

# Employee Share Plans Taxation in Croatia

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American Chamber of Commerce in Croatia *Američka gospodarska komora u Hrvatskoj*

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# Introduction

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In recent years, Employee Share Plans have been introduced in many international companies and have become “best practice” for rewarding and retaining employees worldwide. The purpose of such plans is to promote productivity of employees, retain key employees of the company, and link the interest of employees with the interest of the company to increase growth by involving employees in the success of the company.

In the past, Employee Share Plans were typically available only to the top management of a company. However, the worldwide tendency – especially in some industry sectors – is that participation in such incentive schemes is offered to a much wider range of employees.

In case of companies that are part of an international group, Employee Share Plans are generally governed by the parent company of the international group. In the case of Croatia this company is typically located abroad. An Employee Share Plan typically enables an employee of an international group (including employees of Croatian companies) to obtain a share in the parent company (for no consideration or at a discount compared to the market value of the share). Most countries treat this discount or market value of the share as income for the employee.

However, the advantage of an Employee Share Plan for the employee is that the tax treatment of such income in most tax jurisdictions is usually more beneficial than the tax treatment of employment income. Croatia is an exception as currently there is no possibility of a more favorable tax treatment for local employees who are participants of such a plan. Consequently, employees of Croatian companies/subsidiaries often do not participate in Employee Share Plans due to the high personal income tax and social security burdens imposed in Croatia on such income.

The aim of this position paper is to provide arguments for the introduction of changes to the Croatian Personal Income Tax Act with regards to taxation of Employee Share Plans.

These arguments are supported with a comparison of personal income tax and social security treatment of income from Employee Shares Plans in neighboring EU countries’ with the current situation in Croatia. The comparison is made based on a KPMG Croatia survey conducted for the purpose of this position paper. The survey was conducted in the period between May and September 2017 among 6 neighboring countries, EU member states (Slovakia, Hungary, Slovenia, Czech Republic, Romania and Poland).

With the results of the survey we also present our proposal for amendments to the Croatian Personal Income Tax Act. The suggested amendments are aimed at

making Employee Share Plans a remuneration tool for rewarding Croatian employees in the full meaning, as is the case for employees in other neighboring EU countries. Besides the benefit for employees, catching up with the regional average with regards to taxation of Employee Share Plans might also increase the attractiveness of Croatia for foreign investors.

## Analysis of the current situation in Croatia based on a sample case

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For the purpose of the survey, and in order to analyze the current regulations in Croatia governing the taxation of income from an Employee Share Plan, the following sample case information was used:

- An employee of a Croatian company participates in an Employee Share Plan ("the Plan");
- The Plan is organized by the parent company of the group located abroad, i.e. the Croatian employee would receive a share in a foreign company;
- Based on the Plan, the Croatian employee is granted shares with a market value of EUR 3.600 for no consideration;
- The employee is subject to Croatian personal income taxation and social security contributions (Croatian tax resident);
- The costs of the Plan are recharged by the parent company to the Croatian company (i.e. to the employer of the Croatian employee);
- According to the Plan, an employee who is granted a share for no consideration must satisfy a number of conditions before being entitled to the share – in our case the employee must remain employed by the international group (including Croatian companies) for the period of 3 years. During this period, the employee does not have the right of disposal of the shares (shares are not in his/her ownership) or any other type of receivables from the shares (e.g. dividend);
- Once all the conditions are met the employee has the right of disposal of the shares and can decide to hold on to them or sell them.



## Current Croatian tax and social security treatment of the income received from Employee Share Plan

Based on the provisions of the Croatian Personal Income Tax Bylaw, Article 54, Paragraph 2, Point 1, the income<sup>1</sup> received by an employee of a Croatian company from a participation in an Employee Share Plan from a parent company abroad is considered as net "other income" and personal income tax and social security contributions on such income are payable on a monthly pre-payment basis<sup>2</sup>. In addition, this income is also subject to a final annual personal income tax calculation at the year-end that may lead to additional personal income tax liability for the employee.

There is currently no specific provision in the Croatian Personal Income tax legislation that would prescribe a different tax treatment should the cost of the Plan be recharged to the Croatian employer. Based on the sample case presented, the effective personal income tax and social security burden would be 74,76%<sup>3</sup> for the employee.

However, based on the recent interpretation of the Croatian Tax Administration published in its Opinion (Class: 410-01/15-01/2776, No.: 513-07-21-01/17-2), if the costs of the Plan are recharged by the parent company from abroad to the Croatian employer (which is usually the case), such income should be regarded as employment income for taxation purposes of the employee. In the presented case, such interpretation would result in an effective personal income tax and social security rate of 93,17%. More details on the calculation are as follows.

<sup>1</sup> Market value of shares at the vesting date.

<sup>2</sup> Tax is payable in the moment when the employee has the right of disposal of the shares (i.e. at the date all conditions are satisfied).

<sup>3</sup> Tax and social security rates for 'other income' are applied. Flat tax rate of 24% and flat social security contributions at rate of 10% (pension insurance only as the income is received from abroad) are applied by using the gross up method.

In line with the Croatian Social Security Contributions Act, Article 114, Paragraph 2, the income received in shares from a foreign parent company which is not the formal employer of the Croatian employee is considered as "other income" for the social security purposes and is subject to pension insurance contributions at the rate of 10%<sup>4</sup>.

As the income from Employee Share Plan is treated as a benefit in kind, the fair market value of the shares represents the employee's net income. According to the Article 22, Paragraph 4 of the Croatian Personal Income Tax Bylaw, if an individual receives net income, to calculate the respective personal income tax and social security liabilities, the gross up taxation method should be used.

The application of the above calculation method to an employee who would otherwise be on the highest marginal personal income tax rate<sup>5</sup>, would result in an effective personal income tax and social security burden of **93,17%** for the employee.

Thus, an employee who receives shares from participation in an Employee Share Plan on the basis of his employment relationship, being fully compliant with the law and remitting his liabilities to the Croatian Tax Administration, receives EUR 245,90 (6,83%) out of EUR 3.600 (100%).

Therefore, the personal income tax and social security obligations for income received from abroad fall solely on the employee. In many cases the employee must immediately sell the shares in order to settle the personal income tax and social security liabilities.

From an administrative point of view, as the income is received from abroad (provided by the parent company) the employee is personally obliged to compute, report and pay tax and social security contributions liabilities on this income<sup>6</sup> to the Croatian Tax Administration.

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<sup>4</sup> Same social security calculation method is used when the income received from Employee Share Plan is considered as 'other income' for taxation purposes.

<sup>5</sup> Highest employment income tax rate is 36% increased for Zagreb city tax (18%).

<sup>6</sup> In line with the Personal Income Tax Act, Article 81 Paragraph 1 and Social Security Contributions Act, Article 112.

# Discrimination arising due to application of current legislation

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## *Employees of credit institutions (banks)*

Credit institutions (banks) in Croatia are governed by the Special Croatian National Bank regulation<sup>7</sup> that prescribes the method of compensation for their employees in Croatia. To comply, banks are liable to pay a significant part of variable compensation to their employees in deferred financial instruments (i.e. various Employee Share based Plans).

In practice, this means that financial institutions can pay only a smaller part of variable compensation (e.g. bonus) in cash and in gross amount, and are obliged to provide the remaining part to their employees through various Employee Share Plans as a net benefit in kind which, due to gross up requirement, results in tax and social security burden exceeding 90%.

In line with the relevant regulations, for credit institutions such plans are no longer an option but a mandatory requirement, if they wish to reward their employees. For them, rewarding employees in payment of cash compensation (e.g. bonus) is no longer possible.

These employees, compared to employees of “non-credit institutions”, are heavily discriminated if they are compliant with the law. Based on the sample case presented, their income is taxed as net benefit in kind with an effective rate of 93,17% compared to a rate of 48,23% which would apply to cash compensations paid in gross.

## *Capital income for board members vs. employment income for employees<sup>8</sup>*

Based on the Article 68 of Croatian Personal Income Tax Act, if a board member of a Croatian company who is not in an employment relationship with this company, receives income from an Employment Share Plan through allocation of company's own shares listed in the Croatian stock exchange, such income will be regarded as net capital income. This income is not subject to social security contributions and is excluded from taxation at the end of the year. In this case the effective taxation rate is 39,51%<sup>9</sup>.

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<sup>7</sup> Decision on employee's receipts (Official gazette 31/17)

<sup>8</sup> This sub-chapter assumes different background information i.e. that based on the Employee Share Plan, Shares are provided by the Croatian company and they are listed on Croatian stock exchange.

<sup>9</sup> In this case receipt is considered as net capital income and subject to 24% tax rate (increased for 18% city surtax)

For an employee (including an employee who is also a board member) of the same Croatian company who is participating in the same Plan and receiving the same income from the Employment Share Plan, social security contributions are due. Effective taxation rate in this case exceeds 100%<sup>10</sup>.

Therefore, on the same type of income board members (who are not employees of the company) are released from payment of social security contributions, while employees are liable to pay them in full amount. Implementation of such regulations creates discrimination based on an individual's position in the company and allows a more favorable social security and tax treatment of individuals who are board members only, in comparison to other employees.

## Current Central and Eastern Europe (CEE) region taxation

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<b>Effective personal income tax and social security burdens</b>	
<b>Croatia</b>	<b>93,17%</b>
<b>Slovakia</b>	<b>35,05%</b>
<b>Hungary</b>	<b>30,34%</b>
<b>Slovenia</b>	<b>25,00%</b>
<b>Czech Republic</b>	<b>22,00%</b>
<b>Romania</b>	<b>16,00%</b>
<b>Poland</b>	<b>14,37%</b>

According to regional studies, international companies have begun to heavily invest in the Central and Eastern Europe (CEE) region due to its rapidly growing economic environment, whilst among the countries Poland is the leader in terms of headquarters locations.

Based on the survey conducted by KPMG in Croatia, the above table shows the effective personal income tax and social security burdens imposed on the income received from Employee Share Plans (the average rate in the region is 23,79% excluding Croatia) in the CEE countries. Having in mind that Poland has the lowest effective tax rate levied on the income from Employee Share Plans, this may as well be considered attractive and one aspect to consider when analysing the influx of foreign investments in the country.

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<sup>10</sup> In this case receipt from is considered as net employment income for tax and social security purposes i.e. taxable at the marginal employment income tax rate of 36% (increased for 18% city surtax) and full social security contributions apply (20% - pension insurance and 17,2% healthcare, injury at work and unemployment insurance)



Comparing the effective tax burdens to the Croatian effective tax burden, the difference is extremely high, i.e. the Croatian effective tax burdens are approximately 5-6 times higher than the lowest effective burdens in the region.

Unrealistically high tax burdens in a country often lead to tax evasion that can only be suppressed if the state provides taxpayers with some favorable alternatives for taxation.

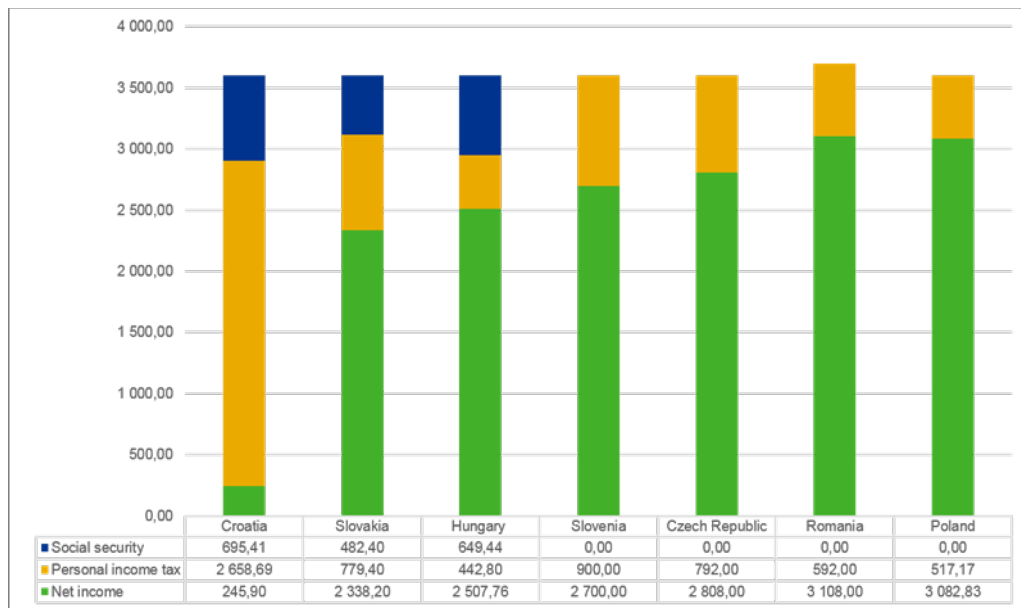


Chart title: Total tax and social security burdens vs. actual net receipts per countries in the CEE region (source: KPMG Croatia survey)

The above chart represents the ratio of the net income, personal income tax and social security liabilities calculated according to the currently applicable rules and regulations in each tax jurisdiction. Every country involved in the analysis, except Croatia, considers the income from Employee Share Plans as a gross receipt.

In the case of Slovakia, Hungary, Slovenia, the Czech Republic and Poland, the taxation point is the vest date, i.e. when the Employee has the right of disposal of such income and the income is considered as employment income.

Different rules are applicable according to the Romanian regulations, where the taxation point is the date of sale of the shares. Romania does not consider the income as employment income, but capital income. Taxable income in this case is the difference between the market value of the shares at the moment of sale compared to the price paid at the date of vest.

Besides Croatia, only Slovakia and Hungary impose social security contributions on such income. As a general comment received from these countries, applicable tax and social security liabilities due on this income are generally lower than such

burdens imposed on employment income, due to the fact that such income is predominantly provided to an employee from outside of the country.

## European position on unrealistically high taxation of income

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The Hungarian State recently faced a law suit in front of European Court of Human Rights in Strasbourg due to (among other claims) unrealistically high taxation of individual income.

The Hungarian State levied a 98% tax burden on a severance payment granted to a civil servant. The case was investigated by the European Court of Human Rights (application no. 66529/11, final judgment issued on 4 November 2013). The Court decided that an unrealistically high tax was imposed on the income by the Hungarian State and in its ruling it referred to European basic principles. The judgment stated that a 98% tax is contrary to the possession and peaceful enjoyment of property (determined in the Protocol of the European Convention on Human Rights) and therefore is not in line with basic European principles. As a result of the Court's decision, the Hungarian State reduced the tax rate.

## Recommendation

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### *Employee Share Plan income to be treated as gross capital income*

In order to follow European trends, we propose to amend the Croatian personal income tax regulations in such a way to allow that the income received based on an employee's participation in an Employees Share Plan governed by a Croatian company or by a foreign parent company of a group the Croatian company is a part of, is treated in the same way as the employee's private investment income that the employee would realize on the open public market (e.g. dividend income and capital gain taxation).

We therefore propose that share based receipts based on an employee's participation in an Employee Share Plan are treated as gross capital income taxable with the personal income tax rate of 12% plus city surtax (the effective tax rate for an employee tax resident of Zagreb would be 14,16%) and exempted from social security contributions.

## Conclusion

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The application of the provided recommendation would ensure equal and simple tax and social security treatment of all receipts realized from Employee Share Plans regardless whether these receipts are provided to employees or board members or if they are received from Croatia or abroad.

Also, this would eliminate unfair taxation for employees of financial institutions in Croatia that are forced to receive part of the bonus in kind (net) and as a result are more heavily taxed.

By applying the recommendation Croatia will increase transparency, reduce tax evasion and eliminate discrimination based on the function an individual performs within the company or in specific industry sector. It will also decrease the possibility of disputes against the Croatian state that Croatian companies and individuals may raise in front of European Court of Human rights.

Since, based on the recommendation, the overall tax burden on Employees Share Plans would decrease, Croatia would become a more favorable country for foreign investments, primarily for setting up regional headquarters, from which the entire Croatian economy would benefit.

## Appendix 1.

	Current treatment		Recommendation
	Net other income	Net employment income	Gross capital income
<b>Input</b>			
Net receipt	3.600,00	3.600,00	
Gross receipt			3.600,00
Gross income	5.580,36	6.954,10	3.600,00
Social security contributions	10%	695,41	n/a
Tax base	5.022,32	6.258,69	3.600,00
Personal income tax <sup>7</sup>		2.253,13	432,00
City surtax	18%	405,56	77,76
Total personal income tax and city surtax		2.658,69	509,76
<b>Net Income</b>	<b>3.600,00</b>	<b>3.600,00</b>	<b>3.090,24</b>
Additional year-end PIT liability	711,16	n/a	n/a
Receipt received by the employee	3.600,00	3.600,00	3.600,00
Total PIT and s/s liability	2.691,52	3.354,10	509,76
<b>Effective s/s and PIT rate</b>	<b>74,76%</b>	<b>93,17</b>	<b>14,16</b>
Actual receipt received by the	<b>908,48</b>	<b>245,90</b>	<b>3.090,24</b>

<sup>7</sup> The following personal income tax rates are applied at the moment of the tax withholding: capital income - 12%, other income - 24%, employment income - 36%

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