Additional commentary on the Windfall Tax Bill

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AmCham

American Chamber of Commerce in Croatia Američka gospodarska komora u Hrvatskoj

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Comments

Groundlessness of the introduction of the windfall tax

We want to point out that the objectives of the Regulation are to cover the taxation of income which is the result of unexpected circumstances. Considering that the introduction of a windfall tax includes a large number of taxpayers whose profits, i.e. rise in profits, are not the result of unexpected circumstances, the introduction of a windfall tax is not based on the Regulation since it goes against the purpose and goals of the Regulation.

Retroactive application of the Act compared to legitimate expectations

The abovementioned Bill puts medium-sized and large businesses at a disadvantage, and it is not in accordance with the Constitution of the Republic of Croatia (Article 90) and the case law of the Constitutional Court (U-I-3685/2015 of April 4, 2017) because it allows for retroactive application.

If such a bill had been passed earlier, when the Government could already foresee the upcoming social threat to citizens, businesses would have preemptively considered the necessary measures they needed to take in their operations (such as realizations of investments, employment, etc.) in order to curtail the sudden and drastic negative effect of the Bill on their economic results and, consequently, on their owners/shareholders and employees. For the reason outlined above, this Bill has been passed too late and it unjustly penalizes businesses that have spent the last few years strongly improving working conditions for their employees, investing in R&D, fixed assets and various projects, and thereby consciously, determinedly and purposefully decreasing profit in order to increase it in the upcoming periods.

Consequently, with regard to the method of calculating the average profit of previous periods according to the Bill, we believe it is unjust that the profit is calculated for all tax periods in which the taxpayer operated (during the last four years).

We believe that the only just method of establishing this criterium would be to take into account only periods in which the taxpayer realized gains (a positive economic result).

Additionally, AmCham proposes **to increase the corrective factor for the base from 20% to at least 50%** in order to adjust unrealistically low income generated in previous years to a more normal level.

It is especially important to note that realized profit represents the assets of a company, that is, an acquired right. A regulation of this kind has the effect of interfering with acquired rights for which there are **legitimate expectations** of those to whom the existing legislation applies.

Unfavorable economic circumstances

The Bill states that a windfall tax is determined and paid in case of unfavorable economic circumstances in the Republic of Croatia. According to this formulation, it follows that the tax is not determined or paid in case of favorable economic circumstances in the Republic of Croatia.

We suggest a clear definition of the criteria and a clear definition of unfavorable economic circumstances.

Allocation

As the Government emphasizes, the objective of introducing a windfall tax is a one-time redistribution of resources that takes from the above-average profitable part of the private sector and gives to socially disadvantaged citizens. We believe that this kind of one-time redistribution will not solve the problems of the targeted groups of citizens. Furthermore, it will create a new kind of precarity for one part of the private sector in operating conditions that are already precarious enough. Moreover, the criteria for redistribution are not even established in the Bill.

Additionally, Article 17 of the Council Regulation (EU) 2022/1854 stipulates the use of revenue of the member states from temporary solidarity contributions and defines it as assigned revenue that can be used only for measures that are exhaustively listed in the Article. These measures are intended to help those who have been disadvantaged by the rise of energy prices. The same Article also stipulates that these measures must be clearly defined, transparent, proportional, non-discriminatory and verifiable. Since the Act also ensures the implementation of the Regulation, **it is mandatory to comply with the aforementioned provision of the Regulation in such a way as to clearly prescribe the measures for which the money collected through this tax will be used**.

Article 13 of the Bill

Article 13, paragraph 1 of the Bill reads as follows:

"*The following incomes shall not be taken into account when determining the amount of income referred to in Article 4, paragraph 1 of this Act, taxable profit referred to in Article 6 of this Act, and taxable profit of previous tax periods referred to in Article 7 of this Act: income resulting from the write-off of liabilities by creditors in pre-bankruptcy and bankruptcy proceedings, income in bankruptcy proceedings resulting from the sale of assets to pay creditors, and* ***income or profit from the sale of fixed tangible or intangible assets to an unrelated party****, if the assets were used in the process of production or provision of services.*"

1. General Comment

First of all, Article 13 of the Bill prescribes income not taken into account when calculating the income in the amount of HRK 300 million referred to in Article 4 of the Bill, and when calculating taxable income in 2022 and the preceding year, which are limited to income from write-offs of liabilities on the basis of bankruptcy and pre-bankruptcy proceedings as well as income from the sale of fixed assets used in the process of production or provision of services.

We also deem it necessary to **widen the scope of the income not included in the calculation of the income in the amount of up to HRK 300 million referred to in Article 4 of the Bill** to other income not arising from regular operations such as releases of provisions, financial income (such as exchange rate income), state subsidy income etc.

We also deem it necessary to widen the scope of the income referred to in Article 4 of the Bill not included in the calculation to encompass income exempt from taxation (e.g. income from dividends etc.).

Additionally, we also draw attention to other income which may be significant but which is, in principle, extraordinary (one-off) income generated as a result of extraordinary business circumstances (e.g. income from the sale of enterprises and similar). In that respect, we deem it necessary to widen the scope of income not subject to the windfall tax to all extraordinary income items.

Furthermore, we propose to take into account an additional deduction in the calculation of the tax base (Articles 6 and 7 of the Bill) and in the calculation of the income referred to in Article 4 of the Bill by the amount of the total cost of benefits to employees such as the amounts of breaks provided in assisted areas and incentives provided under the Investment Incentives Act specified as items 45-52 of the PD form, additionally reducing the tax liability. We ask the tax authority to clearly prescribe that costs are recognized in the calculation of the tax base in accordance with the IFRS 16, Leases.

Limiting the Exemption of Income From the Sale of Fixed Intangible and Tangible Assets to Unrelated Parties

Pursuant to Article 13 of the Corporate Tax Act, if prices or other conditions are agreed between related parties in their business relations, **which differ from the prices or other conditions that would be agreed between unrelated parties**, then the taxable person must carry out an adjustment for the amount of profit that would have been realized if it had been a matter of relations between unrelated parties.

Business relations between related parties are recognized only if the taxable person **possesses and, upon request of the Tax Administration, provides data and information about related parties and business relations with these parties**, the methods used to determine comparable market prices, the reasons for choosing specific methods, and the way in which adjustment is performed.

Pursuant to Article 14 of the Corporate Tax Act, when determining income from interest on loans granted to related parties, interest is calculated at least up to the interest rate **that would be realized between unrelated parties** at the time of loan approval. When determining expenditure from interest on loans received from related parties, accrued interest is recognized up to the interest rate **that would be realized between unrelated parties** at the time of loan approval.

Pursuant to Article 40 of the Ordinance on Corporate Tax, the taxable person must, based on the information available to it at that moment, before the start or at the time of the supervised transaction, **provide documents and records that prove the reasonable efforts undertaken to set the price in accordance with the arm's length principle**.

In accordance with all the above, we believe that the intention of the corporate tax act, when it comes to the business of related parties, is to ensure that the relationships and prices in those relationships are in line with the levels that would be agreed upon by unrelated parties under comparable conditions. Therefore, related parties should not be penalized for the sole fact that they are related parties, provided that they respect the arm's length principle of the transaction (i.e. the principle of independence).

We believe that a formulation which states that income will not be taken into account only when assets are sold to an unrelated party results in a disadvantageous position for all undertakings which are part of a group or which have related parties in the country and/or abroad, in spite of making the sale in accordance with the arm's length principle.

Since the law already provides mechanisms for proving that a certain transaction was made in accordance with the arm's length principle (transfer pricing methods, OECD Guidelines, long-standing practice in Croatian legislation, etc.), we see no obstacle to the same **exemption of sales income being applied to related companies**, if they can prove that the sale was made at market prices, i.e. using one of the prescribed transfer pricing methods.

AmCham's Proposed Amendment to the Article

In conclusion, we prose that the Article be amended as follows:

"The following incomes shall not be taken into account when determining the amount of income referred to in Article 4, paragraph 1 of this Act, taxable profit referred to in Article 6 of this Act, and taxable profit of previous tax periods referred to in Article 7 of this Act: income resulting from the write-off of liabilities by creditors in pre-bankruptcy and bankruptcy proceedings, income in bankruptcy proceedings resulting from the sale of assets to pay creditors, other income that is not a result of regular business such as the release of provisions, financial income, state subsidy income, income exempt from taxation under regulations on corporate income taxation, as well as one-off income generated as a result of extraordinary business circumstances, and income or profit from the sale of fixed tangible or intangible assets to an unrelated party, if the assets were used in the process of production or provision of services. The same shall also apply to income from the sale of fixed tangible or intangible assets to a related party in the country or abroad, provided that the taxable person possesses and provides, at the request of the Tax Administration, documents that can prove that the sale in question was performed

in accordance with the arm's length principle, i.e. applying the methods for proving the arm's length nature of transactions referred to in article 13 of the Corporate Tax Act. Taxpayers may include total costs of benefits to employees as an additional reduction of the income and taxable income under this article, as well as the amounts of subsidies for assisted areas and incentives paid under the Investment Incentives Act whose total amount is stated in item 52 of the PD form. Costs stated in accordance with the IFRS 16, Leases are also used and recognized in the calculations."

Article 15a – proposal of a new article

AmCham proposes a new Article 15a which reads:

"If the taxpayer liable for corporate income tax performed status changes in the previous tax periods and in the relevant Tax Return period and assumed, as the legal successor, rights and liabilities of merged, acquired or spun-off taxpayers arising from the tax legal relationships, the calculation made for the determination of the windfall tax liability referred to in Article 5 of this Act shall be adjusted for the influence of these status changes by calculating the average taxable income in the previous tax periods referred to in Article 5, paragraph 1 of this Act as the sum of amounts of taxable income in the previous tax periods determined in accordance with Article 7 of this Act for each company participating in the status change divided by the number of tax periods in which the taxpayer operated."

Explanation

The proposed provision takes into account the increase of the tax basis of the current period in relation to the average in the preceding periods for the specific company due to a performed status change, e.g. a merger, which is then appropriately included or excluded from the calculation.

For additional information, please contact:
American Chamber of Commerce in Croatia
Andrea Doko Jelušić,
Executive Director T: 01 4836 777
E: andrea.doko@amcham.hr