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Study of the Current System of Non-Profit Taxation in Georgia

(Interpolating the amendments in the tax system in effect since 2017)

Main Findings

Civil Society STAR Initiative

სამოქალაქო საზოგადოების ინიციატივა

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Introduction

The European Union (EU) and Konrad-Adenauer-Stiftung (KAS) funded project '**Civil Society STAR Initiative: CSOs as Sustainable, Transparent, Accountable and Resilient Development Actors in Georgia**' aims to strengthen civil society as an independent, sustainable, transparent, and accountable development actor across Georgia. One of the objectives of the project is targeted to improve the policy and financial framework and environment for the sustainable development of civil society in Georgia.

To that end, the project initiated the "Study of the Current System of Non-Profit Taxation in Georgia (interpolating the amendments in the tax system in effect since 2017)", as a result of which the peculiarities of taxation of non-profit (non-commercial) legal entities have been examined, the main shortcomings related to taxation in the non-commercial sector have been ascertained, recommendations for the improvement and amendment of the legislative environment have been ensued.

The study is intended for non-profit legal entities and civil society organisations (CSOs). It will also be of interest to students, researchers, and revenue service specialists interested in these issues, and will serve practitioners in the field of finance, as well as international donor organisations that want to discern and study in-depth the financial and tax accounting issues pertaining to public organisations.

This paper reviews the key findings and recommendations regarding the tax environment, relevant to CSOs, which will facilitate the actualization of the challenges identified in the study and promote the actions to overcome them.

Key Findings and Outcomes of the Study

Overview of the main outcomes

The study identified pertinent tax-related issues and challenges that became the subject of this paper. Many of the issues are subject to dual interpretation. An important finding of the study and the key challenge is that the current tax legislation in Georgia does not convey any of the goals of the state fiscal policy, which will be aimed at supporting the CSOs, and also fails to establish fundamental and explicit orientations in terms of tax control. The Tax Code of Georgia, most of the situational manuals created on its basis are focused on the determination of taxation issues of enterprises and do not pay enough attention to the administration of taxation issues of operations within the framework of non-economic, non-commercial activities.

The challenge is grounded in the fact that the tax legislation is not coherent or foreseeable with regard to the number of issues, and such uncertainty regarding the interpretations of the tax legislation devises a heterogeneous practice of its utilization and, instead of creating incentives, turns the tax instrument into a deterrent tool for public organisations.

Another primary impetus to the problem is the fact that there is no government policy to stimulate CSOs and the relevant legislation does not address the important features of this sector, while the tax legislation is one of the main tools to stimulate the activities of organisations. Representatives of the sector, specialists believe that it is important to stimulate the development of the sector through the use of various tax mechanisms. Incentive mechanisms should be effective and address both tax administration issues and various tax incentives and preferences.

The key problematic issues addressed in this study:

- The general legal bases and defining tax principles of the activities of CSOs are divergent. It should also be noted that although the activities of the CSOs are not restricted in any area, ancillary entrepreneurial activities are considered activities that are subject to the idealistic goals of the CSOs. The income received from such ancillary activities should become a means of financing core activities. Moreover, beneficiaries, of any form, should not exercise any real control over the activities of the organisation at any stage of the its development (neither at liquidation nor at reorganisation stage). This is an important dividing line between commercial (where the goals of the organisation are subordinated to the private interests of individuals) and non-profit organisations.
- The Law of Georgia on Entrepreneurs and the Civil Code of Georgia distinguish

between the concepts of entrepreneurial and non-entrepreneurial activities. And the Tax Code of Georgia defines the concept of economic activity. At the same time, the Tax Code of Georgia separately defines the concepts of economic activity in general and specifically for VAT purposes. The determination of entrepreneurial activity seeks to define the nature of an entrepreneurial entity in order to legally recognize it, while the concept of economic activity is more technical, serves tax purposes, and is expressed in terms such as collecting income or compensation. The definition of "economic activity" for VAT purposes is based on the definition of "entrepreneurial activity", although it is also a more technical term and contains various exceptions that have tax purposes. In the legislation, in addition to the terms discussed above, there are concepts such as non-profit, charitable, and grant-funded activities. Such a tax "diversity" and "multilateralism" aims to comprehensively regulate tax administration, although it is sometimes vague and requires further clarification by the legislature.

- From 2019, a new mechanism of profit taxation has had its impact on the organisations as well. According to paragraph 2 of Article 97 of the Tax Code of Georgia, it is defined that the object of profit taxation of an organisation conducting economic activities shall be:
 - a) the costs incurred, or other payments not connected with economic activities and/or which are not related to the objective of the organisation's activities (including those not connected with charity activities or not related to the objective of a grant agreement);
 - b) the free supply of goods/provision of services, and/or transfer of financial resources if it is not related to the objective of the organisation's activities;
 - c) the representation costs paid in excess of the limited amount determined under this Code.

- According to the Tax Code of Georgia, profit tax is the tax liability undertaken by an enterprise, and an organisation is considered an enterprise if it performs ancillary economic activities. However, certain activities may be considered as economic activities, which may later become a basis for the organisation to be considered an enterprise and, as a result, be subjected to profit taxation. Thus, the Tax Code distinguishes between organisations performing the ancillary economic activities and those that do not perform ancillary economic activities. It should be noted that ancillary economic activities are an additional significant source of revenue for organisations achieving their non-profit goals. The Tax Code, in general, is not focused on encouraging non-profit activities of organisations and effectively puts these two types of entities discussed above on unequal terms.

- For tax purposes, hired work entails an employment relationship between the employee and the employer, as well as another form of relationship such as an internship. According to the law, an important condition pertaining to the hired work is the performance of work in exchange for remuneration (salary). Georgian law also separately determines the notion of a volunteer, which is not subject to the conditions set for the hired workforce by the Tax Code. In general, the issue of voluntary labour taxation is unresolved and urgently requires a further regulative framework.
- For tax purposes, the definition of "property" as well as the issue of taxation of free transfer of property worth up to 1000 GEL to physical persons during the tax year is to be clarified. In particular, the salary could be understood as the payment of money directly to the hired employee or the natural transfer of property or providing the services, or the reimbursement of expenses. This type of income is defined as a "benefit" by the Tax Code. Free transfer of property to a natural person also falls into the category of benefits, and, in this framework. If the natural person is not registered as an individual entrepreneur, a tax liability arises for the organisation. In addition, the Tax Code provides for exceptions, in particular, when transferring property worth up to 1000 GEL to a natural person free of charge during the tax year, the organisation shall be released from the obligation to withhold tax at the source. It is noteworthy that the concept of "service" in the Tax Code is distinguished from the notion of "goods" and, consequently, the notion of "intangible assets". In our opinion, according to the Tax Code, services do not include intangible assets and for the purposes of taxation of free supply of services to individuals, its approximation with property, we think, is unjustified. However, we note once again the ambiguity of this issue and highlight the need to expedite its further determination.
- In the structure of organisations' expenses, costs incurred for various events (trainings, workshops, conferences, etc.), which include reimbursement of the accommodation, transportation, food, and similar expenses of project beneficiaries, trainers and other service providers involved in the project, play an important role in terms of taxation. It is debatable whether such costs should be considered as a benefit to the various beneficiaries and/or service providers or as the expenses of the project. This is an important conceptual issue because if an organisation requires to incur the expense to achieve its own goals, it cannot be considered a benefit to a physical person. Consequently, the dilemma of properly taxing such transactions with income tax arises.
When remunerating volunteers, obviously, the organisation is reimbursing certain expenses. It should be noted that in this context, the expenses are undertaken for the benefit of non-commercial interests and not for the benefit of individuals, and, in that regard, the issue of documenting the costs is brought

to the fore, which implies the linking of these expenses to the activity of the organisation. Both substantive and formal documentary evidence must be taken into account when certifying costs. Nevertheless, positions on this issue are not uniform in either the private or public sector, and often transactions are considered to be for the benefit of volunteers and, consequently, are treated as income taxable transactions, which is also controversial.

- With regard to VAT as a territorial tax, it is important to clarify the definition of the supply of goods and services in the territory of Georgia. Clarification of the territorial affiliation of the operation is of particular importance if one of the parties to the operation is not a resident. In this respect, the Tax Code distinguishes between different cases of economic relations between a taxable person and a non-taxable person. Depending on whether the party to the operation is a taxable and/or non-taxable person, the location of service provision may be the place where the recipient of the service is based, or where the service provider is based. However, the tax code in some cases does not provide for a precise definition pertaining to the place of provision of services. In addition to the above, when CSOs receive certain services from non-residents, the transaction is often subject to VAT reverse charge, which means that the CSOs act as tax agents. In this case, too, it is important to clarify the concept of the place of service provision for tax purposes, which also requires further clarification under the existing tax legislation.
- Should the amounts paid to non-resident individuals/beneficiaries be considered as income from a Georgia-based source? To answer this question, we must determine whether this income is earned through activities in Georgia or not. Regrettably, the legislation does not clarify what this term entails for income and profit tax purposes. The law defines only certain concepts of activities (entrepreneurial, charitable, religious, etc.), however, for the purposes of taxation of non-resident persons, the definition of "activity" remains subject to interpretation, which leads to ambiguities in tax administration. In our opinion, the term "activity" refers to the actions performed by the entity. For non-resident beneficiaries, such actions should be carried out on the territory of Georgia and their result should be an income so that it can be considered as income received from a source in the territory of Georgia.
- Non-residents could be project beneficiaries, service providers, or employees. In this regard "Agreements on the avoidance of double taxation and the prevention of tax evasion" are important to consider. Issues related to VAT reverse charge should also be considered. Such services may not be subject to taxable income and may not be taxed with VAT reverse charge, or may be charged income tax and may not be subject to VAT reverse charge, or may be taxed or exempt from both forms of taxes. This issue in tax legislation sometimes causes ambiguity, which complicates the tax administration for the organisations.

- In the case of CSOs, in order to determine whether an entity is liable for VAT, an organisation must engage in certain economic activities for VAT purposes, regardless of the purpose and outcome of those activities. CSOs, in the course of their non-economic or charitable activities, often supply goods or services free of charge, which, for VAT purposes, may constitute a taxable transaction. Therefore, in some cases, the question of whether CSO should be considered an entity subject to VAT is of great importance. The issue of VAT deduction is noteworthy at this time. A prerequisite for VAT deduction is the purpose or application of using the goods/services in VAT taxable transactions. At the same time, the concepts pertaining to the refund and deduction of VAT on goods and services purchased for the entity operating under the grant are not fully applicable to this precondition. This issue is important for the correct definition of certain VAT taxable transactions.
- CSOs cannot benefit from tax benefits during the implementation of a non-commercial project financed by the income received from various sources of funding (donations, ancillary economic activities, membership fees, etc.). The exception is the case of financing projects with grant-based revenues. This circumstance complicates the transparent activities of non-profit legal entities and, as a result, NPOs are indirectly subject to a preferential tax regime when they provide grants to affiliated organisations from revenues received from various sources of funding.
- In addition to VAT refund operations under the grant, NPOs carry out VAT-exempt transactions under projects funded in the framework of the international agreements that have entered into force, as ratified by the Parliament of Georgia. Per contra to the need to utilize the VAT refund mechanism under the grant-funded actions, procurements by project parties from donor-funded initiatives, as ratified by the Parliament of Georgia and entered into force on the basis of international agreements, are made on a VAT-exempt basis. It should be noted that most international agreements provide for the exemption of donor-funded actions from VAT. However, the Tax Code and relevant normative acts do not clearly express this design, which raises the need for clarification in the legislation.
- One of the important issues is the challenge pertaining to the legal recognition of social enterprises. Although in some instances they exist in the form of non-profit legal entities and sometimes in the form of LLCs, qualitatively neither of the legal forms provides the institutional framework that social enterprises must meet as economic entities.

The following important issues can be identified as a result of the survey, in-depth interviews, and summary results of the focus groups:

- Income tax withholding issues related to project expenses;
- Refund of VAT paid on goods and services purchased under grant agreements;
- The issue of VAT refund within the framework of public, non-commercial (non-entrepreneurial) non-grant projects implemented in line with the goals of the organisation;
- Problems with VAT refunds or VAT exemptions in case of the provision of co-financing by beneficiaries in non-profit projects;
- The issue of taxation of funds provided to non-resident beneficiaries (physical persons) under the grant project;
- The issue of utilizing the transferred material assets, after the completion of the grant project in ancillary economic activities;
- The issue of the use of volunteer labour;
- The determination of the legal recognition of social enterprises;
- The issue of the possibility of remuneration of foreign currency agreements at the rate set by the commercial banks (as opposed to the National Bank of Georgia), given that the transaction arising from this agreement is subject to taxation.

The study prescribes the following potential avenues to stimulate the activities of CSOs:

- Promote corporate donations, not only through deductions, but also by providing additional profit tax benefits (for example, per the established practice in Latvia, Spain, Hungary, Portugal), which shall be linked to the amount of the donation;
- Introduce the so-called “percentage philanthropy”, which entails enabling taxpayers to designate a certain percentage of their income tax paid to support public organisations;
- If additional incentive mechanisms are not introduced by the Tax Code, it is recommended to discard the obligation to submit a financial report regarding the status of the charitable organisation in the form approved by the auditor;
- Expand the concept of VAT deduction and interpret it as the right to deduct VAT on goods and/or services purchased under a grant agreement. The possibility of VAT deduction in non-commercial projects under a general rule by means of a declaration should be introduced by adding an appropriate field or appendix to the declaration. The right to obtain VAT deduction must be within the general statute of limitations (3 years instead of 3 months);
- CSOs should be entitled to a VAT refund on projects funded through sources other than the grants;
- Regulate volunteer labour taxation issues;
- Resolve the issue of the legal recognition of social enterprises.