



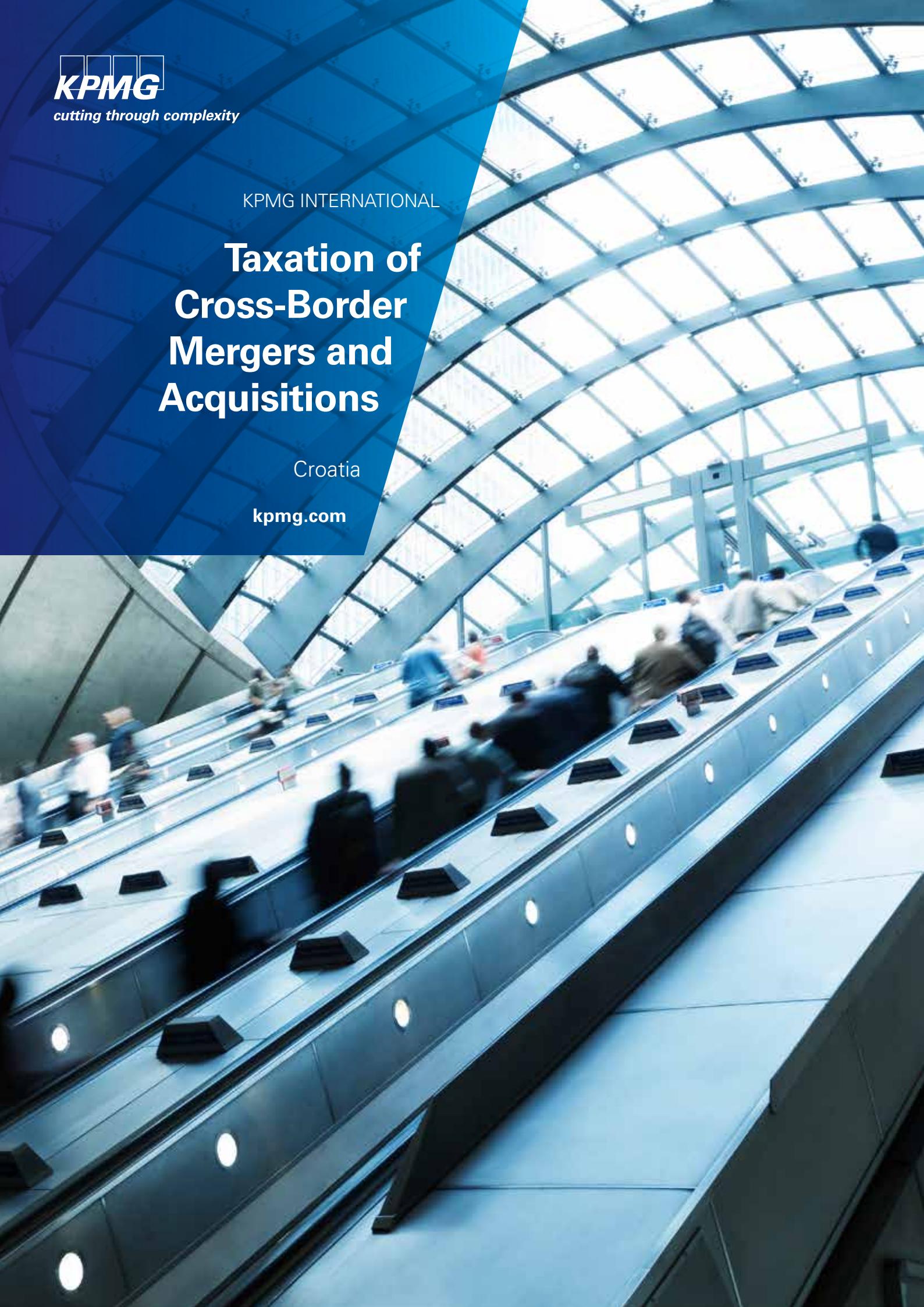
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Taxation of Cross-Border Mergers and Acquisitions

Croatia

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Croatia

Introduction

The chapter addresses the three fundamental decisions facing a prospective acquirer in Croatia:

- What should be acquired: the target's shares or its assets?
- What acquisition vehicle should be used?
- How should the acquisition vehicle be financed?

Tax is, of course, only one piece of the transaction structuring puzzle. Company law governs the legal form of a transaction, and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of this chapter, but some of the key points that arise when planning the steps in a transaction are summarized later in the chapter.

Recent developments

Croatia completed European Union (EU) accession negotiations on 30 June 2011 and signed the Accession Treaty on 9 December 2011. Following the positive outcome of the referendum on EU accession held on 22 January 2012, Croatia entered the EU on 1 July 2013.

As a result, Croatian legislation is harmonized with EU legislation. Along with amendments to the Corporate Profit Tax (CPT) legislation introduced in 2008 (i.e. the provisions regulating mergers, transfers of assets and share swaps between legal entities operating in different EU Member States and taxation of interest and royalty payments between associated companies) and which became applicable once Croatia entered the EU, other EU directives automatically apply in Croatia (e.g. the directive on the taxation of parent companies and their subsidiaries).

Under amended CPT legislation, as of 1 July 2010, transfer pricing provisions that previously applied only to cross-border transactions now also apply to transactions between domestic related parties where one party is in a tax-favorable position or has tax losses carried forward from previous periods that can be utilized in the current tax period.

Asset purchase or share purchase

The usual form of an acquisition in Croatia is the purchase of shares of a company rather than its assets. The purchase of assets is a less attractive option for the seller because capital gains on sales of assets are taxable and there is a risk of double taxation on remittance of the sales proceeds.

Where the vendor of the shares of a company is a Croatian tax non-resident, any capital gains may be exempt from taxation in Croatia. However, the acquisition of assets has certain advantages for the purchaser. Both forms of acquisition are discussed below.

Purchase of assets

In the case of a purchase of assets, the agreed value is usually above book value and the acquirer may use this increased cost base for capital gains tax and depreciation purposes. Historical tax liabilities generally remain with the vendor and are not transferred with the purchased assets.

Purchase price

It is necessary to apportion the total consideration among the assets acquired. A purchase agreement should be concluded to specify the allocation, which is usually accepted for tax purposes provided it is commercially justifiable.

Goodwill

Generally, goodwill that arises in acquisitions is subject to annual impairment testing for accounting purposes. Any impairment of goodwill cannot be deducted for tax purposes under Croatian legislation.

Depreciation

For tax purposes, fixed assets are depreciated using the straight-line method of depreciation, using annual depreciation rates as follows:

- buildings and boats over 1,000 gross register tons (GRT) – 5 percent
- personal cars – 20 percent
- intangible assets, equipment, vehicles and plant – 25 percent
- information technology (IT) equipment and mobile phones – 50 percent
- other long-term assets – 10 percent.

The taxpayer may elect to double these depreciation rates, in which case, the depreciation period will be halved. Generally, no justification is required to apply double depreciation rates. However, if a company applies 'normal' depreciation rates and then decides to change its depreciation policy and apply double depreciation rates, the tax authorities might request an explanation for the change. The depreciation charge

prescribed by the CPT Law can be claimed for tax purposes only where the same amounts were booked in the company's income statement.

Tax attributes

Tax losses are not transferred to the purchaser on an asset acquisition. They remain with the vendor or are eliminated.

Where the purchaser wishes to acquire the vendor company's trade along with its tax losses, a business activity may be transferred to a new company (typically through simultaneous demerger and merger) and the new company can then be sold to the purchaser. However, transferred tax losses are only available to the purchaser (i.e. merged company) where the activity test is satisfied as detailed in this chapter's section on tax losses.

Value added tax

Value added tax (VAT) is charged on many goods and services at a standard 25 percent rate. Reduced rates of 13 percent and 5 percent apply to certain goods and services. The transfer of a business as a going concern is not subject to VAT, provided certain conditions are met. To benefit from this exemption, the aim of the transfer must be to put the new owner in possession of a business unit. Therefore, the sale of a portion of assets cannot be classified as a transfer of a business unit: all assets and liabilities related to the business unit need to be transferred.

Transfer taxes

There are no stamp duty and stamp duty land tax requirements in Croatia. However, Croatia does levy transfer tax at the rate of 5 percent on transfers of land and pre-VAT buildings (i.e. buildings constructed before 1 January 1998 when VAT was introduced in Croatia) and to used motor vehicles and used airplanes.

In certain cases, the transfer of assets as a contribution in kind to the share capital of a company eliminates transfer taxes.

Purchase of shares

The purchase of shares as a form of acquisition does not result in an increased cost base of the underlying assets.

Tax indemnities and warranties

On a purchase of shares, the purchaser takes over not only the company's assets but also its liabilities, including contingent liabilities. Thus, the purchaser usually requires more extensive indemnities and warranties than in the case

of an asset purchase. Where significant amounts are involved, the purchaser customarily conducts a due diligence exercise, including a review of the target company's tax affairs.

Tax losses

Tax losses may be carried forward for a maximum of 5 years. Earlier losses are set off before later ones. Croatia has no loss carry back or tax grouping provisions.

The utilization of tax losses is restricted in the case of a corporate restructuring. A legal successor does not assume the right to carry forward the tax losses of a legal predecessor where either:

- the legal predecessor did not perform any business activity during the two taxation periods preceding the statutory change
- the legal successor significantly changes the type of business activity performed by the legal predecessor in the two taxation periods following the statutory change (except where the purpose of the change is to preserve a workplace or recover the business).

For the above utilized tax losses, the legal successor is obliged to increase its taxable base in the period in which the right to carry forward tax losses has expired.

These provisions on the utilization of tax losses and increase of taxable base of a taxpayer also apply where there is a change of the taxpayer's ownership structure of more than 50 percent compared to the ownership structure at the beginning of a tax period.

Pre-sale dividend

It is possible for the seller to realize part of the consideration through a pre-sale dividend payment. The proceeds from the sale of shares are decreased as a result of the payment of the pre-sale dividend. Since dividend payments are currently not subject to taxation for Croatian corporate shareholders, a pre-sale dividend payment reduces tax liabilities on the gain on the sale of the shares that may arise for the seller.

Tax clearances

Although it is possible to request official opinions with respect to certain taxation issues, it is not possible to obtain a definitive clearance from the tax authorities on a company's taxation position. It is possible to obtain a statement from the tax authorities on the status of a company's tax affairs, but, since this is typically based on self-assessed liabilities, it cannot be relied on.

Choice of acquisition vehicle

There are several acquisition vehicles the purchaser may choose, depending on the specifics of the acquisition. There is no capital duty on the introduction of new capital to a Croatian company.

Local holding company

Local holding companies are not preferred by purchasers as it may be difficult to offset the target's taxable profits with interest payments on funds borrowed by the Croatian holding company to purchase the target company. The reason is that, in the absence of tax-grouping provisions, the deduction for interest payments on borrowed funds generally can be achieved only through a subsequent merger of the Croatian holding company and the target company. Further analysis of the accounting and taxation implications of the merger is required to determine whether this is feasible.

Where the funds to purchase the target company are obtained cross-border, interest payments may be subject to certain limitations discussed in the sections on deductibility of interest and withholding tax (WHT) on debt below.

Foreign parent company

Where a foreign parent company wishes to offset the cost of financing the purchase of the target company against its own taxable profits, the target company may be purchased through the foreign parent company.

WHT of 12 percent applies to dividends paid by a Croatian company to foreign companies. The WHT rate may be decreased or eliminated under one of Croatia's tax treaties.

In addition, dividends paid to EU resident companies or qualifying Swiss companies are exempt from Croatian WHT, provided certain conditions are met (see the section on WHT on debt later in this chapter).

Non-resident intermediate holding company

The purchaser may opt for a non-resident intermediary holding company as an acquisition vehicle where the foreign parent's country of residence taxes capital gains and/or dividends received from foreign companies. This structure also allows the purchaser to take advantage of a more favorable tax treaty than the treaty its country of residence has concluded with Croatia.

Local branch

Interposing a Croatian branch between the purchasing company and the target would not achieve additional tax advantages because a branch is treated as a regular taxpayer for Croatian tax purposes. However, the head office of any branch office may be able to claim any tax losses, especially financing costs. This would need to be considered on a case-by-case basis.

Joint venture

It is possible to establish a partnership or contractual joint venture in Croatia. In either case, a local company or branch office must be established.

Choice of acquisition funding

A purchaser that decides to acquire a Croatian target with cash using a Croatian company as the acquisition vehicle needs to decide whether to structure the acquisition as an asset purchase or share purchase and whether to finance the Croatian acquirer with debt or equity.

Debt

The principal advantage of debt is the potential tax-deductibility of interest (see this chapter's section on deductibility of interest), as the payment of a dividend does not give rise to a tax deduction. Another potential advantage of debt is the deductibility of expenses, such as guarantee fees and bank fees, in computing profits for tax purposes.

To minimize the tax cost of debt, there must be sufficient taxable profits in the company borrowing the funds to offset interest expenses. Dividend income received by a Croatian company is not taxable, and there are no tax-grouping provisions. Therefore, the acquisition of a Croatian target company by a Croatian acquisition vehicle with no taxable income is tax-inefficient.

Deductibility of interest

Croatian CPT Law prescribes certain limitations on the tax-deductibility of expenses. Generally, in order to be deductible for CPT purposes, expenses need to be incurred with the purpose of generating income (i.e. profits), taking into consideration two specific limitations.

The first limitation arises from the thin capitalization rules that apply to non-resident shareholders that are not financial institutions. Interest on loans provided by direct non-resident shareholders with at least 25 percent of the shares or voting rights is not deductible for CPT purposes insofar as the loan exceeds four times the amount of the capital held by that shareholder. The thin capitalization rules also apply to loans guaranteed by a direct non-resident shareholder and to loans received from related parties.

The second limitation is that interest paid on loans provided by either resident related parties that are in a tax-favorable or tax loss position or by non-resident related parties is CPT-deductible up to the prescribed interest rate (currently, 7 percent per year). Parties are related where one of the parties directly or indirectly participates in the management, supervision or capital of the other, or where the same legal persons (one of which is a resident Croatian company and the other is a non-resident company) participate in the management, supervision or capital of another company.

Where the loan is provided by an entity tax-resident in a country with which Croatia has concluded a tax or investment protection treaty, a higher interest rate may apply if such an interest rate would be at arm's length.

Withholding tax on debt and methods to reduce or eliminate it

Interest payments made by Croatian-resident entities to any Croatian non-resident entities (whether or not related) are subject to Croatian WHT at the rate of 15 percent at the time of payment.

Exceptions are available for loans provided by foreign banks and financial institutions and interest paid on qualifying bonds issued by Croatian entities.

A WHT rate of 20 percent applies to most service fees paid to entities having their legal seat or place of effective management in tax havens. This increased rate does not apply to interest payments or service fee payments made to EU Member States.

Further, where the foreign entity providing the loan is in a jurisdiction with which Croatia has a tax treaty and that foreign entity is the beneficial owner of the interest, the treaty may reduce or eliminate the WHT liability. To take advantage of a reduced rate, the prescribed form needs to be submitted to the tax authorities. To eliminate the WHT, the Croatian company needs to be in possession of either a statement that

the receiving entity is a tax-resident of the treaty country or a prescribed form.

In addition, interest paid to EU resident companies or qualifying Swiss companies is exempt from Croatian WHT where a minimum direct 25 percent shareholding exists between both companies or where a third company owns directly at least 25 percent of both companies, provided that the participation is held for an uninterrupted period of at least 2 years and certain other conditions are met.

Checklist for debt funding

- The use of bank debt may avoid thin capitalization and transfer pricing problems and eliminate WHT.
- Tax losses from interest expenses can be carried forward for 5 years.
- Consider whether the level of taxable profits is sufficient to enable tax relief for interest payments.
- Establish whether a tax deduction may be available at higher rates in other territories.
- WHT of 15 percent may apply to interest payments to non-Croatian entities.

Equity

A purchaser may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration or by raising funds through a seller placing. Further, the purchaser may wish to capitalize the target post-acquisition.

Croatia does not have any capital duty, and neither stamp duty nor stamp duty reserve tax apply to new share issues. Dividends payable to Croatian resident companies are not treated as taxable income to Croatian resident companies for Croatian tax purposes.

WHT of 12 percent applies to dividends paid by a Croatian company to foreign companies. A tax treaty may reduce or eliminate the WHT. Dividends paid to EU resident companies or qualifying Swiss companies are exempt from Croatian WHT where the shareholder owns at least 10 percent (for Swiss shareholders, at least 25 percent) of the payer's shares and the shares have been held continuously for at least 2 years and certain other conditions are met.

Although equity offers less flexibility should the parent subsequently wish to recover the funds it has injected, equity may be more appropriate than debt in certain circumstances, such as the following:

- Where the target company is loss-making, it may not be possible to obtain immediate tax relief in the target for interest payments.
- Possible restrictions for tax relief for interest in the country of the borrower may eliminate the principal advantage of using debt.
- Where the target is thinly capitalized, it would be disadvantageous to increase borrowings without also injecting fresh equity. A tax-efficient structure normally requires an appropriate mix of debt and equity so that debt-to-equity is adequate for Croatian tax purposes.
- There may be non-tax grounds for preferring equity, for example, where it is necessary or desirable for the target to have a low debt-to-equity ratio.

Mergers and demergers should have no influence on taxation if the continuity in taxation exists. Continuity in taxation is deemed to exist where, on merger or demerger, there is no change in the value of items of assets and liabilities that are being transferred. In addition, on a merger, the activity test must be satisfied in order to utilize tax losses (see this chapter's tax losses section).

Hybrids

Hybrid instruments could be used to achieve an interest deduction for the borrower without any income tax for the lender. To date, however, there is little experience in this area in Croatia and potential benefits may be limited.

Discounted securities

The issue of bonds and other securities may be an effective way for a Croatian company to raise finance.

Deferred settlement

The right to receive an unknown future amount is regarded as an asset that could be taxable in the same way as unrealized gains are taxable in Croatia.

Other considerations

Concerns of the seller

The tax position of the seller can be expected to significantly influence any transaction. In certain circumstances, the seller may prefer to realize part of the value of their investment, for example, where the seller has brought forward tax losses.

Croatia does not tax gains of non-residents that are not subject to CPT in Croatia.

Companies Law and accounting

The Companies Law prescribes how Croatian companies may be formed, operated, reorganized and dissolved. The accounting law prescribes that International Financial Reporting Standards (IFRS) should be followed by large entities, listed companies or companies that are in the process of being listed. Croatian Financial Reporting Standards (CFRS) should be followed by small and medium-sized entities.

The Companies Law and accounting standards determine the accounting treatment of a business combination. In general, most combinations are accounted for as acquisitions, with merger accounting only being applied in limited circumstances. Merger accounting is not allowed under IFRS; all business combinations must be accounted for as acquisitions. The relevant Croatian accounting standards and Companies Law restrict merger accounting to (and make it obligatory for) a very small number of genuine mergers and group reorganizations not involving minority interests.

One of the main practical distinctions between acquisition accounting and merger accounting is that acquisition accounting may give rise to goodwill. Under IFRS, the goodwill is tested annually for impairment; under CFRS, goodwill is amortized over a period of 5 years.

Another important feature of Croatian Companies Law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable reserves. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the ability to distribute the pre-acquisition profits of the acquired company may be restricted.

Finally, a common issue on transaction structuring arises from the provisions concerning financial assistance. Broadly, it is illegal for a public company (or one of its private subsidiaries) to give financial assistance, directly or indirectly, for the purpose of the acquisition of that company's shares.

Group relief/consolidation

Current Croatian legislation does not include provisions for group relief/consolidation.

Transfer pricing

Where any intercompany transactions arise post-acquisition between the purchaser and the target, failure to charge an arm's length price for services or goods provided may cause the Croatian tax authorities to challenge the transactions.

Foreign investments of a local target company

Current Croatian legislation does not include controlled foreign company provisions.

Comparison of asset and share purchases

Advantages of asset purchases

- Buyer can depreciate or amortize the purchase price for tax purposes.
- Buyer obtains a step-up in the cost base of assets for capital gains purposes.
- Buyer does not inherit previous liabilities of the company.
- No acquisition of a tax liability on retained earnings.
- Possible to acquire only a part of a business.

Disadvantages of asset purchases

- Possible need to renegotiate supply, employment and technology agreements.
- A higher capital outlay is usually involved (unless debts are also assumed).

- May be unattractive to the seller, especially if a share sale would be exempt.
- Accounting profits may be affected by the creation of acquisition goodwill.
- Benefit of losses incurred by the target company remains with the seller.

Advantages of share purchases

- Usually a lower capital outlay (purchase of net assets only).
- Usually more attractive to the seller, both commercially and from a tax perspective (because the disposal may be exempt), so the price may be lower.
- Buyer may benefit from tax losses of the target company.
- Buyer may gain the benefit of existing supply or technology contracts.
- Lower transfer taxes are usually payable.

Disadvantages of share purchases

- Buyer acquires an unrealized tax liability for depreciation recovery on the difference between the accounting and tax book values of assets.
- Buyer effectively becomes liable for any claims or previous liabilities of the entity (including tax).
- No deduction is available for the purchase price.
- Possibly more difficult to finance tax-efficiently.

Croatia – Withholding tax rates

This table sets out reduced WHT rates that may be available for various types of payments to non-residents under Croatia's tax treaties. This table is based on information available up to 1 November 2013.

Source: *International Bureau of Fiscal Documentation, 2014*

	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies ² (%)		
Domestic rates				
Companies:	12	0	0/15	15
Individuals:	12	N/A	0/40	25
Treaty rates				
<i>Treaty with:</i>				
Albania	10	10	10	10
Armenia	10	0 ³	10	5
Austria	15	0 ⁴	5	0
Azerbaijan ⁵	10	5	10	10
Belarus	15	5	10	10
Belgium	15	5	0/10 ⁶	0
Bosnia and Herzegovina	10	5	10	10
Bulgaria	5	5	5	0
Canada	15	5 ⁷	10	10
Chile	15	5 ⁸	5/15 ⁹	5/10 ¹⁰
China (People's Rep.)	5	5	10	10
Czech Republic	5	5	0	10
Denmark	10	5 ¹¹	5	10
Estonia	15	5	10	10
Finland	15	5	0	10
France	15	0	0	0
Germany	15	5	0	0
Greece	10	5	10	10
Hungary	10	5	0	0
Hungary	10	5	0	0
Iceland	10	5	10	10
Indonesia	10	10	10	10
Iran	10	5	5	5
Ireland	10	5	0	10
Israel	15	5	5/10 ¹²	5
Italy	15	15	0/10 ¹³	5
Jordan	10	5	10	10
Korea (Rep.)	10	5	5	0

	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, companies (%)	Qualifying companies ² (%)		
Kuwait	0	0	0	10
Latvia	10	5	10	10
Lithuania	15	5	10	10
Macedonia (FYR)	15	5	10	10
Malaysia	10	5	10	10
Malta	5	5	0	0
Mauritius	0	0	0	0
Moldova	10	5	5	10
Montenegro ¹⁴	10	5	10	10
Morocco	10	8	10	10
Netherlands	15	0	0	0
Norway ¹⁵	15	15	0	10
Oman	0	0	5	10
Poland	15	5	10	10
Qatar	0	0	0	10
Romania	5	5	10	10
Russia	10	5 ¹⁶	10	10
San Marino	10	5	10	5
Serbia	10	5	10	10
Slovak Republic	10	5	10	10
Slovenia	5	5	5	5
South Africa	10	5	0	5
Spain	15	0	0/8	8
Sweden	15	5	0	0
Switzerland	15	5	5	0
Syria	10	5	10	12
Turkey	10	10	10	10
Ukraine	10	5	10	10
United Kingdom	15	5	10	10

Notes:

1. Many treaties provide for an exemption for certain types of interest, e.g. interest paid to the state, local authorities, the central bank, export credit institutions or in relation to sales on credit. Such exemptions are not considered in this column.
2. Unless stated otherwise, the rate in this column applies if the recipient company holds directly or indirectly at least 25 percent of the capital or the voting power of the paying company, as the case may be.
3. The zero rate applies if the recipient company holds directly or indirectly at least 25 percent of the capital of the company paying the dividends for at least 2 years and such dividends are not liable to profit tax in Armenia.
4. A 10 percent holding is required.
5. Effective from 1 January 2014.
6. The lower rate applies to interest from loans granted by banks.
7. A holding of 10 percent of voting rights or 20 percent of capital is required.
8. A 20 percent holding is required.
9. The lower rate applies to interest from loans granted by banks and insurance companies.
10. The lower rate applies to equipment rentals.
11. The lower rate applies if (i) the recipient company holds directly at least 25 percent of the capital of the paying company continuously for at least 1 year, or (ii) if the recipient is a pension fund or other similar institution, subject to further conditions.
12. The lower rate applies to interest from loans granted by banks.
13. The zero rate applies, *inter alia*, to interest paid by public bodies.
14. Treaty concluded between Croatia and the former Serbia and Montenegro.
15. Treaty concluded by the former Yugoslavia.
16. The rate applies if the Russian company owns at least 25 percent of the capital in the Croatian company and the value of the holding is at least 100,000 US dollars (USD).

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