According to the court, piercing the corporate veil in the context of tax liabilities is used when a company’s activity is directed towards tax avoidance, also making schemes within this scope and the company is used as a tool by the partner.²⁴

After all, the court returns to the precondition of the Entrepreneurs Law of Georgia which declares that piercing the corporate veil is used only when a partner abuses the forms of legal limitation of liability. The Chamber considered that not only does this provision include the abuse of the corporate forms of limitation of liability, but also the abuse of limited liability directly. This implies the use of the partner’s limited liability for damaging the interests of others.²⁵

²⁰ Ibid.

²¹ Ibid, see Merkt in MüKo zum GmbHG, §13,Rn.343;

²² Supreme Court of Georgia, Case Judgement #as-1158-1104-2014, 06 May 2015, section 2;

²³ Supreme Court of Georgia, Case Judgement #as-1158-1104-2014, 06 May 2015, section 2;

²⁴ Ibid, see Altmeppen, Abschied von Durchgriff in “Kapitalgesellschaft” NJW 2007, s.2657; BGH GmbHR 2007, S.927.

²⁵ Ibid, see Bayer/Lutter in Lutter/Hommelhoff GmbHG Komm.,18.Aufl. §13, Rn.19.

Finally the Supreme Court decided that “the abuse of the limited liability form by a partner is obvious, when in LLC a partner directly leads and carries out activities aimed to avoid taxes, also when a society is used by a partner as a source for generating undeclared incomes”.²⁶

The court concludes that in the specific case there was the abuse of the legal form of liability limitation. Since X was a factual head of LLC Z and K, had been hiring employees, importing goods, establishing price and holding monthly statements, he was personally liable for everything.²⁷

Of course, the court’s judgement was consistent, but in this part it should have explained and discussed the scope of tax avoidance and separated it from tax evasion and tax planning.

4. Conclusion

The main topic of the present work was demonstrating potential threat to Georgian jurisdiction by analyzing the terminological problem in international tax law within the framework of the decision of the Supreme Court of Georgia (6th May of 2015).

According to the work, when it comes to the personal material liability of directors and partners based on tax avoidance, the role of national courts are worthwhile and courts should use this circumstance to give considerable definitions.

The ambiguity about the terms may determine the scope of personal material liability of partners and directors, also solve the issue whether a director who did not pay less taxes violates the company’s best interests or not. Exactly in this part the court could explain the terms. This is clearly done in the part about the partners, but in the directors’ part it leads to uncertainty, for example, should a director pay less taxes (tax planning) according to the best interests of his company and be under threat that the tax authority may recognize it as Tax avoidance or take risks and be ready that partners will sue about ignorance of the company’s interests?

²⁶ Ibid.

²⁷ Supreme Court of Georgia, Case Judgement #as-1158-1104-2014, 06 May 2015, section 2;

This question may be answered if we determine what kind of taxes could have director paid by the law. For this a company should use the following test:

1. Whether the taxpayer receives tax reliefs as a result of transaction which is contrary to the will of the law or not:
 - 1.1 Economic activity;
 - 1.2 Business environment;
 - 1.3 Post transaction period;
2. whether basing on objective circumstances the purpose of transaction is to carry out economic activity or receiving tax benefits;
3. Interval of business structure existence;
4. What has caused such planning of transaction?

Thus, this work includes possible solutions to some of the above-mentioned disputes in tax and entrepreneurial law. However, there are a lot of questions regarding tax avoidance and directors'/partners' liability. I think the change of the term "tax avoidance" to "tax evasion" in the Criminal Code will lead to certain consensus. It is obvious that the OECD's comments on these terms and the relevant court practice will reduce the risks of "intimidation" of directors/partners by tax authorities. ■