BAKER TILLY GEORGIA

# Tax and Legal Newsletter

## Upcoming Changes in Tax legislation

No amendments have been made in Georgian Tax Legislation in January, 2018.

## Important Court Cases

The Chamber of Civil Cases of the Supreme Court of Georgia has made a significant decision regarding "Piercing of Corporate Veil". The court considered that violation of rules of law by Director or partner (shareholder) of company with limited liability, represents violation of "Duty of Care" towards the company. For such infringement Director/Partner shall be responsible for the damage caused to the company with all his property, personally and directly. In mentioned case the court enacted that Director and Partner of the company have solidary responsibility. Significant details of the decision are given below:

The Plaintiff (Revenue Service) demanded the defendants (Limited Liability Company, its Director and its Partners) to impose unpaid tax arrears and corresponding fine. The Defendants (individuals) were found guilty for avoiding a large amount of tax.

The Cassation Chamber emphasized the legal basis of the claim, in particular the Revenue Service demanded from the company's (Defendant) Director and Partners (shareholders) compensation of damages caused by the tort. The claim was based on the fact that the company's Director and the Partners were deliberately avoiding the large amount of taxes which result damages for the State.

The Court of Cassation noted that limited liability, according to modern economic theory, does not constitute a problem with the company's voluntary creditors who have the opportunity to negotiate in order to avoid risks arising out of the transaction with the company. However, this theory does not foresee non-contractual creditors such as creditors arising on the basis of tort which cannot enter into contractual relationship with the company, its Directors and Partners. The same can be said of a creditor arose as a result of tax liabilities as a state which, according to the non-involuntary nature of tax liabilities, also belongs to a series of non-contractual creditors.

Need of application of "Piercing of Corporate Veil" usually arises when company has the liability, but it is not a solvent. The creditor, in search of a solvent person, lays a complaint against company's Partner and indicates that for some reason he is personally responsible for the obligations originated on behalf of the company. In such a case when the company is insolvent and the creditor demands payment from the Partner, the court shall decide whether the obligation of compensation of loss caused by the failure lies on a third party or a Partner. In every case, the unconditional use of the limited liability principle would have resulted in an outcome that always damages the creditor.

The Court explains that the base for use of "Piercing of Corporate Veil" is the case when the company is used as the "instrument", "Alter Ego" or "Fix" in the hands of the Partner. One of the widespread grounds for "Piercing of Corporate Veil" is the "inadequate capitalization" of the company. "Inadequate capitalization" for the purposes of "Piercing of Corporate Veil" does not imply having a minimum capital set by law (in many countries, including Georgia, there is not such demand for companies). "Inadequate capitalization” implies the fact that the company's capital is very small or incompatible with the type of company's activities and the risks to which the company's business activities are created. In other words, here are assumed the expected economic needs and not the formal-legal requirements. An element of "inadequate capitalization" has particular importance to non-contractual (non-partial) creditors in the use of the “Piercing of Corporate Veil”.

Another important element for “Piercing of Corporate Veil” is “Disregarding of Corporate Formalities”. The following can be deemed as such violation: not conducting meetings of the Directors and Partners, when Partners and Directors managerial and representative powers are not clearly separated, Partners and company's assets are mixed up, when the company's funds are used for the personal purposes of the Partners, when personal expenses are considered as company expenses by violation of the financial statement regulations, or when there is not relevant accounting and financial statement and properly executed documentation.

In the context of tax liabilities, "transparent liability" is used when the company's Partners' activities are directed to the creation of schemes for avoiding taxes and the limited liability company is used as a "tool".

The Law of Georgia on Entrepreneurs provides the responsibility of “Piercing of Corporate Veil“, When Partners/Directors abuse the legal form of limited liability.

The Court of Cassation considered that the abovementioned provision of the Law of Georgia on Entrepreneurs shall mean not only abuse of corporate form of company but abuse of Limited Liability (as liability) itself, which means the use of the privilege of Limitation of Liability by the Partner only for damaging the interests of others and to bring his own economic risks and losses by deliberate misleading of creditor.

Abuse of limited liability form by Partner is obvious, when a Partner of limited liability company, directly leads and carries out activities which aimed evading taxes. The burden of proof of misuse of the form of limited liability by the company's Partner lies on Plaintiff.

The Court of Cassation found that the responsibility of the Company's Partners in the above-mentioned case is not based on Article 992 of the Civil Code of Georgia (Deliberate Obligation) but the special provision regulating the relationship is the paragraph 6 of Article 3 of the Law on Entrepreneurs. Consequently, the existence of a criminal verdict against the company's Partners is not sufficient, and the factual circumstances set out in the criminal case against them can not be regarded as unquestionably proven, based on the content of Article 106 of the Civil Code Procedures of Georgia. Based on the contents of the abovementioned article, the verdict of the Criminal Court is only one of the evidences in civil proceedings and needs to be evaluated together with other evidence.

Directors must exercise reasonable care, skill and diligence. Cere responsibility requires from the Director to make decisions that will increase the company's profit. Such decisions may bare high risk, but according to presumption of "suitability of a business decision", if the leading person makes reasonable decisions and acts in the company's best interests, taking everything, he thinks relevant into account, “Piercing of Corporate Veil” shall not apply.

There is the view that the tax evasion schemes impose criminal or administrative responsibility on heads (managers/directors) of the company and consequently, this persons must not have liabilities arose from provisions of Civil Code. Nonetheless according to recent legal practice in many countries, criminal activities of the leading persons of the company, especially corruption, transfers public liabilities (to act in the framework of Law) of the Directors into care responsibility as well. Thus, the management of the company has the obligation to increase the company's profit, but it should only be implemented within the rule established by respective law.

In the present case, the Court of Appeals has established that one of the Partners (defendants) at the same time represented the company's Director. Hence, the Court of Cassation found that by evading taxes, the Director of the company violated the care obligation to the company, and he is responsible for damage caused to the State by violation of the duties of the caretaker. The Director shall be responsible for the damage with his whole property.

Thus, if the remuneration is necessary to satisfy the creditors of the company, the company is obliged to claim compensation for damages caused by violation of the duties of care. In the present case the company did not have such a request to the Director.

Eventually, the Court considered that, in the event of such necessity, the State as a creditor must be entitled to demand the remuneration directly from the Director.

The discussed decision can be fully viewed on the website of Supreme Court of Georgia.

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