Croatia Tax Avoidance Revisited Exploring the Boundaries of Anti-Avoidance Rules in the EU BEPS Context

I. The Meaning of Avoidance and Aggressive Tax Planning and the BEPS Initiative

1) The Meaning of Tax Avoidance in National Legal Systems

Croatian tax system does not define tax avoidance. Moreover, it is not possible to recognize any element of articulate approach to the problem of tax avoidance in legal system as whole, including its special part – tax system. Although, under the influence of some wider and global actions and initiatives it might be noted that some steps to combat financial and tax non-discipline are done.

As Croatian tax system is funded on the principle of legality it is not to expect from administrative regulations to clarify the meaning of tax avoidance due to the lack of legal basis and legislative framework and strong adherence of Croatian judiciary to the constitutional principle of legality.

Croatian tax law has adopted institute of advance tax rulings through the General Tax Act¹ amendments in 2015, after previous failed attempt in 2009. Advance tax rulings are recognized as important part of modern tax systems that aims are the protection of taxpayers' rights and achieving the predictability of tax authorities’ actions. Thus, rule of law and legal certainty are main targets as expected effects. It is noted that the advance tax rulings might have some other meanings that should be more analysed. This analyse is to be focused also on the relationship between tax rulings and tax avoidance. Namely, it is known from literature that tax payers do not request tax rulings since they still prefer a the wide range of tax planning arrangements, that sometimes includes tax avoidance behaviours. Since Croatian tax system has just recently introduced advance tax rulings it is not possible to determine any practice in this field and same is with the impact on the avoidance.

As it is expected from the above mentioned a lack of legislative or other coherent approach to the avoidance there is no settled or any case-law on the meaning of tax avoidance. The existing case-law might be found only on the tax evasion issues, and still rare and non-settled.

---

¹ General tax Act, GTA Official Gazette of the Republic of Croatia “Narodne novine” (OG), Nos. 147/08, 18/11, 78/12, 136/12, 73/13, 26/15,. (hereinafter: GTA).
Considering the developments relating to the OECD BEPS Report no debate thereof has been noted in the Croatian tax community so it might be said that BEPS had no repercussion on the meaning of avoidance in Croatian legal system. Perhaps the impact could be seen through the some procedural and institutional amendments during 2012 and 2015. That is to say, some “mandatory” changes of the legal framework regarding the exchange of information happened, so it is possible to conclude that the BEPS initiatives opened Croatian tax legislation amendments and finally the institute of advance tax rulings was adopted. In the same circumstances was established a special sector for tax frauds as a part of Croatian Ministry of finances. Also, the GTA’s provisions regulating piercing the corporate veil have been firstly introduced by amendments, effective 1 January 2013. This provisions provide for a special procedure of proving abuse of right concerning e.g. a director, shareholder or related party, presenting the provisions that facilitate the piercing the corporate veil in the tax procedure and for tax purposes. The 2012 GTA amendments introduced new categories of statutory guarantors for tax liabilities of companies. This refers to company members, board members, and executive directors and associated parties, whose abuse of rights and authorities has resulted in the company’s incapacity to pay the tax debt. Liability of aforementioned persons must be determined in a special form of tax procedure exhaustively regulated as a part of the tax procedure. GTA provisions that introduced the piercing of the corporate veil caused problems in their application.

2) The Meaning of Tax Planning, Abusive Tax Planning and Aggressive Tax Planning in National Legal Systems

In the context of tax planning, it is useful to underline that this term is analysed stricto sensu meaning planning targeted to the avoidance of taxation, since it is obvious that this term might be understood also as an general action of tax payer without any intention but pure estimation of tax consequences that will arose with future activities of tax payer.

---


3 Chapter VIa of GTA: Special provisions for determining abuse of rights, Article 158a to 158f.

Above mentioned on the tax avoidance issues applies equally on the tax planning, abusive tax planning or aggressive tax planning in Croatian legal system. The same situation is with case-law, as it is not even registered any case. As there is no study on the matter of compliance of Croatian tax legislation with ECJ case law, in general, it is not possible to predict its influence on the developments of Croatian anti-avoidance tax policy. In the view of latest developments on the EU and international level it should be recommended to follow the tax avoidance concept delimited by the ECJ that could serve as an appropriate interpretative guideline to the Tax Administration and the national judiciary.

II. The Reaction to Avoidance and Aggressive Tax Planning in the BEPS Context

1. Domestic General Anti-Avoidance Rules (GAARs)

The Croatian tax system does not contain GAAR. Although this is reasoned in the same way in other, several academic contributions it should be mentioned that opposite standpoints might be found in literature, too. As it was previous detected, such a view is attributed on the misunderstanding of the “economic approach principle”, as it is set by Art. 10(1) of the GTA. That is to say, Art. 10(1) GTA sets out that “(T)ax facts shall be determined according to their economic essence”. In addition, Art. 10(2) GTA prescribes that “(I)f the revenue, income, profit or other assessable benefit was acquired without a legal basis, the tax authority shall determine the tax liability in accordance with a special law regulating certain types of taxes. It seems that, although the purpose of these provisions is close to those of a GAAR, they cannot be defined as general rules enabling the tax administration efficient fight against tax avoidance. Cited GTA’s economic approach principle presents a codification of the

---


6 See more, Gadžo, Klemenčić, Hodžić, Žunić Kovačević, chapter in the IBFD book “GAARs - A Key Element of Tax Systems in the Post-BEPS World” – will be published).

substance-over-form approach and useful legitimate tool of tax administration in the process of determining and classifying tax facts.

Even though, this provisions on the economic approach principle are part of Croatian tax law since 2001 with first codification of tax procedural rules in Croatia when the GTA entered into force, there is a little number of case-law, both on the administrative level and on the judicial level too. Precisely it is possible to find several cases that jurisprudence underlines the economic approach. As for the administrative cases, where tax authorities refer to economic approach, they are usually a cause or reason for judiciary control. Nevertheless, it is worth to mention that tax authorities have published their standpoints as kind of public rulings and interpretations (there are only two available) with reference to the same economic approach form article 10 GTA. The first addresses the issue of tax deductible expenses in the assignment of receivables with an unusually big commission. The second opinion referred to the issue of tax treatment of leasehold improvements in the case of termination of contract.

Following on the above described rules, Art. 11 GTA regulates additionally, as the principle of tax procedure, an mechanism targeted at preventing the abuse of legal form. It is prescribed that “(If a sham transaction conceals another legal transaction, the basis for the assessment of tax liability shall be that concealed legal transaction.” For that reason, Art. 11 GTA empowers tax authorities to change the qualification of transaction.

The term “sham” applies to a situation where the genuine intention of the relevant parties do not match what they have reported to the tax authorities with respect to relevant transactions. Croatian jurisprudence has some opportunities to recognise the importance of the reviewed GTA provisions. There are some examples of the case –law in this field where courts confirmed the administrative standpoints - the tax authorities conclusion: e.g. the case where is determined that in a such circumstances when the sales contract conceal the other legal business - loan agreement – then input VAT cannot be recognized (input invoices) because it is a sham transaction or the case where it is confirmed that tax authorities shall assess whether behind the concluded legal transaction is concealed other transaction which is

---

8 Ruling class.: 410-01/11-01/2470, no. 513-07-21-01/11-2, Available at: http://www.iusinfo.hr/OfficialPosition/
9 Ruling class: 410-01/10-01/1551, no. 513-07-21-01/10-2, Available at, loc.cit.
the basis for tax assessment. Similarly, in the case where the administrative court confirmed the finds that were found in the tax audit, on the concealment of the sale agreement where the partnership agreement was sham transaction it was underlined by the tax authorities, (and court, by bringing the judgment) that in accordance with Article 10 paragraph 1 GTA with regard to determining the tax facts considered important to determine the effects of agreement and that they have to be dealt with the economic point of view, regardless of how the parties have entitled formally this agreement or transactions.

Considering the fact that Croatia has legislation allowing the tax authorities to combat shams, some find a GAAR superfluous for combating such transactions. It is known that tax avoidance and shams are different concepts, so a GAAR is to be applied when the sham doctrine is lacking or is not strong enough. Sham transactions or simulations and tax avoidance are comprised by the broader term of abuse of law. It is necessary to allow the tax authorities to reject behaviours proven to be a sham or motivated by tax avoidance. It is in the literature stressed that Croatian tax system regulate this matter through the provision intended to prevent fraudulent behaviour, especially in special or material tax legislation, for example the rules of Profit Tax Act that apply on the transfer pricing issues, thin capitalisation and hidden profit payments.

In favour of the view at necessary implementation of GAAR in Croatian tax legislation it is important to point out some contributing factor of the Croatian tax system and the Croatian legal system in general. Art. 51 of the Croatian Constitution thus provides general obligation to pay taxes by prescribing that everyone should participate in the defrayment of public expenses, in accordance with their economic capacity. The same article in paragraph 2 stipulates that the tax system should be based upon the principles of equality and equity. GTA expand in more detail way this provisions, in particular through the provision on the principles of taxation procedure that are in Part II of GTA.

---

19 Accordingly Art. 9 GTA oblige the parties in the tax relationship to act in good faith, that is base for previously mentioned advance tax rulings The principle of good faith conduct is further elaborated by the Ministry of Finance Ordinance (Official Gazette of the Republic of Croatia, No. 59/09), but also advance tax
As Art. 19 of the Constitution sets out the principle of legality as the key principle of the Croatian legal and tax system it is a demand that any action undertaken by the tax administration targeting tax avoidance should be based on the law. So, legislative interventions in this field are of great importance because Croatian civil law legal system has strong devotion to the constitutional principle of legality. A long tradition of the literal interpretation of the law by the courts has similar consequences.  

In the period when GTA was amended during 2015, inter alia, as implementing advance tax rulings was reasoned as complying with EU legislation. As it was known that GAAR would be as needed amendment, it was unofficial standpoint of Ministry of Finance that there is settled GAAR. It was obviously misunderstood as institute.

There are some proposals of recent authorities on the revising tax system as whole, to become more competitive, efficient and equal but there is no official proposal on GAAR’s introduction at the time this contribution was written. If policymakers opt for the introduction of such an anti-avoidance instrument it is likely that its elements and wording will take into account developments on the EU level.

GAAR should be considered as something bigger and stronger than the legal rules: it is a declaration or confirmation of the fundamental principle and rule on the issue- whether the legislature or the judiciary has principal competence to determine the absence of economic interest-or in general- on the distribution of competence for determining abuse of rights and avoidance of taxation.

The proposal for uniform regulation of GAAR in the EU Member States’s legislation, even the desirable adjustment of already present GAARS, should be considered, since we believe it might become useful as it would enable national courts to participate and follow comparative practices and case-law in its application.

It seems that in the countries that belong to the group of civil or continental legal regimes, there is the dominance of the doctrine of abuse of rights that target combating abuse of law in general, so this domination in same applies at the area of tax law. In the field of tax law, this rules prohibiting the abuse of rights, are based on the principle of equality and equal treatment of all tax payers. So, in this ay equity in taxation means that everyone has to bear
the tax burden and pay taxes in accordance with ability to pay or according to economic strength.

In such framework, tax planning or abuse of law, where one tax payer bears less of a burden than is proportionate to its economic strength constitute a violation of the general principle of equality. The importance of this principle is obvious since the principle of equality in taxation is in a great number of countries constitutional principle.

2. EC Recommendation C-(2012) 8806 of 6 December 2012 and subject-to-tax rule

At the time of the signing DTC between the Croatia and the Spain additional Protocol was signed containing the limited subject-to-tax rule referring to DTC\(^1\) Art. 17:”…the provisions of this Article shall not apply if the recipient of the income, being a resident Croatian, do not pay taxes or is exempted from paying tax on that income in accordance with Croatian law. In this case, such income may be taxed in Spain.”.\(^2\) But, it seems there is no official policy attitude towards introducing a subject-to-tax rule as proposed by the EC in its Croatia’s DTC’s.\(^3\)

III. Transfer Pricing Rules, GAARs, Specific Anti-Avoidance Rules (SAARs) and Linking Rules

The first transfer pricing regulation in Croatia was established in 2005. OECD guidelines are implemented in Corporate Income Tax Act\(^4\) and Regulation.\(^5\) Tax administration published Manual for transfer pricing audit in 2009.

Article 13 of the CIT Act and Article 40 of the CIT Regulation prescribe arm’s-length pricing as the basic principle to be followed and define the methods allowed and the documentation

---

\(^{1}\) Croatia - Spain DTC, the Official Gazette of the Republic of Croatia, where the international agreements are published “Narodne novine – međunarodni ugovori”, hereinafter: OG – MU, No. 3/06.

\(^{2}\) Croatia - Spain DTC, Art. 17 regulating pensions taxation, reads as follow” Subject to the provisions of paragraph 2 of Article 18, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.”.


\(^{4}\) Corporate Income Tax Act (hereinafter: CITA), Official Gazette of the Republic of Croatia, Nos. 177/04, 90/05, 57/06, 146/08, 80/10, 22/12, 148/13, 143/14.

\(^{5}\) Corporate Income Tax Regulation, OG, Nos. 95/05, 133/07, 156/08, 146/09, 123/10, 137/11, 61/12, 146/12, 160/13, 12/14, 157/14, 137/15
required to support prices between related parties. In general, arm’s-length pricing is required only for cross-border transactions between related parties. However, in line with the amendments to the CIT Act (in force as of 1 July 2010), the obligation to comply with transfer pricing rules is extended to transactions between domestic entities if one of the entities is either in a tax-loss position or in a special tax status (paying tax at lower rate or exempt from paying corporate income tax). Article 13 of the CIT Act and Article 40 of the CIT Regulation prescribe arm’s-length pricing as the basic principle to be followed and define the methods allowed and the documentation required to support prices between related parties. The Croatian CIT Act regulations do not provide detailed rules on how to arrive at the arm’s-length price that should be applied in related-party transactions. However, the CIT Act prescribes the following methods that a taxpayer can use to determine the arm’s-length price: CUP, resale-minus, cost-plus, profit split and TNMM. All five standard methods are allowed; however, traditional transactional methods (CUP, resale-minus and cost-plus methods) should have the priority when establishing whether the conditions imposed between related parties are at arm’s length. If possible, the CUP method should be applied and other available methods should be used on occasions when traditional methods cannot be reliably applied.

In the past few years, the tax authorities have increased their focus on prices applied in transactions with related parties and the frequency of transfer pricing audits. Due to limited experience in transfer pricing, the tax authorities tended to dispute service charges between related companies. However, tax inspectors have become more knowledgeable about transfer pricing. The tax authorities issued a manual containing instructions for tax inspectors to follow in transfer pricing audits. The manual also provides a translation of the OECD Guidelines. Therefore, the OECD Guidelines should represent a good theoretical basis for defining transfer prices and for preparing the documentation that supports them. Croatia has not implemented legislation concerning APAs, but they are expected to be introduced in the near future as advance tax rulings are implemented just recently, during 2015. There is no litigations raised on the application of TP rules application.

Croatia has include limitation on benefits clause in several of its DTC’s to prevent treaty shopping e.g. in the circumstances of interposition of company that is resident in a state that is party to DTC by non-resident persons in order to take advantages of the benefits envisaged in the convention for certain income obtained in the other contracting state. That is case with
DTC Croatia - Spain. Similarly, DTC concluded with Netherlands prescribes that no relief shall be available under the DTC if the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this DTC by means of that creation or assignment.

Controlled foreign company (CFC) regimes are used in many countries as a means to prevent erosion of the domestic tax base and to discourage residents from shifting income to jurisdictions that do not impose tax or that impose tax at low rates but Croatian tax legislation does not contain CFC provisions.

Croatian tax legislation includes limits on the deduction of interest. Interest on a loans granted by shareholder, shareholder’s related party or third party and guaranteed for by shareholder is not deductible if the shareholder holds 25% or more of the shares or voting rights of the taxpayer and the value of the loan exceeds four times the value of the shareholder’s share in equity of taxpayer. If the loans to which thin capitalisation rules are applied exceed the 4:1 ratio than the amount of interest exceeding this ratio is not deductible. The thin capitalisation rules do not apply to loans granted by banks or financial institutions even in the cases where shareholder is the guarantor of a loan. Accordingly, for Croatian corporate profit tax law purposes: (1) the maximum amount of deductible interest on loans from a Croatian tax non-resident to a Croatian tax resident related party will also decrease from 7% per annum to 3% per annum; and (2) the minimum acceptable interest rate on loans from a Croatian tax resident made to a Croatian tax non-resident related party for corporate profit tax purposes also decreases from 7% per annum to 3% per annum. These rules further apply to loans between two Croatian tax residents if one of them is in a “favourable” tax position.

While Croatia does not have a GAAR, various SAARs have been adopted over the years. It may be concluded from the previous legislative activity in this area that the introduction of a GAAR was considered to be unnecessary and that the policy choice was to rely on SAARs as cornerstones of anti-avoidance legislation. However, a more detailed analysis reveals that the special rules have often been adopted without a consistent underlying policy, leading to the conclusion that Croatian tax policymakers do not have a clear and coherent anti-avoidance approach.

26 Croatia - Spain DTC, see f.n.21.
SAARs are predominantly found in the corporate tax legislation. Such as, the rules on the withholding tax – a tax that is levied on certain items of passive income paid by Croatian residents to non-residents, subject to treaty restrictions – follow a shape similar to other European countries, recognizing the existence of the “low tax” jurisdictions. Namely, Art. 31(10) CITA sets out that the withholding tax must be levied at a higher rate (20%) if the recipient of the pertinent income is resident in a tax haven country, i.e. resident in one of the 50 countries enumerated in the special list issued by the Ministry of Finance and published on its web pages.\(^{28}\)

In the Croatian tax system there are provisions which enable a legal reduction of taxes, introduced with the intent of the legislator to benefit certain areas\(^ {29}\) and to encourage certain activities e.g. corporations employing a certain number of employees, scientific activities, education and the training of employees. Until 2001, the allowance for corporate equity (ACE) and the use of an accelerated depreciation allowance were employed as measures against tax avoidance.\(^ {30}\) After CITA entered into force in 2001, legal tax avoidance was possible through provisions on tax exemptions for investment in capital assets and allowances for the employment of new staff. This was abolished in 2006.\(^ {31}\) A number of special rules as SAARs, introduced with the aim of curbing tax avoidance can be found in the CITA *de lege lata*.\(^ {32}\)

Similar, the other SAAR is targeted at the abuse of options to reduce corporate tax base via reinvesting the company profits, i.e. increasing the capital of the company for investment and development purposes. While this special tax benefit – provided for under Art. 6(1)(6) CITA – was introduced in 2012 with the goal of helping the real economy in the times of economic crisis to make new investments and contribute to economic growth,\(^ {33}\) the legislator recognized its possible use as a tax avoidance instrument.\(^ {34}\) Therefore, the taxpayer who uses this tax benefit must, within six months after the expiry of the deadline for the filing of a corporate income tax return, present to the competent local office of the Tax Administration evidence of the increase of registered capital effected by the profit earned in the tax period for which the

---

28 See http://www.porezna-uprava.hr/hr_propisi/_layouts/in2.vuk.sp.propisi.intranet/propisi.aspx#id=pro22.
29 R. Prebble (2005), *supra* n. 3, p. 213.

reduced tax base has been declared. Moreover, the entitlement to reduce the corporate income tax will not be granted if it is obvious that the intention behind the increase of the company’s capital was tax fraud or tax evasion. The latter provision, provided for under Art. 6(7) CITA, is of special importance because it is an explicit SAAR. Although the term “tax avoidance” is not defined in the CITA, it can be assumed that this provision targets not only illegal tax avoidance, i.e. tax fraud, but also the activities aimed at the reduction of the tax burden that are not intended to produce a reinvestment effect but just tax relief.\textsuperscript{35} It is difficult to make assumptions about the approach of the Tax Administration in determining the purpose of the capital increase.\textsuperscript{36}

As in most civil law countries, the corporate income tax base in Croatia is calculated using the company’s financial accounts as the starting point. Art. 8 CITA contains a thin cap rule, providing that the taxpayer’s accounting profit/loss must be increased by the interest on shareholder loans. The conditions are that the shareholder holds at least 25% in the taxpayer’s capital/voting rights and the loan exceeds four times the amount of his holding. For these purposes the loans received by the company from third parties, guaranteed by the shareholder, are considered to be shareholder’s loans, as it is above mentioned.

IV. Application of GAARs, TP Rules and SAARs

Since Croatia does not have a GAAR it is hard to imagine what the relation between a GAAR and the above mentioned SAARs would be. It is arguable if there is a place to apply rules in accordance with the \textit{lex specialis} doctrine. It is possible to point out that such an approach that where specific anti-avoidance rules co-exist alongside a GAAR, the former should apply, excluding the application of a GAAR - would be in accordance with legal certainty requirements.

The relationship between GAARs and tax treaties has always been a controversial issue. Considering the absence of a GAAR in the Croatian tax system it is only possible to give a hypothetical view that the application of a domestic GAAR should be recognized as a prerequisite, in line with the Commentary on Art. 1. of the OECD Model Convention (Para. 9.2.). It should be emphasized that the situation is much clearer with regard to those tax

\textsuperscript{35} \textit{Ibidem}, p. 10.
treaties that expressly allow the application of domestic anti-avoidance rules.\textsuperscript{37} In this context it is important to mention the fundamental principle of taxation on the prohibited retroactive application of tax provisions, as it is prescribed in Art. 5 GTA.

\textsuperscript{37} Such provisions are in the DTC with Israel (2006) and Portugal (2014).