Taxation of cross-border mergers and acquisitions

Croatia

kpmg.com/tax

KPMG International

Croatia

Introduction

This report 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. Accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of this report, but some key points that arise when planning the steps in a transaction are summarized later in the report.

Recent developments

Two recent developments impacting M&A are discussed in detail later in this chapter:

— new rules regarding the taxation of the transfer of real estate came into force

— the ability to apply for binding tax opinions on the tax treatment of future and planned transactions, business events and activities.

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 — 5 percent

— personal cars — 20 percent

— intangible assets, equipment, vehicles and plant — 25 percent

— information technology 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 Corporate Profit Tax (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 report's section on tax losses.

Value added tax

Value added tax (VAT) is charged on most goods and services at the 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.

As of 1 January 2015, new rules regarding the taxation of the transfer of real estate came into force. The sale of land (except for construction sites), buildings and the land on which buildings stand are exempt from VAT. The exemption does not apply to a sale before first occupation or if less than 2 years elapsed between the date of first occupation and the date of sale.

Transfer taxes

There are no stamp duty and stamp duty land tax requirements in Croatia.

Croatia levies transfer tax at the rate of 5 percent on transfers of real estate that is not considered to be 'new' which includes real estate in use for longer than 2 years used motor vehicles and used airplanes.

Amendments introduced the option to have certain real estate taxed with VAT rather than transfer tax in cases where the acquirer is VAT registered, with the view to eliminating the tax cost of supplies of real estate for business purposes.

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 carryback 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 2 taxation periods preceding the statutory change
- the legal successor significantly changes the type of business activity performed by the legal predecessor in the 2 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 in 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

Based on amendments to the Croatian General Tax Law, effective as of 17 March 2015, and regulations on binding tax opinions, statistical reports, correction of tax returns and tax settlements, effective as of 25 July 2015, it is possible to apply for binding tax opinions.

An advisory body for binding tax opinions (appointed by the director of the tax authorities) has the authority to issue binding tax opinions on the tax treatment of future and planned transactions, business events and activities. Such opinions are binding on the tax authorities. Generally, the deadline for the issuance of a binding tax opinion is 60 days (90 days for more complicated opinions and longer periods in exceptional cases). The cost of obtaining a binding tax opinion for companies ranges from 5,000 to 30,000 Croatian Kuna (HRK), depending on company income (income from HRK3 to 150 million). The cost of obtaining a binding opinion for individuals amounts to HRK5,000.

Areas of application for a binding tax opinions are as follows:

— determining taxable supplies for the purpose of input VAT deduction pro-rata

— application of tax regulations regarding investment projects with a value in excess of HRK20 million

— determining the corporate profit tax base in the case of merger, de-merger, partial de-merger, transfer of assets and share-for-share exchange

— application of double tax treaties

— tax treatment of 'unusual' business activities.

The tax authorities' previous practice was to issue opinions on a taxpayer's request. Such opinions were not binding for the tax authorities or the taxpayer. Although it is still possible to apply for such non-binding opinions, with the introduction of the binding opinion concept, an additional level of certainty is available to the taxpayers.

Further, in the course of tax proceedings, prior to issuance of minutes of inspection, the tax authorities and the taxpayer can conclude a settlement for tax liabilities identified in a tax inspection. One of the conditions required for entering into a tax settlement is that the taxpayer accepts the newly identified tax liability and waives the right to use legal remedies. If a tax settlement is concluded, penalty interest can be reduced by up to 100 percent (although it is not possible to reduce potential fines).

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

Purchasers do not prefer local holding companies 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 European Union (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 report).

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 interest rate prescribed by the Minister of Finance. If no such interest rate is prescribed, the Croatian National Bank's discount rate is used. On 23 December 2015, the Croatian Minister of Finance proclaimed that the interest rate for Croatian CPT Act purposes on loans between related parties in 2016 would be 5.14 percent per annum. 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 possess 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 applies 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, 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. For example:

— 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 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 report'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, provided the non-resident has no permanent establishment in Croatia.

Companies law and accounting

Croatian 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 micro, small and medium-sized entities. Nevertheless, a subsidiary company that would generally be obliged to use CFRS may use IFRS instead if its parent company uses IFRS.

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 acquiring that company's shares.

Group relief/consolidation

Current Croatian law does not provide for group relief/consolidation.

Transfer pricing

Where 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 law 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.

KPMG in Croatia

Paul Suchar
KPMG Croatia d.o.o. za reviziju
Ivana Lučića 2a, Seventeenth Floor
Zagreb 10000
Croatia

T: + 385 1 5390 000
E: psuchar@kpmg.com

kpmg.com

kpmg.com/tax

kpmg.com/app

Designed by Evalueserve.
Publication name: Croatia: Taxation of cross-border mergers and acquisitions
Publication number: 133201-G
Publication date: April 2016