Recommendations for Tax Reform in 2020

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AmCham

American Chamber of Commerce in Croatia Američka gospodarska komora u Hrvatskoj

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Introduction

According to AmCham's *Survey of the Business Environment in Croatia*, taxation of labor and the tax burden are seen as one of the main limiting business factors in Croatia, but the effect of the previous tax unburdening has been noted.

Main limiting factors for doing business in 2018:
1) Lack of adequate workforce
2) Unstable regulatory framework
3) Taxation of labor

Main limiting factors for doing business in 2019:
1) Taxation of labor
2) Lack of adequate workforce
2) High taxation on doing business

The greatest disadvantages of doing business in Croatia compared to CEE countries (2019) were, in equal proportions, the small size of the market and level of taxation and thirdly slow administration.

AmCham has welcomed tax unburdening to date, presented through four rounds of tax reform, particularly measures related to:

- Equity plans
- Equalizing the VAT rate on medicinal products
- Raising the monthly gross amount with an income tax rate of 24%
- Introducing possibility to reward employees through a non-taxable amount of up to HRK 5,000
- Introducing possibility of non-taxable payments regarding the accommodation and meals for employees
- Introducing possibility of payments of supplementary/additional health insurance premiums up to HRK 2,500 a year per employee as non-taxable income
- Increasing the non-taxable part of income (that is, personal deduction) from HRK 3,800 to HRK 4,000
- Introducing voluntary reporting of tax liability regarding the foreign income earned by natural persons

AmCham believes that further tax unburdening is necessary.

The American Chamber of Commerce in this position paper sets out recommendations for the further reduction of the tax burden aimed at attracting investment and greater competitiveness of Croatian employers in attracting and retaining the workforce.

General Recommendations

Better legislation

Frequent changes and amendments to tax regulations is one of the key features of the Croatian tax system. Frequent, unpredictable, and non-standardized changes to the tax system, regardless of content, are not good for the economy. The announcements by the Ministry of Finance that there will be no tax changes in the current year if they had not been agreed on in the previous year, as well as the practice of planning tax regulations in the previous year, AmCham sees as a positive move, but it is important to keep this principle in the future.

Tax authorities as partners to the business community

AmCham members often report on their impression that tax inspectors are focused on looking for errors in order to penalize businesses. Inspectors and the Tax Administration should position themselves as advisors to the business community. If it is clear that an error was unintentional, it is sufficient and far more useful to issue a warning with a plan to rectify the error.

In a considerable number of cases, tax inspectors discover an error in the books and build a case to penalize companies, leaving them with the sole option of going through years of appeals and litigation. Such behavior by the tax authorities directly affects the business and investment environment in the country.

In accordance with the best practices of tax authorities in developed countries, when entrepreneurs voluntarily inform the tax authorities of previously miscalculated taxes or other procedural errors, the Croatian Tax Administration should take their initiative and openness into consideration, mitigate possible adverse consequences (additional liabilities and penalties), and cooperate with the entrepreneur on solving the problem.

It is important to stick to the principle of proportionality. Family run farms or small businesses often do not have a permanently employed accountant and it is not justifiable to have the same expectations and demands from them as from larger companies with accounting departments. Examples of practices show inconsistent conduct of tax officers, who often have requests that cannot be met within the set deadlines.

AmCham invites the Tax Administration to be more proactive in the area of preventive measures, instead of issuing additional tax liabilities and fines in cases of mere oversights (such as not submitting a blank VAT form).

Separation of first- and second-level tax authorities

The Tax Administration, which is responsible for tax decisions, and the appellate body, i.e. the Independent Sector for Second-Instance Administrative Procedure, should be strictly separated not only formally, but in practice as well. Further progress must be made in the area of reaching higher levels of expertise and experience of second-instance body experts.

The current appellate body often only confirms tax decisions made at first instance. In these circumstances, appeals against first-instance decisions seem meaningless and often only prolong the process.

Specialization of administrative judges for finance (primarily tax) law is also necessary. As a rule, judges dealing with a very wide range of administrative disputes from different legal areas also decide on highly sophisticated financial and tax cases, and their judgments, as a rule, have significant financial consequences.

Obligation to pay arising only after the administrative dispute

According to the existing legislation, the order of activities and obligations is as follows:

Tax audits are performed by the Tax Administration or (e.g. in the case of special taxes on motor vehicles) the Customs Administration;

After an audit, a record is made followed by a tax decision, against which the legal entity may appeal before the Independent Sector for Second-Instance Administrative Procedure;

If the second-instance body confirms the decision, the legal entity is entitled to initiate an administrative procedure before the Administrative Court, but this does not delay the collection of the tax liability determined by the decision.

The Tax Administration can thus cause damage difficult to repair to the legal entity in a very short period of time, e.g. cause it to become insolvent or bankrupt, while the legal entity depends on the agility of the Administrative Court where disputes usually last several years.

Introducing voluntary reporting of undisclosed tax liabilities

The General Tax Act and other tax regulations related to the determination, calculation, and reporting of certain types of taxes prescribe penalties for tax misdemeanors and calculation of default interest on late liability payments. According to the provisions of the General Tax Act, interest is charged starting from the due date of a particular tax liability, and the maturity of a particular type of tax

is determined by special laws. As a rule, a tax liability becomes due on the day the tax liability arises.

In the tax systems of some EU member states, "voluntary disclosure of undisclosed tax liability" has been introduced. Its purpose is to encourage taxpayers to voluntarily disclose undisclosed tax liabilities before the Tax Administration determines these undisclosed tax liabilities during a supervisory procedure within the statute of limitations deadlines. In return, the Tax Administration, depending on the amount of the undisclosed tax liability and the circumstances that led to the failure to disclose on time (with or without the intent to evade), reduces the penalty and interest rates in percentages depending on the circumstances that are specifically defined.

AmCham has welcomed the introduction of voluntary reporting of tax liability regarding the foreign income earned by natural persons as a part of the Article 12.b of the General Tax Act, however, it has deemed that such possibility should also be introduced for other tax types.

The introduction of the proposed measure would create a positive environment in relations between taxpayers and tax authorities and serve as an incentive for taxpayers to voluntarily approach the Tax Administration and disclose tax liabilities that were not disclosed on time, while at the same time being aware of the material consequences of such an act, which should be less than in the case when the Tax Administration determines the liability itself.

Issuing certificates by the Tax Administration on the absence of tax debts promptly and on the basis of the current situation

Issuing certificates on the status of tax debt is facilitated by the good functioning of the ePorezna system, which AmCham welcomes. However, despite this system, the accuracy of the data on the tax debt status depends on timely data entry, which is performed by the Tax Administration. It is important to continue to increase efficiency in this respect.

For the purpose of further facilitating the participation of entrepreneurs in public tenders for which they regularly need confirmation that they do not have tax debts, it is suggested that debts of up to a reasonable amount, e.g. of up to HRK 1,000, should also be treated as the absence of tax debt. This can easily be achieved in the system in a way that debts below this particular amount do not appear at all on the tax debt print-out, as if there is no tax debt at all.

A similar measure was temporarily introduced while implementing the procedure of tax payment in special circumstances caused by the COVID-19 pandemic in the Ordinance on the Implementation of the General Tax Act. According to the Ordinance provisions, if the amount of the tax debt is less than HRK 200.00, which is the lowest cost of the enforcement proceedings according to the provisions of the General Tax Act, it is deemed that there is no uncollected tax debt due.

Administrative measures for facilitating business operations of entrepreneurs and the Tax Administration

Entrepreneurs often complain about a high level of bureaucracy, i.e. a large number of administrative requirements they have to fulfill for their tax and related liabilities. Further relief is proposed based on the digitization and automation of the entire system (modernization of the Tax Administration IT system), which would contribute to the increase of transparency, equal treatment, and simplifying processes, and would be more environmentally friendly ("paperless business"). A large number of forms does not contribute to easier business operations. In addition, forms should be simplified. For example, what presents a difficulty is a large number of codes used in "JOPPD" forms or a large amount of data in VAT returns (e.g. the UK VAT form contains 5 to 7 fields, while the Croatian one has more than 20), the "RPO" form (taxpayer registration) and the like.

It is also desirable to differently arrange the issuing of the Central Tax Administration Office's opinion to the taxpayers, outside the system of binding opinions issued within a special procedure. An illustrative example is the question asked on August 6, to which the response was received at the end of the year. In comparison, in the UK, the same entrepreneur received a response within a few days.

It is important to implement measures aimed at improving the investment environment through a cheaper and simplified way of doing business.

Extending the period of tax loss carryforward

Existing regulations on the five-year loss carryforward do not encourage long-term investments, especially not investments in high-tech. It is necessary to extend the loss carryforward period in accordance with the best European and global practices. For example, Austria has a period of 7 years, while the US has 20 years. We believe that this period in Croatia should be extended from 5 to 10 years. A good example could be the solution implemented by Slovenia, where there is no time limit for the tax loss carryforward, but every year only 50% of the realized profit can be covered by the loss carryforward, and for 50% corporate tax needs to be paid.

Correction of tax liabilities due to uncollectible receivables

Croatian tax legislation does not provide for bad debt VAT relief, nor is there a possibility of unilateral VAT adjustment without the customer's written confirmation of having adjusted input VAT in its VAT records. Many customers are not willing to perform the adjustment and provide the required confirmation. AmCham believes that the Croatian Tax Administration (CTA) should allow for unilateral VAT adjustment for bad debts by adjusting Croatian VAT legislation to align with EU rules.

The key reasons for an urgent need for the change in the Croatian VAT legislation arise from the recent practice (judgments) of the CJEU (Court of Justice of the European Union). The Court is in favor of the taxpayers' entitlement to reduce the taxable amount in case of non-payment even in cases where EU Member States do not allow such reduction as is the case in Croatia (and the tax authorities of the Member States have to follow the Court's judgments). Amongst other, it comes from the practice of the Court that:

- Forbidding the reduction of the taxable amount in case of non-payment would be contrary to the principle of tax neutrality,
- Member States may prescribe conditions for reduction of the taxable amount with the aim to prevent tax evasion or avoidance.

However, these measures have to be limited to achievement of these goals and should interfere as little as possible with principles of the VAT Directive, especially with the principle of neutrality. Particularly in case of non-payment, these conditions should be limited to taxpayer obtaining the proof that the consideration charged to the buyer for the supply would not be received.

The taxpayer can reduce the taxable amount once it is definitive that the customer will not pay the full price for the supply or when the taxpayer can show with reasonable probability that the debt will not be honored.

Legislative provisions provide Croatian taxpayers with the possibility of amending obligations on the basis of VAT in relation to bad debts, but the amending is made more difficult for the taxpayer due to the procedure involved. Namely, one of the conditions for amendment is that the taxpayer who has supplied the goods or performed a service must have a written statement from the recipient of the delivery that they have amended the input tax deduction in their business books and records. In other words, an amendment is not possible without the customer's cooperation.

For example, the UK tax system imposes an automatic and legal obligation on customers to refund input tax to the Tax Administration if they have not paid their suppliers within six months of delivery of goods or service received. The American Chamber of Commerce also believes that the Croatian Tax Administration should, by changing the legal regulations, also be involved in the process of collecting bad debts and prescribe a deadline for taxpayers to make an amendment of the input tax if they have not paid their suppliers on time. This would facilitate the amendment process to taxpayers who were unable to collect payments for the delivered goods and performed services, while at the same time having to pay VAT with their own funds because they could not collect their debts from customers. The burden of amendment would also be shifted from the taxpayer to the Tax Administration, which is considered a more appropriate and effective procedure.

Many EU countries allow bad debt relief from the VAT perspective and prescribe certain formal requirements in this regard. For example, in the Czech Republic, France, Greece, Italy, the Netherlands and Slovenia, for the application of the bad debt relief it is generally required that the debtor enters a formal bankruptcy or other insolvency procedures as defined by the law, often with additional limiting

conditions for the application of the bad debt relief (e.g. amended supplier invoice or credit note, court ruling, and similar).

On the other hand, the application of a bad debt relief in Belgium lays down only the condition that a bad debt has to be reported in financial statements and other reporting obligations, such as the issuance of a corrective document that includes specific information with regards to the bad debt at the moment when the supplier is able to prove by all means that the receivable is to be considered as lost. Similar conditions that enable a wider scope of application of the bad debt relief are also applied, for example, in Austria, Cyprus, Denmark, Ireland, Latvia and Poland, with an additional condition of issuance of a written notification by the supplier to the customer (purchaser), based on which the customer has an obligation to adjust (i.e. reduce) its input VAT. AmCham believes that there are no obstacles to implementing such a solution in the Croatian tax system.

Therefore in order to adjust its regulations to positive practices in other EU countries, AmCham suggests that current Article 33 (7) of the Croatian VAT Act, is changed in the following way "if the taxable amount is subsequently changed due to revocation, various discounts or the inability to collect, then the taxable person who supplied the goods or services may correct the VAT amount if it informs the taxable person for whom the goods were supplied or services performed in writing of the amount of the VAT for which the buyer does not have the right for deduction".

AmCham also suggests that the following paragraphs are added to the Article 33.

(8) The taxpayer can also repair (reduce) the amount of VAT charged if after a final court decision on the completion of bankruptcy proceedings or the successful completion of the compulsory settlement proceedings the taxpayer's receivable has not been repaid or not repaid in full. A taxpayer can act in the same way if it obtains a final court decision terminating the enforcement proceedings or other document which shows that the completion of the execution procedure it's receivable has not been repaid or not repaid in full. The same applies to the taxpayer which has not been repaid or it has not been repaid in full because the debtor has been deleted from the register or registers or other relevant statutory records.

(9) Notwithstanding the preceding paragraph, if the taxpayer subsequently receives a payment or a partial payment for the supply of goods or services, the taxpayer must correct (reduce) the amount of the accordingly unpaid VAT, i.e. pay the respective amount of VAT to the state budget.

Further rules regarding the reduction of the VAT obligation due to inability to collect as prescribed by the Article 43 (1) of the VAT Rulebook remain the same: "If the remuneration is subsequently decreased due to various discounts which the supplier approves to the buyer, such as discounts due to earlier payments, rebates and other types of bonuses, or due to inability to collect, the taxable amount is decreased in accordance with Article 33 (7) of the VAT Act.".

Extension for Personal income tax and Corporate profit tax filing deadlines

Croatian tax legislation provides for very short annual PIT and CPT filing deadlines, often leading to incomplete submissions due to lack of information. AmCham believes that the Tax Administration CTA should allow filing deadline extensions.

Exceptionally, because of the declaration of special circumstances caused by the COVID-19 pandemic, delay measures and/or installment payments of tax liabilities due, exemptions from the contribution liabilities for co-financed net salaries, exemptions from paying tax liabilities and the implementation of other provisions regarding the procedures during the special circumstances have been introduced by the General Tax Act and the Ordinance on the Implementation of the General Tax Act. Other provisions stipulate the exceptional deadline extension for submitting the income tax return and other related forms and reports until 30 June of the year in progress. In so doing, the maturity of liabilities of public expense by forms submitted in such a way is moved to the 31 July 2020. However, the listed provisions were applied only during the time of special circumstances.

a) *Personal income tax*

Personal Income Tax reporting dates[1]			
	Deadline*	**Extensions**	
Croatia	**28 February**		
Bosnia and Herzegovina	28 February		
Slovakia	31 March	30 June	30 September[1]
Czech Republic	01 April	01 July	01 November[2]
Austria	30 April	30 June[3]	
Poland	30 April		
Serbia	15 May		
Hungary	20 May	20 November[4]	
Slovenia	31 May	31 July[5]	
Germany	31 July	28 February[6]	
Italy	31 October		

*in the current year for the previous year

[1] June if the tax authorities have received a notification for extension. September for individuals who receive foreign source income.

[2]July if filing with the assistance of a tax advisor. November for individuals who receive foreign source income.

[1] https://www.ey.com/Publication/vwLUAssets/ey-2018-19-worldwide-personal-tax-and-immigration-guide/$FILE/ey-2018-19-worldwide-personal-tax-and-immigration-guide.pdf On 24.7.2019.

[3]June for individuals who file electronically, but only if they earn over a minimum amount from sources other than their employment or are employed by more than 1 employer at once.

[4]If taxpayer is not personally accountable for lack of the information for submission.

[5]Only if individual does not receive the calculation from the government by 31 May.

[6]If filing with the assistance of a tax advisor, for the second following year (e.g. 28 February 2020 for 2018 tax return)

Croatian PIT legislation provides very short annual PIT filing deadlines, which are 31 January (INO-DOH form) and the last day of February (ZPP-DOH form) of the current year for the income received in the previous year. In practice, this often leads to incomplete documentation being submitted, especially for individuals who receive income from abroad. Namely, at the moment of submission, these individuals do not have full information on income received from abroad; or on foreign tax liabilities which can be utilized as a tax credit against Croatian tax liabilities and, in some cases, even on their tax residence position.

AmCham recommends that the Croatian PIT legislation be amended so that:

- the deadline for annual PIT filling is 31 March of the current year for income received in the previous year.

- individuals, who on 31 March do not have full information on income received from abroad and foreign tax liabilities, may request an "automatic" extension of the PIT filling deadline to 30 November of the current year for income received during the previous year.

In accordance with AmCham's proposal, the general deadline for annual PIT filling will be 31 March of the current year for the income received in the previous year (instead of the current applicable deadlines of 31 January and the end of February).

An individual who receives income from abroad and does not have full information on income from abroad received in previous year and foreign tax liabilities, will notify the CTA and request an extension of the deadline. This notification is to be submitted by 31 March of the current year for income received in the previous year (AmCham suggests that the notification's content and form is prescribed by PIT legislation). Once the individual will have full information on income received from abroad and foreign tax liabilities he/she will file Croatian annual forms, but not later than 30 November of the current year for income received during previous year.

This proposal is in line with the current PIT provisions which prescribe that a certificate on tax paid abroad is to be provided to the CTA by 30 November of the current year for income received in the previous year.

It is expected that this will have a positive impact on both the individual's and the CTA's administrative capacities, i.e. it will reduce additional administration on both sides:

Individuals receiving income from abroad will not be required to submit incomplete documentation (due to lack of information) in order to meet the filing deadline and to submit the documentation once the information is received, through amendments to the previously submitted incomplete documentation (in order to report the respective income and foreign tax liabilities correctly).

The CTA will not receive non-accurate incomplete documentation, which it needs to process when received, on foreign income and foreign tax liabilities, which might lead to wrong PIT refund planning.

This proposal will also significantly ease the administrative burden and improve the compliance / reporting timetables for individuals receiving income from abroad which will be a positive development for: those Croatian individuals deriving income from abroad; and those foreign individuals working and doing business in Croatia.

b) *Corporate profit tax*

Corporate Profit Tax reporting dates[2]			
	Deadline*	**Extensions**	
Croatia[1]	**30 April**		
Bosnia and Herzegovina[2]	31 March		
Slovakia[3]	31 March	30 June	30 September
Czech Republic[4]	31 March	30 June	
Poland[5]	31 March		
Slovenia[5]	31 March		
Austria[6]	30 April	30 June	31 March / 30 April
Hungary[7]	31 May		
Germany[8]	31 May	31 December	
Serbia[9]	30 June		
Italy[10]	30 September		

*in the current year for the previous year

[1]Or 4 months after the company's year end.

[2]In Federation of Bosnia and Herzegovina; In Republika Srpska and Brčko District 90 days after company's year end.

[3]Or 3 months after the company's year end. June if the tax authorities have received notification for extension. September if the company received income from foreign sources.

[4]June automatically if the taxpayer is subject to a statutory audit. Otherwise extension can be granted at the discretion of the tax authorities.

[5]Or 3 months after the company's year end.

[2] https://www.ey.com/Publication/vwLUAssets/ey-2018-19-worldwide-personal-tax-and-immigration-guide/$FILE/ey-2018-19-worldwide-personal-tax-and-immigration-guide.pdf On 24.7.2019.

[6]June if filed electronically. 31 March / 30 April of the second following year if a taxpayer is represented by a certified tax advisor.

[7]Or 5 months after the company's year end.

[8]December if a licensed tax consultant prepares the return.

[9]Or 6 months after the company's year end.

[10]Or 9 months after the company's year end.

Under the Croatian Corporate Profit Tax Act, the deadline for filing a corporate income tax return is four months after the end of a business year. This deadline is final and no option of extension is provided for.

Many countries in the region allow for a longer deadline for filing a corporate income tax return, and in addition, many countries allow taxpayers to request an extension of the deadline.

Taxpayers who have business units and pay corporate income tax abroad are usually unable to obtain the necessary documentation for calculating the tax paid abroad by the prescribed deadline and are therefore forced to subsequently correct the filed corporate income tax return.

Furthermore, according to the Accounting Act, the deadline for the preparation and submission of (unconsolidated) annual financial statements is six months from the end of a business year. Annual financial statements are the basis for the preparation of a corporate income tax return, i.e. accounting profit is the starting point for determining the corporate income tax liability. This means that taxpayers must first prepare and determine their annual financial statements in order to have accurate and complete information for the purpose of determining the corporate income tax liability, but the legal deadline for their preparation and submission is longer than the deadline for the preparation and submission of a corporate income tax return.

In practice, many taxpayers have a problem with finalizing the annual financial statements by the deadline for the submission of a corporate income tax return, which is particularly the case in medium-sized and large enterprises, that is, enterprises that are subject to audit (and other companies that carry out audits of their financial statements). In practice, it is very demanding to close the business books, prepare the annual financial statements and audit the annual financial statements by the deadline for filing a corporate income tax return.

In some cases, taxpayers have to intervene in their business books even after filing a corporate income tax return in order to correct the errors identified by the taxpayers themselves or because of audit findings. Even though, in such cases, taxpayers prepare and submit their annual financial statements for public release, they are forced to make a subsequent correction of the corporate income tax return.

Consequently, the extension of the deadline for filing a corporate income tax return would to some extent reduce the administrative burden of taxpayers, and indirectly the Tax Administration.

Accordingly, AmCham proposes that the deadline for the filing of a corporate income tax return should be extended to six months after the end of a business year (i.e. to be equal to the deadlines for submitting annual financial statements for public release) or that taxpayers at least have the option of requesting an extension of the deadline for filing a corporate income tax return.

Income tax - reducing the tax burden on labor contributions

In the Survey of the Business Environment in Croatia that AmCham presented at the beginning of 2020, there is visible progress in terms of the reduction in the taxation of labor. AmCham believes that the Government should continue to work on further reducing the taxation of labor in order to make it more competitive compared to other Central and Eastern European countries and for it to focus on retaining the workforce in Croatia.

The KPMG table below provides an overview of tax rates and contributions in Croatia and competing markets.

Overview of tax systems in 2019	Croatia	Bulgaria	Czech Republic	Romania	Serbia	Slovakia
Corporate tax rate (in general)	12% - for generated revenue of up to HRK 3,000,000.00 18% - for generated revenue of HRK 3,000,000.01 or greater	10%	19%	16%	15%	21%
VAT rate (in general)	25%	20%	21% (reduced rate of 10% and 15% is applicable for certain goods)	19%	20%	20%
Income tax rates (wages)	24%, 36% + surtax up to 18% (the highest rate is applied to annual taxable income above HRK 360,000.00, or EUR 48,000.00 in 2018	10%	20.1% - 23.35% depending on income level*	10%	10% (+10% for annual income from EUR 20,938.00 to EUR 41,875.00, or +15% for incomes above EUR 41,875.00**)	19% (25% if annual income exceeds EUR 36,256.37)
Contributions on wages	Employee: 20% (partially limited) Employer: 16,5% (unlimited)	Employee: 13.78% (limited) Employer: 18.92% to 19.62% (limited)	Employee: 11% (partially limited) Employer: 33,8%* (partially limited)	Employee: 35% (unlimited) Employer: 2.25% (unlimited)	Employee: 19.9% (limited) Employer: 16.65% (limited)	Employee: 13.4% (partially limited) Employer: 35.2% (partially limited)

* The Czech government currently considers reducing the income tax rate; if the proposal of the new Act were adopted, new progressive rates would be 15% and 23¸%

Source: KPMG, September 2020

The table shows that Croatia is not competitive when it comes to the tax burden on labor, particularly in the area of higher incomes. This is one of the reasons why a large number of propulsive sectors in Croatia are experiencing problems with a lack of qualified workers, a fact especially evident in, for example, the ICT industry and tourism.

Reducing the tax burden on labor would contribute to the opening up of regional centers of international companies in Croatia, since due to the reduction of the public imposts burden on wages it would be more affordable for entrepreneurs to pay the best managers. This would enable Croatia to establish its position as a regional business center, where its membership in the EU and its geographical position would be of help, and expensive employment is a hindrance.

AmCham proposes three key measures:

- Increase of non-taxable personal deductions to HRK 4,800
- Decrease of income tax rate from 24% to 12%
- Decrease of the 36% income tax rate

The increase of non-taxable personal deductions to HRK 4,800, together with the proposed changes in income tax rates, would provide the working population with a greater disposable income, along with the expected increase in consumption and greater economic activity.

Increase of non-taxable personal deductions

The increase of the non-taxable part of income (i.e. personal deductions) has already been realized in several phases from HRK 2,600 to HRK 4,000. However, AmCham considers that further increase to HRK 4,800 would be beneficial for a large scope of the working population in Croatia by lowering the total tax burden and increasing net income for persons with high and middle incomes.

It would also open up space for employers of persons with net income of up to HRK 4,000 (who would not otherwise feel an effect of the increase of the non-taxable part of the salary as they do not pay personal income tax because of their relatively low salary) to consider increasing salaries of those persons as the net effect for the employee and the gross effect for the employer would be more favorable than in the situation where a 24% income tax would have to be applied to the part of the increased salary if personal deductions remained the same.

The social effects this measure would have require no further explanation.

Decrease of income tax rate from 24% to 12%

Lowering the 24% income tax rate to 12% would have a very strong impact on the Croatian economy and increase the purchasing power of a large number of working population.

The measure is proposed to further unburden relatively low or "medium" incomes. With the same cost for employers, employees receive higher net income, which increases their economic power and capacity for consumption, i.e., it increases their living standards. This indirectly positively impacts economic growth in Croatia. Over the past few quarters, the greater economic power of the population stemming from the implemented reduction of the tax burden has led to higher rates of economic growth generated significantly by personal consumption. AmCham believes that lowering the 24% income tax rate would contribute to further economic growth due to higher consumption of citizens who would have a higher disposable income.

Decrease of the 36% income tax rate

In order to fully spark investments, attract regional Headquarters and boost higher paid professions in Croatia income tax rate of 36% should be significantly lowered. Alternatively, the 36% rate should be applied only for gross monthly salaries higher than 75.000 HRK.

For professions that are relatively "better" paid, the 36% tax rate (increased by a city surtax, where applicable) represents a significant burden on income and reduces the competitiveness of Croatian employers compared to other comparable countries. Reducing this tax rate makes it possible to create/attract jobs for highly educated employees who create high added value (e.g. IT, tourism, financial sector, pharmaceuticals...). Croatia needs to keep up with the trend of employee role change in companies operating in several countries where these employees are in charge of markets in several countries. An attractive income taxation system, with a lower burden for a comparatively higher income, will attract such companies and enable Croatian tax residents to get regional roles (not necessarily managerial, but highly qualified) because these employees would have a higher net income at the same salary cost. For that reason, AmCham suggests lowering the higher tax rate or further increasing the threshold of the higher tax bracket. Both measures have a positive impact on increasing net income at the same cost.

Changes to the tax treatment of "remuneration in kind"

The Income Tax Act lays down that any remuneration paid by the employer to its worker which is not in cash falls under the definition of remuneration in kind and represents the worker's taxable remuneration (apart from certain exceptions laid down in the Act and Ordinance).

For practical purposes, this means that the actual remuneration is a net value, which, according to the definition set out in the Act, must be grossed up in order to calculate the state income, i.e. to pay the taxes and contributions. Such a calculation method leads to an extremely large tax burden, since grossing up the remuneration at the tax rates set out for the salary leads to an effective tax rate that may reach as much as 153.17% (if the individual moves to a higher tax bracket).

Moreover, the Act does not lay down any different tax treatment depending on whether the tax and contribution liabilities are paid by the employer or employee:

- If they are paid by the employer, apart from the expense itself for obtaining a remuneration in kind, such a tax burden discourages employers from enabling any kind of additional benefits to their employees (except for those expressly defined as untaxable up to a certain amount) because they find the costs simply too high;
- If they are paid by the employee, the value of the taxes and contributions that the employee must pay is higher than what they receive from the employer, therefore, the employee simply has no financial motive to accept such remuneration.

An informative research carried out by KMPG in August 2020 in several neighboring countries (Austria, Hungary, Slovakia, Slovenia) indicates that, apart from having established taxation exemptions regarding certain categories of remuneration in kind, countries generally do not treat remuneration in kind as net, but rather gross remuneration, particularly if the taxes are paid by the employees. A short list of taxation method by country* can be found below:

Hungary	Hungary has implemented various models of remuneration in kind which employers may grant their employees without paying income tax (even though they must pay the mandatory contributions), provided that the funds are paid for a specific purpose (accommodation, entertainment, leisure) and that they are spent exclusively in relation to Hungarian service providers. The amount is limited to approximately €2,280 or HRK 17,000 annually per employee. Moreover, there are certain types of remuneration that are completely exempt from taxes and contributions, such as tickets for sports and cultural events.
Slovakia	Slovakian regulations define two types of remuneration in kind: monetary benefits and non-monetary benefits. Monetary benefits are treated the same as the salary (gross remuneration), while non-monetary benefits are grossed up for the purpose of calculating the amount of taxes and contributions.
Austria	As a rule, Austria treats remuneration in kind as gross for the purpose of calculating the amount of taxes and contributions.
Slovenia	Slovenian regulations do not require remuneration in kind to be grossed up if the employee as a natural person is subject to taxation (the same treatment as cash remuneration). An exception applies only if the tax liability is assumed by the employer.

Source: KPMG, September 2020

With regard to the above and the need of finding additional methods of rewarding and incentivizing labor in Croatia, we recommend that the authorities consider deleting the provision prescribing the obligation to gross up remuneration in kind because it makes such remuneration extremely uncompetitive and administratively complex to implement. Instead, we propose that the authorities consider defining the market value of the remuneration in kind as the gross value for the purpose of tax and contribution payment.

Raising bonus payments for work results

AmCham suggests increasing the non-taxable amount of "bonus payments for work results and other forms of additional reward for workers (additional salary, bonus on the monthly salary, etc.)" from HRK 5,000 to HRK 12,000 (Ordinance on personal income tax, Article 7, paragraph 2)

The measure provides an optimal net effect for employees and employers in the circumstances when employers have the option of additionally rewarding their workers. AmCham believes that an appropriate amount for this is HRK 1,000 per month.

This measure would not influence revenues of the local authorities which would make it easier to adopt without objections by other stakeholders.

Reducing the tax burden on some employee income

Taxing income from bonuses in the form of allotment of shares and equity option contracts

From 1 January 2019 onwards, all remuneration based on bonuses in the form of allotment of shares and equity option contracts have the same tax treatment, i.e. they are considered to be capital income in kind, which is subject to the tax rate of 24% (plus surtax). However, in practice, there are different interpretations of the new provisions of the Income Tax Act, which can mostly be reduced to two issues:

- whether the term "share" as stated in the Act also cover other forms of participation in capital, which means that the more favorable tax treatment prescribed for equity option plans could also be applied to shares in limited liability companies ("d.o.o.");
- whether the value of remuneration in kind in the form of allotment of shares and equity option contracts should be considered as net remuneration (which must be grossed up for taxation purposes) or gross remuneration (without the need for grossing up).

Including limited liability companies ("d.o.o.") in the implementation of options plans

The current wording of the Income Tax Act explicitly provides for more favorable tax treatment for the allotment of or equity options contracts for **shares**, but does not define the treatment of **business interest**. Since it is unclear whether the Act defines the term "share" as a general term meaning participation in the capital of the company, whether the company is "d.d." or "d.o.o.", various interpretations have arisen in practice, and limited liability companies are becoming more interested in enabling a more favorable treatment of participation in the capital of the company for their employees.

As a result of the tax reform and more favorable taxation of bonuses to employees in the form of equity options, many companies began implementing this model to increase their competitiveness on the European market and retain their employees. In some industries such as IT and start-ups, such models are crucial for the continuation of their operations in Croatia. However, a vast majority of such companies in Croatia were established as "d.o.o.", i.e. limited liability companies.

The legal interpretations that can be found in practice support the fact that there is no essential difference between the acquisition of shares and business interest by workers:

- shares and business interest yield equal property rights;
- income from shares (dividends) is taxed in the same manner as income from business interest, at the single tax rate of 12%;
- "d.o.o." is an organizational form of a capital company, therefore, it is appropriate that income from such business interest should be taxed as capital;
- most of the companies generating additional economic growth in Croatia and small and medium-sized companies that are, as a rule, always "d.o.o."; a different tax treatment of the acquisition of business interest in them would be discriminatory;
- insisting on transforming a company from "d.o.o." to "d.d." only for the purpose of a more favorable taxation of the employee-share scheme would be merely a matter of form, since there would essentially be no other changes – neither within the company (apart from the formality) nor in the employment relationship.

<u>AmCham's recommendation:</u> expressly include business interest in the preferential treatment of option plans

An amendment to the Income Tax Act is proposed, whereby it would be clearly prescribed that, apart from the allotment or purchase of own shares, the **allotment and purchase of interest in a company** is also considered income from capital.

We consider that this would compensate for the legal gap and any doubts arising for a large number of companies whose structure is "d.o.o.", but which – due to the positive signals from the legislator and legal interpretation of capital ownership – began the implementation of granting option bonuses to their employees by allocating or purchasing business interest, subsequently stopping that process due to the insufficiently clear definition in the legislation, therefore creating the risk that a potential tax inspection would interpret it as a remuneration in kind taxed as a salary or other income. This outcome would lead to excessive taxation, with effective tax rates ranging from 70 to over 150%.

Due to such an uncertainty on the one hand, and the necessity of implementing worker participation in the company capital on the other, companies are considering the possibility of restructuring and moving their registered offices out of Croatia.

If the relevant legal framework were to be clearly defined, such a scenario would surely be avoided, with the added benefit of stimulating the development of SMEs and start-ups in Croatia.

Net vs gross remuneration with regard to option plans

Depending on whether income based on an option plan is deemed net or gross remuneration, the effective tax rate can vary:

- if the value of such remuneration is deemed net remuneration in kind (subject to the grossing-up requirement), the effective tax rate amounts to 39.51% (for taxpayers registered in the City of Zagreb).
- if the value of such remuneration is deemed gross remuneration in kind (not subject to the grossing-up requirement), the effective tax rate amounts to 28.32% (for taxpayers registered in the City of Zagreb), which is still above the effective tax rate in Central and Eastern Europe.

AmCham's recommendation: define income based on an option purchase as remuneration taxable at the rate of 12%

We propose to amend the Croatian legislation regarding income tax so that remuneration in the form of share allotment and optional purchase of shares/interest is deemed gross income from capital, taxable at the rate of 12% plus surtax, which would eliminate the need for grossing up and increasing the effective tax rate.

The tax rate of 12% is the currently applicable tax rate for dividends, interest and capital gains, therefore, the reduction of the tax rate from 24% to 12% would be in

line with those tax rates. With such a favorable tax treatment, Croatia would enable highly qualified workforce to stay or relocate to Croatia, thus becoming a more attractive destination for foreign investments, particularly for the establishment of regional headquarters of foreign and domestic companies in Croatia.

Allowances for workers' health

Allowance for workers' meals

AmCham was proposing by earlier recommendations the introduction of possibility of payment of the non-taxable allowance for the workers' meals in a reasonable daily amount (per workday) of, e.g. HRK 30-35, and the Croatian government has introduced a flat-rate of up to HRK 5,000 or up to HRK 12,000 on the basis of the actual costs incurred. AmCham has welcomed the adoption of this proposal by the business community.

Allowance for sports activities

Due to a high number of sick days, obesity of a part of the population, healthcare costs and damages to the economy and the state in general that have arisen from this, AmCham proposes the introduction of the possibility of non-taxable financing of employees' sports activities, with an aim to improve their general health (e.g. monthly or annual gym and city pool membership, sports fields time slots, etc.).

For easier administration, AmCham suggests that the non-taxable amount for sports activities can be paid directly to the service provider.

Tax break for additional and supplementary health insurance

AmCham has welcomed the introduction of possibility of non-taxable payments of premiums of supplementary/additional health insurance for employees up to HRK 2,500 a year per employee and, in accordance with earlier recommendations, it proposes the maximum amount of the supplementary/additional health insurance relief of up to HRK 7,500.

An example of a country applying tax breaks to health insurance premiums is Portugal where the health insurance premium is used as a tax deduction in personal income tax. The deduction has a set limit that is determined depending on other tax breaks and depends on the level of taxable income, with the maximum tax break amounting to EUR 1,000.

Organization of team building activities

Work requires a certain psycho-physical effort of every employee. At the same time, individual workers are most often part of an organizational unit or a team with whom they solve and complete tasks.

In line with the trends of developed economies, Croatian employers increasingly organize team building activities. Joint activities of coworkers lead to a better team spirit, sense of belonging to a collective and contribute to better mutual trust, understanding and respect, resulting in significantly better individual and collective business results.

Currently, this type of activities are subject to taxation, which is a significant cost to employers who often decide not to organize recreational activities for employees or to reduce the scope and quality of planned activities in order to reduce costs. Organization of team building is a standard in the contemporary organization management and human potential management. Taxing recreational activities for employees makes it difficult to keep up to date with the most contemporary business trends for employers in Croatia.

AmCham believes that non-taxation of team building activities, more specifically the clear regulation of the tax treatment of team building activities, would have multiple positive effects on the psychophysical benefit of employees, but also on better productivity of individuals, companies and ultimately the Croatian economy.

Use of taxi services during a business trip

If a worker uses taxi services or some other mean of transportation for transportation from the airport to the destination of business trip, these expenses are not considered to be transportation in the destination of the business trip and are recognized as transportation cost of the business trip. It is considered as transportation to the destination of the business trip, not within the destination of the business trip, so the cost can be compensated to the employee without paying income taxes and contributions.

In case where expenses for the taxi services are related to the transportation within the destination of the business trip, mentioned expenses should be paid from the amount of the daily allowance. However, if expenses are reimbursed to the employee, they should be taxed as salary in kind.

In principle workers are trying to maximize use of their time during a business trip. In case where there are multiple meetings and business activities organized in a single day taxi services are usually used to avoid slowdown and unnecessary prolongation of stay. Use of taxi services for business purposes is a business expenditure and should not be covered from a worker's daily allowance.

AmCham considers that the use of taxi services during a business trip should be treated as the cost of the trip, without being treated as salary in kind, meaning that the daily allowance should only be used to cover the cost of drinks and meals during a business trip.

Introduction of tax relief for private use of official plug-in veichles

If a company owns plug-in vehicles (BEV and PHEV) and its employees use them for private purposes, AmCham believes that such use should be exempt from taxes on fringe benefits in kind as in the United Kingdom and the Netherlands.

Introduction of tax-free fixed compensation for work from home

Taking into consideration current situation as well as increasingly accepted form of work by employers and employees, that is work form home, AmCham stands for the following:

Allowing the introduction of a paragraph on the tax-free fixed compensation of expenses which occur when an employee uses their own equipment (as defined by the Labor Act) and other expenses the employee might experience while performing work (when it is not as simple to determine that the expenditure is only work related, for example, internet expenses, company phone and others - for example, electricity, water, central heating expenses) in tax legislation.

In Slovenia, the prescribed monthly tax-free work from home compensation totals 5% of the salary, but not more than 5% of the Slovenian average salary (which is currently more than 90 euros a month). To make the work from home compensation tax-free, it is necessary to define it through internal work regulations and employment contract, the equipment bought for work from home must be necessary and common for specific work and compensation for work from home should be backed by real expenses.

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