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Valuing the attractiveness of the Croatian tax system for resident and non resident enterprises in a EU framework

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The EU framework: business opportunities and challenges

- Different corporate tax rates
  - Lack of tax harmonization
  - Monetary and fiscal policy

- Free flow of income inside the Community
  - Dividend, interest and royalty directives

- Outbound vs. inbound investments

Outbound: key drivers of tax planning

Moving something

- Assets
  - E.g., money, IP
- Functions
  - Marketing, financial, R&D, purchase, sale
- Risks
  - Credit, inventory

Exploiting something

- Tax arbitrage
- Tax deferral
- Tax re-qualification

Tax arbitrage

In a domestic context

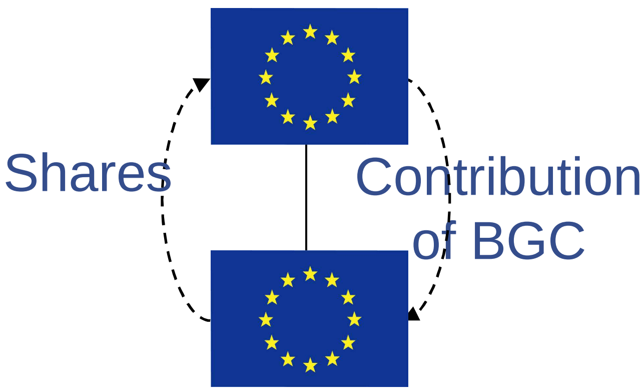
- Step-up regimes
  - Why?
  - Substitute tax vs. ordinary depreciation
- Special regimes for special entities
  - E.g., REITs

In a cross border context

- Nominal tax rate
  - Ireland 12.5%
  - Madeira 0%
- Special regimes
  - E.g., Belgium NID

Example of tax arbitrage in a domestic cont’: step-up

- Stand-alone company with equity of 50 and a net FMV of 300. Therefore unexpressed goodwill of 250



Before the contribution of the BGC

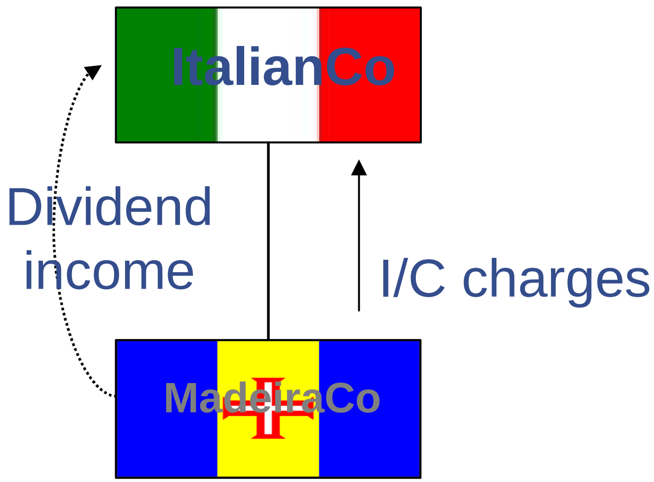
OpCo			
Assets	1.050	50	Equity
		1.000	Debt
Total	1.050	1.050	Total

After the contribution of the BGC

OpCo			
Shares	300	50	Equity
		250	Reserves
Total	300	300	Total

NewCo			
Assets	1.050	300	Equity
Goodwill	250	1.000	Debt
Total	1.300	1.300	Total

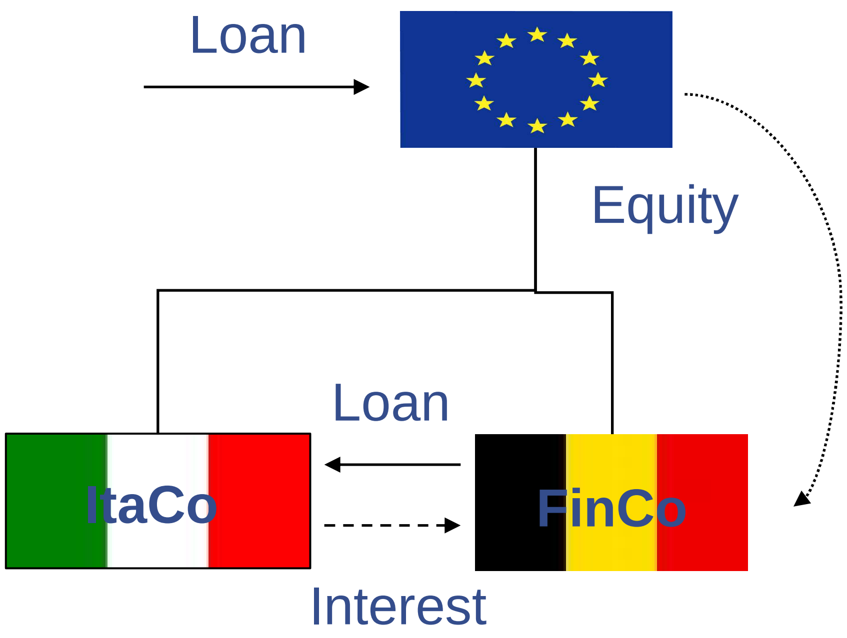
Example of tax arbitrage in an int' cont': moving activities abroad



– Idea
  - Certain activities can be freely moved from one country to another (e.g., finance, purchases, sales, marketing)

– Analysis
  - I/C charges
  - Italy deduct at 27.5% corporate income tax plus 3.9% local income tax
  - Dividends are subject to tax at 1.375%
  - Madeira exemption until 2011 (3/5% after that date)
  - ETR reduces from 27.5% + 3.9% = 31.4% to 1.375% (until 2011)

Example of tax arbitrage in an int' cont': Belgian NID



– Idea
  - Financing Italian operations using Belgian NID regime

– Analysis
  - Notional interest deduction ("NID") at 3.781% for financial year 2007 to be set off against interest income
  - Interest deduction in Italy subject to 30% EBITDA rule
  - Possible exemption from Italian WHT under the IRD
  - Possible double dip if equity is loan funded in Foreign Investor's country

Tax arbitrage: the nominal rates as (preliminary) drivers for investments*

MALTA	FRA	BEL	SPA	UK	SWE	ITA	FIN	NL	AUT	DEN	GRE	POR	SLO
35	33	33	32	28	28	27	26	25	25	25	25	25	23

LUX	CH REP	CRO	POL	SLO	HUN	ROM	GER	LAT	LIT	IRL	BUL	CYP	EST
22	21	20	19	19	16	16	15	15	15	12	10	10	0

Croatia nominal rate 20% is, apparently, not very attractive

* Only general rates

Tax deferral

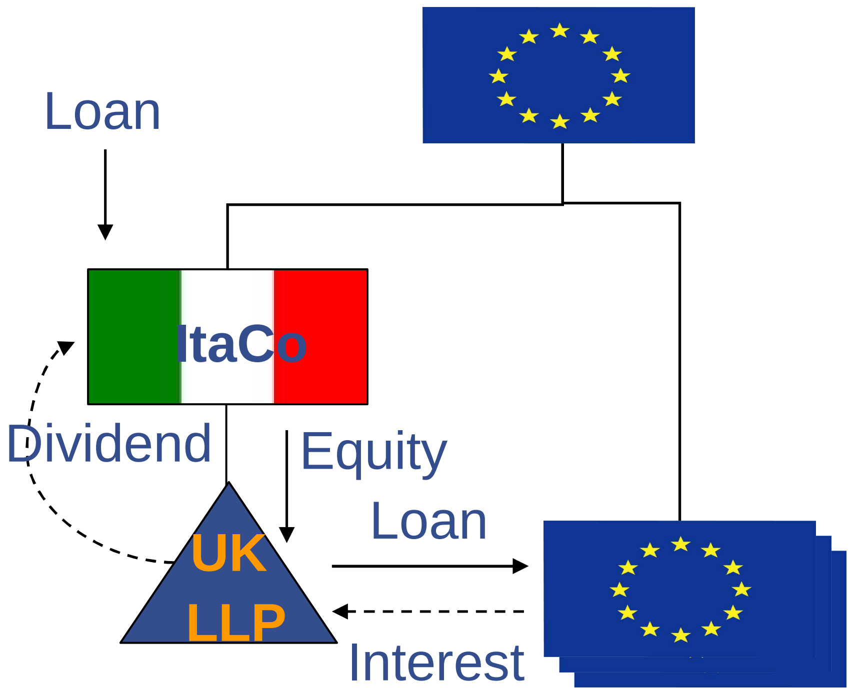
In a domestic context

- Accrual vs. cash principle
  - Individuals vs. companies
  - Domestic vs. foreign companies
- NOLs refreshing techniques
  - Avoid losing losses due to expiration period

In a cross border context

- Nominal tax rate
  - Madeira 0% (tax havens)
- Hybrid entities
  - E.g., partnerships

Example of tax deferral in an int' cont': foreign partnerships as finance vehicles



- Idea
  - Create double interest deduction in Italy and other ForcCo jurisdictions
- Analysis
  - In Italy
    - No taxation of UK LLP until distribution
    - 95% exemption on UK LLP profits: 5% taxed only upon distribution
    - New CFC? Does it still work?
  - Other subs deduct interest depending on local rules
  - UK residence of the LLP to be managed

ECJ case law on fiscal reasons

- Tax considerations can play legitimately in moving abroad if arrangements do not end up in **purely artificial arrangements**

  - **Objective factors** include premises, staff and equipment and not a mere "letterbox" or "front" subsidiary: Case C-341/04 *Eurofood IFSC*, par. 34 and 35

    – However, it is not clear how these criteria may apply in respect of, for example, <u>intra-group financial services and holding companies,</u> whose activities generally do not require significant physical presence: COM (2007) 785 final of December 10, 2007, par. 2

Tax re-qualification

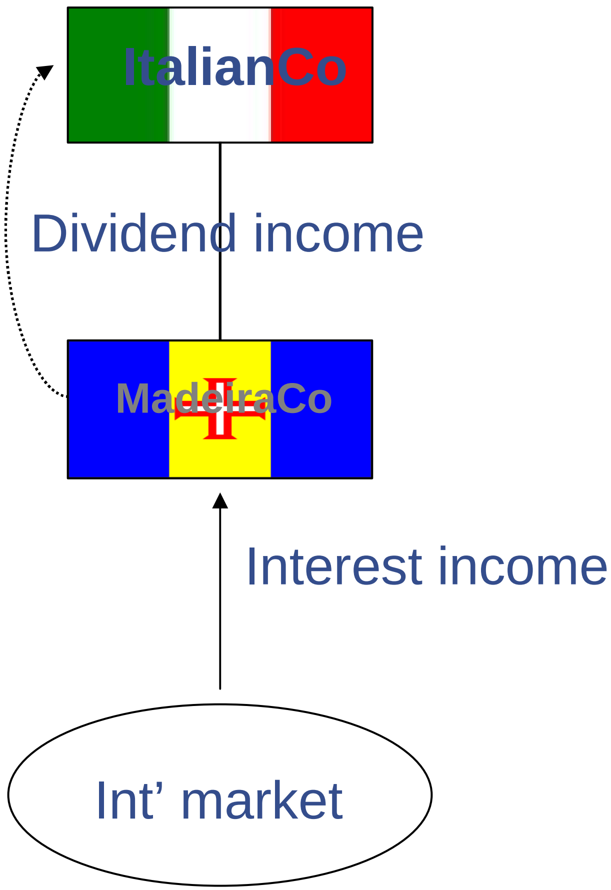
In a domestic context

- Individuals vs. companies. E.g.,
  - Income from employment vs. business income
  - Income from capital vs. miscellaneous income

In a cross border context

- Nominal tax rate
  - Ireland 12.5%
  - Madeira 0%
- Hybrid instruments. E.g,
  - Silent partnership agreements
  - Interest free loans

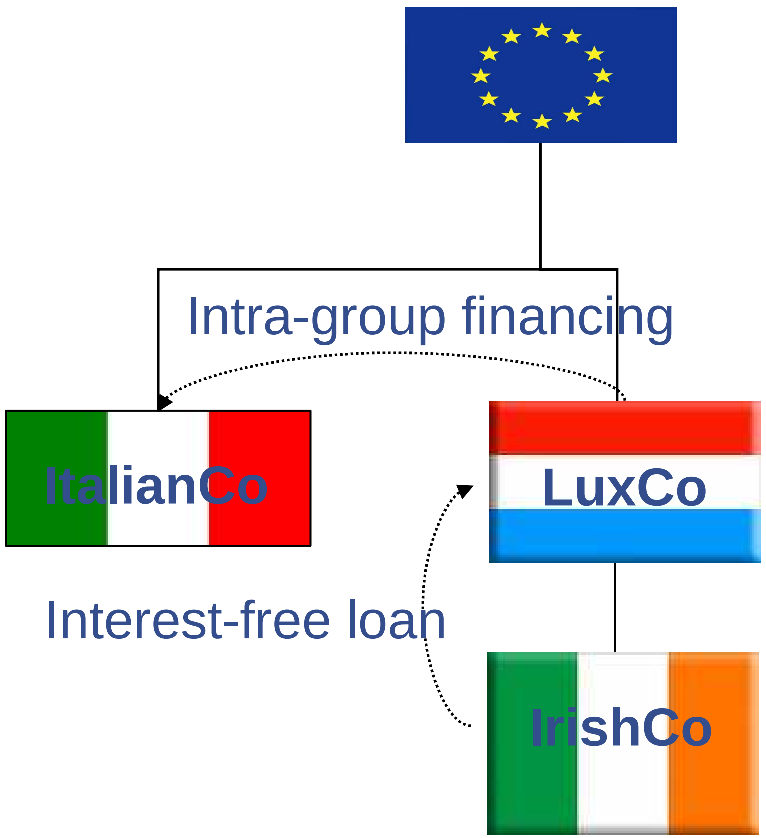
Example of tax re-qualification in an int' cont': subscription of bonds through a foreign vehicle



– Idea
  - Instead of directly subscribing bonds issued in the international market, ItalianCo use a foreign vehicle to transform interest into dividends

– Analysis
  - Interest income would be subject to tax at 27.5%
  - Dividends are subject to tax at 1.375%
  - Madeira exemption until 2011 (3/5% after that date)
  - ETR reduces from 27.5% to 1.375% (until 2011)

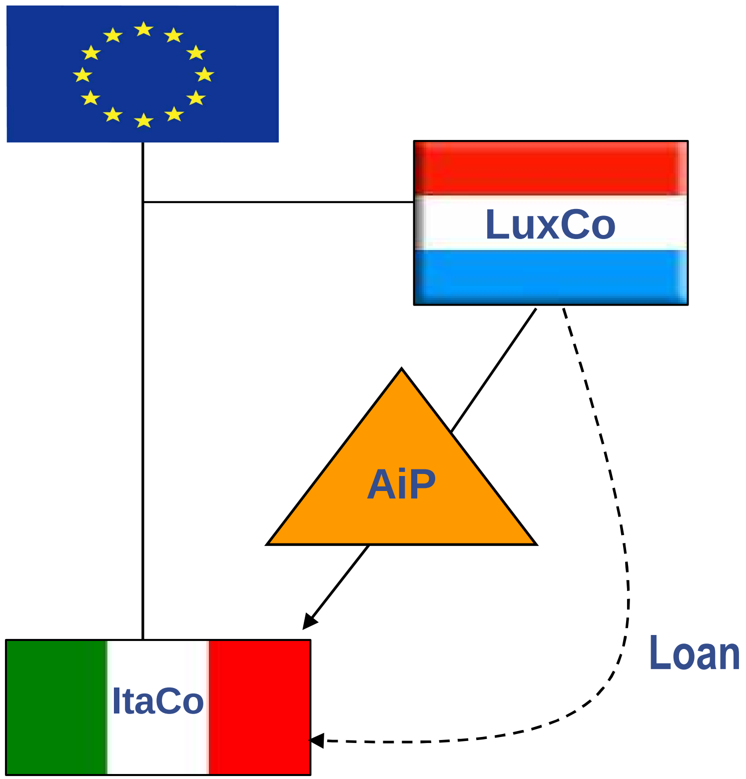
Example of tax re-qualification in an int' cont': Irish interest free loan



– Idea
  - No interest recapture

– Analysis
  - Deemed interest deduction at the level of LuxCo that offsets interest income Possible exemption from WHT under the IRD
  - Arm's length spread in LuxCo
  - Interest deduction in Italy subject to 30% EBITDA rule

Example of tax re-qualification in an int' cont': Italian Super AiP



– Idea
  - ItaCo borrows funds from LuxCo by means of:
    - An AiP for generally 5% of the amount of the borrowing
    - A straightforward loan for the major part of the financing

– Analysis
  - Foreign exemption in Luxembourg
  - Interest deduction in Italy subject to 30%EBITDA rule but 10% WHT
  - AiP remuneration not deductible but 15% WHT

Tax requalification: rulings or clear and stable rules

- International tax arrangements are difficult to fit into domestic law (e.g., hybrids)
  - Clear and stable rules help long-term investment planning
  - Tax authorities' approach help in preventing uncertainties
- States in which legislation does not change and tax authorities are opened-mind have a clear advantage in creating a **friendly** environment to investors

Inbound: key drivers of investments

- Where to invest?
    - Non-tax considerations
- How to invest?
    - PE vs. subsidiaries
- What are the cash repatriation techniques?
    - Dividend / interest / royalty income
- What are the exit strategies?
    - Asset deal vs. share deal

Where to invest? Non tax considerations

- Infrastructure (airport, banks, telephone, service providers)
- Language
- Time-zone
- Third parties, shareholders
- Administration costs
- Mix of permitted activities
- Accounting standards meet desired accounting result
- Regulatory authorities
- Align legal structure and organizational structure
- Control mechanism

How to invest?

- Permanent establishment are normally more flexible
  - Less legal constraints, e.g.,
    - No minimum capital requirements
    - Board of directors not needed
    - Statutory auditors absent
  - Free flow of income with HO
- Not easy to present commercial-wise
- Unlimited legal liability
    - Easy to get around

The right to establish a branch under EU law

The fact that a company does not conduct any business in the MS in which it has its registered office and pursues its activities only in the MS where its branch is established is not sufficient to prove the existence of abuse or fraudulent conduct which would entitle the latter MS to deny that company the benefit of the provisions of Community law relating to the right of establishment

9.3.99 – C-212/97 *Centros*, par. 29

See also: 30.3.03 – C-167/01 *Inspire Art*

What are the cash repatriation techniques?

- Debt vs. equity – license of IP
  - Equity not deductible and might be “expensive”
    - Capital tax
  - Interest and royalty deductible
    - Thin capitalization
  - Withholding taxes
    - Interest & royalty directive

- Not always a tax choice
  - Listed companies need to guarantee dividends to the shareholders

ECJ case law on thin capitalization

National anti-abuse rules may comprise **‘safe harbors’** criteria to target situations in which the probability of abuse is highest:

COM (2007) 785 final of December 10, 2007, par. 2

The taxpayer must be given the opportunity, without being subject to undue administrative constraints, to produce evidence of any commercial justification that there may be for that arrangement: 13.3.07 *Thin cap*, C-524/04

With regard to intra-group transactions that means adherence to the **arm’s length principle:** 13.3.07 *Thin cap*, C-524/04

Withholding tax on dividends*

SWE	FIN	DEN	ITA	AUT	FRA	BEL	EST	POR	GER	IRL	POL	SPA	ROM
30	28	28	27	25	25	25	21	20	20	20	19	18	16

NL	LUX	SLO	LIT	CH REP	LAT	BUL	CRO	HUN	SLO	GRE	UK	MALTA	CYP
15	15	15	15	15	10	5	0	0	0	0	0	0	0

The Croatian zero rate on dividends is important to attract non-EU investors

* Only general rules

Withholding tax on interest*

DEN	GRE	GER	IRL	POR	UK	POL	SLO	SPA	FRA	ROM	SLO	CH REP	BEL
30	25	25	20	20	20	20	19	18	16	16	15	15	15

CRO	ITA	BUL	LIT	LAT	HUN	EST	LUX	AUT	NL	FIN	SWE	MALTA	CYP
15	12	10	10	0	0	0	0	0	0	0	0	0	0

Croatia 15% tax is not appropriate in a EU context. Interest may freely flow in Europe and be repatriated outside Europe from countries that do not apply interest/dividend withholding tax

* Only general rules

Withholding tax on royalties*

FRA	DEN	ITA	FIN	SWE	AUT	SPA	UK	GRE	POL	IRL	SLO	ROM	GER
33	30	30	28	28	25	24	22	20	20	20	19	16	15

POR	BEL	CH REP	EST	SLO	CRO	BUL	LIT	CYP	LAT	HUN	LUX	NL	MALTA
15	15	15	15	15	15	10	10	10	5	0	0	0	0

Croatia 15% tax is not appropriate in a EU context. Royalty may freely flow in Europe and be repatriated outside Europe from countries that do not apply royalty/dividend withholding tax

* Only general rules

Exit strategies

- Share deal
  - Participation exemption
    - PEX regimes are present in most MS
    - Exclusive right to tax in the State of residence of the seller
- Asset deal
  - Normally subject to tax

In a nutshell… what does make a tax jurisdiction attractive for EU and non-EU investors?

- Non-tax (business) environment
- Nominal rates
  - Special regimes
- Hybrid entities
- Friendly tax authorities
  - Rulings, clear and stable rules
- Possibility to repatriate profits in and outside the EU without charges
  - Interest, dividend, royalties withholding taxes
- Possibility to come out from the business without charges
  - Capital gain exemption and others

Thank you!

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