



MERGERS AND ACQUISITIONS

Croatia

Taxation of Cross-Border
Mergers and Acquisitions

2010 Edition

TAX

Croatia

Introduction

The chapter addresses the three fundamental decisions facing a prospective acquirer in Croatia:

- What should be acquired: the target's shares, or its assets?
- What acquisition vehicle should be used?
- How should the acquisition vehicle be financed?

Tax is, of course, only one piece of the transaction-structuring jigsaw. Company law governs the legal form of a transaction and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of this chapter, but some of the key points that arise when planning the steps in a transaction plan are summarized explained later in the chapter.

Recent Developments

Croatia is in the final stages of the accession negotiations with the European Union and harmonization of its commercial law, including the taxation system, is progressing. The amendments to the Croatian Corporate Profit Tax Law (CPT Law) of 5 December 2008, which regulate mergers, transfers of equity and share swaps between legal entities operating in different EU Member States, are based on the Directives 90/434/EEZ and 2005/19/EZ. The amendments will become effective on Croatia's accession to the European Union.

Amendments to the Value Added Tax Law (VAT Law) have also been introduced, and will become effective on 1 January 2010. The most important amendments relate to financial and insurance services, place of taxation of services, business activities of foreign entrepreneurs in Croatia, and delivery of goods without compensation

The Croatian government introduced a Special Tax Law (crisis tax) on 1 August 2009 as an antirecession measure. Crisis tax is applicable, amongst other, to residents' receipts of dividends and shares in profit. It applies to all distributions of profit as of 1 August 2009 to Croatian tax-resident taxpayers, regardless of the period these payments relate to. The payer of the receipt is required to calculate and pay crisis tax on the

receipt of payment. There are two crisis tax rates: 2 percent on all net receipts from HRK 3,000 up to and including HRK 6,000 (approximately EUR 410 to EUR 820) and a 4-percent rate on all net receipts over HRK 6,000 (approximately EUR 820). Crisis tax will be applicable until 31 December 2010.

Asset Purchase or Share Purchase

The usual form of an acquisition in Croatia is the purchase of shares of a company, rather than purchase of the company's assets. The purchase of assets is a less attractive option for the seller, because capital gains on sales of assets are taxable and there is a risk of double taxation on remittance of the sales proceeds. If the vendor of the shares of a company is a Croatian tax non-resident, any capital gains may be exempt from taxation. However, the acquisition of assets has certain advantages for the purchaser, which should be taken into consideration as well. Both forms of acquisition are discussed later in the chapter.

Purchase of Assets

In the case of a purchase of assets, the agreed value is usually above book value and this increased cost base may be used by the acquirer for capital gains tax and depreciation purposes. Moreover, any historical tax liabilities generally remain with the vendor and are not transferred with the purchased assets.

Purchase Price

It is necessary to apportion the total consideration among the assets acquired and therefore, a purchase agreement should be concluded in which the allocation is specified. It will usually be acceptable for tax purposes provided it is commercially justifiable.

Goodwill

Goodwill which arises in acquisitions is generally subject to annual impairment testing for accounting purposes. Any impairment of goodwill cannot be deducted for tax purposes under Croatian legislation.

Depreciation

For tax purposes, fixed assets are depreciated using the straight line method of depreciation, using annual depreciation rates as set as:

- buildings and boats over 1,000 GRT, 5 percent;
- personal cars, 20 percent;
- intangible assets, equipment, vehicles and plant, 25 percent;
- IT equipment and mobile phones, 50 percent; and
- other long term assets, 10 percent.

The earlier prescribed rates may be doubled. The depreciation charge prescribed by the CPT Law can be claimed for tax purposes only if the same amounts were booked in the company's income statement.

Tax Attributes

Tax losses are not transferred to the purchaser on an asset acquisition. They remain with the vendor, or are eliminated. On the other hand, if the purchaser wishes to acquire the vendor company's trade along with its tax losses, a business activity may be transferred to a new company (typically through simultaneous demerger and merger), where a new company would then be sold to the purchaser.

Value-Added Tax (VAT)

VAT is charged on a large number of goods and services at a standard 23-percent rate. Reduced rates of 10 percent and 0 percent are applicable on certain goods and services. The transfer of a business as a going concern is not subject to VAT, provided certain conditions are met. To benefit from this exemption the aim of the transfer must be to put the new owner in possession of a business. Therefore, the sale of a portion of assets cannot be classified as a transfer of a business: all assets and liabilities related to the business activity need to be transferred.

Transfer Taxes

There are no stamp duty and stamp duty land tax requirements in Croatia. However, Croatia does levy transfer tax at the rate of 5 percent on transfers of land, pre-VAT buildings (that is, buildings constructed prior to 1 January 1998 when VAT was introduced in Croatia, motor vehicles and airplanes).

In certain cases the transfer of assets as a contribution in-kind to the share capital of a company eliminates transfer taxes.

Purchase of Shares

The purchase of shares as a form of acquisition does not result in an increased cost base of the underlying assets involved.

Tax Indemnities and Warranties

If the form of acquisition involves the purchase of shares, the purchaser takes over not only the company's assets, but all liabilities, including contingent liabilities. In this case, the purchaser usually requires more extensive indemnities and warranties than in the case of an asset purchase. If significant amounts are involved, it is customary for the purchaser to arrange a due diligence exercise, including a review of the target company's tax affairs.

Tax Losses

Tax losses generated by the target company are passed on to the purchaser in case of a share acquisition. The losses may be carried forward for five years from the year they were incurred and reported by the company, irrespective of the acquisition.

Pre-Sale Dividend

It is possible for the seller to realize part of the consideration through a pre-sale dividend payment. The proceeds from the sale of shares are decreased as a consequence, and the gain on the sale is also decreased. Since dividend payments are not subject to taxation (except for crisis tax) under Croatian legislation, a pre-sale dividend payment reduces tax liabilities on the gain on the sale of the shares that may arise for the seller.

Tax Clearances

It is not possible to obtain a definitive clearance from the tax authorities on a company's taxation position. It is possible to obtain a statement from the tax authorities on the status of a company's tax affairs, but, since this is typically based on self-assessed liabilities, it cannot be relied upon.

Choice of Acquisition Vehicle

There are several acquisition vehicles the purchaser may choose, depending on the specifics of the acquisition. There is no capital duty on the introduction of new capital to a Croatian company.

Local Holding Company

Local holding companies are preferred if the purchaser wishes to have the option of offsetting the target's taxable profits with interest payments on funds borrowed by the Croatian holding company to purchase the target company. However, if the funds to purchase the target company are obtained cross-border, interest payments are subject to withholding tax (WHT) in Croatia. The purchaser may, therefore, prefer to

establish an intermediate company in a favorable treaty territory, or other structures or loan instruments that do not attract WHT. In the absence of tax grouping provisions, the deduction for interest payments on borrowed funds is generally achieved through a subsequent merger of the Croatian holding company and the target company. However, further analysis of the accounting and taxation implications of the merger is required to determine if this is feasible.

Foreign Parent Company

If a foreign parent company wishes to offset the cost of financing the purchase of the target company against its own taxable profits, the target company may be purchased through the foreign parent company. From the Croatian tax point of view this would not lead to any additional tax liabilities, because dividend payments made to non-residents are not subject to CPT, WHT, or the crisis tax.

Non-Resident Intermediate Holding Company

The purchaser may opt for a non-resident intermediary holding company as an acquisition vehicle if the foreign parent's country of residence taxes capital gains and/or dividends received from foreign companies. This structure would also allow the purchaser to take advantage of a more favorable tax treaty than the treaty its country of residence has concluded with Croatia.

Local Branch

Interposing a Croatian branch between the purchasing company and the target would not achieve additional tax advantages, because a branch is treated as a regular taxpayer for Croatian tax purposes. However, the head office of any branch office may be able to claim any tax losses, especially financing costs. This would need to be considered on a case by case basis.

Joint Ventures

It is possible to establish a partnership or contractual joint venture in Croatia, but in either case a local company or branch office has to be established.

Choice of Acquisition Funding

A purchaser that decides to acquire a Croatian target with cash using a Croatian company as the acquisition vehicle will firstly have to decide whether to structure the acquisition as an asset purchase or share purchase, and then decide whether to finance the Croatian acquirer with debt or equity.

Debt

The principal advantage of debt is the potential tax-deductibility of interest (see Deductibility of Interest), as

the payment of a dividend does not give rise to a tax deduction. Another potential advantage of debt is the deductibility of expenses, such as guarantee fees and bank fees, in computing profits for tax purposes.

To minimize the tax cost of debt there must be sufficient taxable profits in the company borrowing the funds to offset interest expenses. In this regard it should be noted that dividend income received by a Croatian company is not taxable. There are also no tax grouping provisions. Therefore, the acquisition of a Croatian target company by a Croatian acquisition vehicle with no taxable income is tax-inefficient.

Deductibility of Interest

When considering the issue of interest deductibility, it should be noted that the Croatian CPT Law prescribes certain limitations on the tax deductibility of expenses. General expenses need to be directly incurred with the purpose of generating income if they are to be treated as tax deductible, and there are two specific limitations.

The first is the thin-capitalization rules that apply to non-resident shareholders that are not financial institutions. Interest on loans provided by direct non-resident shareholders with at least 25 percent of the shares or voting rights are not deductible for CPT purposes insofar as the loan that exceeds four times the amount of the share capital held by that shareholder. The thin-capitalization rules also apply to loans guaranteed by a direct non-resident shareholder.

The second specific limitation is that interest paid on loans provided by non-resident related parties is CPT deductible up to the prescribed interest rate (currently 9 percent per annum). Parties are related when one of the parties directly, or indirectly, participates in the management, supervision, or capital of the other; or, where the same legal persons (one of which is a resident Croatian company and the other is a non-resident company) participate in the management, supervision or capital of another company. Should the loan be provided by an entity tax-resident in a country with which Croatia has concluded a double tax treaty or an investment protection treaty, a higher interest rate may apply if such an interest rate would be at arm's length.

Withholding Tax on Debt and Methods to Reduce or Eliminate

Interest payments made by Croatian-resident entities to any Croatian non-resident entities (whether the parties are related or not) are subject to Croatian withholding tax at the rate of 15 percent at the time of payment.

Exceptions to the earlier rule relate to loans provided by foreign banks and financial institutions and interest paid on qualifying bonds issued by Croatian entities.

Further, if the foreign entity providing the loan is in a jurisdiction with which Croatia has a double tax treaty in effect, and if that foreign entity is the beneficial owner of the interest, the withholding tax liability may be reduced or eliminated under the tax treaty. To take advantage of a reduced rate, the prescribed form needs to be submitted to the tax authorities. To eliminate the withholding tax, the Croatian company needs to be in possession of a statement that the receiving entity is a tax-resident of the country that has a double tax treaty with Croatia.

Checklist for Debt Funding

- The use of bank debt may avoid thin-capitalization and transfer pricing problems and eliminate withholding tax.
- Tax losses as a result of interest expenses can be carried forward for five years.
- Consider whether the level of taxable profits would enable tax relief for interest payments to be used effectively.
- Establish whether it is possible that a tax deduction may be available at higher rates in other territories.
- Withholding tax of 15 percent may apply to interest payments to non-Croatian entities.

Equity

A purchaser may use equity to fund its acquisition, possibly by issuing shares to the seller in satisfaction of the consideration, or by raising funds through a seller placing. Further, the purchaser may wish to capitalize the target post-acquisition.

Croatia does not have any capital duty, and neither stamp duty nor stamp duty reserve tax applies to new share issues. As a matter of domestic law, there is no withholding tax on dividends paid by a Croatian company. Dividends are not deductible for Croatian tax purposes.

The use of equity, although offering less flexibility should the parent subsequently wish to recover the funds it has injected, may be more appropriate than debt in certain circumstances, such as the following:

- Where the target is loss-making, it may not be possible to obtain immediate tax relief for interest payments.

- There may be restrictions in the country of the lender for tax relief for interest. These may eliminate the principal advantage of using debt.
- Where the company is thinly capitalized, it would be disadvantageous to increase borrowings without also obtaining an injection of fresh equity. A tax-efficient structure normally requires an appropriate mix of debt and equity so that debt-to-equity is adequate for Croatian tax purposes.
- There may be non-tax grounds for preferring equity. For example, in certain circumstances it may be necessary or desirable for a company to have a low debt-to-equity ratio.

Mergers and de-mergers should have no influence on taxation if the continuity in taxation exists. Continuity in taxation is deemed to exist if, upon merger or de-merger, there is no change in the value of items of assets and liabilities that are being transferred.

Hybrids

Hybrid instruments could be used to achieve an interest deduction for the borrower without any income tax for the lender, but there is as yet little experience in this area in Croatia and potential benefits may be limited.

Discounted Securities

The issue of bonds and other securities may be an effective method for a Croatian company to raise finance.

Deferred Settlement

The right to receive an unknown future amount is regarded as an asset that could be taxable in the same way as unrealized gains are taxable in Croatia.

Other Considerations

Concerns of the Seller

The tax position of the seller can be expected to have a significant influence on any transaction. In certain circumstances the seller may prefer to realize part of the value of his/her investment, if, for example, if it has brought-forward tax losses.

Croatia does not tax gains of non-residents.

Company Law and Accounting

The Companies Act prescribes how Croatian companies may be formed, operated, reorganized, and dissolved. The accounting law prescribes the accounting standards that need to be followed; either IFRS for large entities or Croatian Financial Reporting Standards for small and medium-sized entities.

As for mergers and acquisitions, a business combination (defined, under IFRS, as the bringing together of separate entities or businesses into one reporting entity) may be categorized as either a merger or an acquisition. In essence, a combination is regarded as a merger when it effects a pooling of business interests (that is, where one company's equity is exchanged for equity in another company), or shares in a newly incorporated company are issued to the merging companies' shareholders in exchange for the equity, with both sides receiving little or no consideration in the form of cash or other assets.

Company law and accounting standards determine the accounting treatment of a business combination. In general, most combinations are accounted for as acquisitions, merger accounting only being applied in limited circumstances. Merger accounting is not allowed under IFRS; all business combinations must be accounted for as acquisitions. The relevant Croatian accounting standards and company law restrict merger accounting to (and make it obligatory for) a very small number of genuine mergers and group reorganizations not involving minority interests. Genuine mergers are those in which the shareholders come together in a partnership for the mutual sharing of the risks and rewards of the combined entity, and in which no party to the combination in substance obtains control over any other, or is otherwise seen to be dominant in any way. Numerous detailed conditions must be met.

One of the main practical distinctions between acquisition accounting and merger accounting is that acquisition accounting may give rise to goodwill. The net assets acquired are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration given exceeds the aggregate of these values. As long as IFRS is not adopted or incorporated into Croatian standards, the goodwill is then amortized through the profit and loss account over five years. Acquisition accounting principles also apply to purchases of trade and assets with any goodwill and fair value adjustments appearing on the acquirer's own balance sheet. In merger accounting, goodwill does not arise, as the acquirer and the seller are treated as though they had operated in combination since incorporation; adjustments are made to the value of the acquired net assets only to the extent that this is necessary to bring accounting policies into line.

Another important feature of Croatian company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's

distributable reserves. Regardless of whether acquisition or merger accounting is adopted in the group accounts, the ability to distribute the pre-acquisition profits of the acquired company may be restricted.

Finally, a common issue on transaction structuring is the provisions concerning financial assistance. Broadly, these say that it is illegal for a public company (or one of its private subsidiaries) to give financial assistance, directly or indirectly, for the purpose of the acquisition of that company's shares.

Group Relief/Consolidation

Current Croatian legislation does not include provisions for group relief/consolidation.

Transfer Pricing

If any inter-company transactions arise post acquisition between the purchaser and the target, failure to charge an arm's-length price for services or goods provided may cause the Croatian tax authorities to challenge the transactions.

Foreign Investments of a Local Target Company

Current Croatian legislation does not include controlled foreign company provisions.

Comparison of Asset and Share Purchases

Advantages of Asset Purchases

- The purchase price can be depreciated or amortized for tax purposes by the buyer.
- A step-up in the cost base of assets for capital gains purposes is obtained by the buyer.
- No previous liabilities of the company are inherited by the buyer.
- There is no acquisition of a tax liability on retained earnings.
- It is possible to acquire only a part of a business.

Disadvantages of Asset Purchases

- The possible need arises to renegotiate supply, employment and technology agreements, etc.
- A higher capital outlay is usually involved (unless debts are also assumed).
- It may be unattractive to the seller, especially if a share sale would be exempt.

- Accounting profits may be affected by the creation of acquisition goodwill.
- The benefit of any losses incurred by the target company remains with the seller.

Advantages of Share Purchases

- There is usually a lower capital outlay (purchase of net assets only).
- It is likely to be more attractive to the seller, both commercially and from a tax perspective (because the disposal may be exempt), so the price may be lower.
- The buyer may benefit from tax losses of the target company.
- The buyer may gain the benefit of existing supply or technology contracts.
- Lower transfer taxes will usually be payable.

Disadvantages of Share Purchases

- The buyer acquires an unrealized tax liability for depreciation recovery on the difference between the accounting and tax book values of assets.
- The buyer effectively becomes liable for any claims or previous liabilities of the entity (including tax).
- No deduction is available for the purchase price.
- It may be more difficult to finance tax-efficiently.

Withholding Tax Rate Chart

The rate information and footnotes contained in this table are from the Croatian Ministry of Finance, 2009 and the 2009 IBFD/KPMG Global Corporate Tax Handbook.

Country	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, Companies (%)	Qualifying Companies ² (%)		
Albania	10	10	10	10
Austria	15	0 ³	5	0
Belarus	15	5	10	10
Belgium	15	5 ³	10	0
Bosnia and Herzegovina	10	5	10	10
Bulgaria	5	5	5	0
Canada	15	5 ⁵	10	10
Chile	15	5 ⁶	5/15 ⁴	5/10 ⁷
China (People's Rep.)	5	5	10	10
Czech Republic	5	5	0	10
Denmark ⁸	15	5	0	10
Denmark new treaty ¹¹	10	5 ²	5	10
Estonia	15	5 ³	10	10
Finland ⁸	15	5	0	10
France	15	0 ³	0	0
Germany	15	5 ³	0	0
Greece	10	5	10	10
Hungary	10	5	0	0
Iran	10	5	5	5
Ireland	10	5 ³	0	10
Israel	15	5/10 ³	5	5/10
Italy ⁸	10	10	10	10
Italy new treaty ¹¹	15	15	10	5
Jordan	10	5	10	10
Korea (Rep.)	10	5	5	0
Latvia	10	5	10	10
Lithuania	15	5 ³	10	10
Macedonia	15	5	10	10
Malaysia	10	5 ³	10	10
Malta	5	5	0	0
Mauritius	0	0	0	0
Moldova	10	5	5	10
Montenegro ⁹	10	5	10	10
Netherlands	15	0 ³	0	0
Norway ⁸	15	15	0	10
Poland	15	5	10	10
Romania	5	5	10	10
Russia	10	5 ¹⁰	10	10
San Marino	10	5	10	5
Serbia ⁹	10	5	10	10
Slovak Republic	10	5 ³	10	10
Slovenia	5	5	5	5
South Africa	10	5	0	5
Spain	15	0	8	8
Sweden ⁸	15	5	0	0
Switzerland	15	5	5	0
Turkey	10	10	10	10
Ukraine	10	5	10	10
United Kingdom ⁸	15	5	10	10

Notes

1. Many treaties provide for an exemption for certain types of interest, such as interest paid to the state, local authorities, the central bank, export credit institutions, or in relation to sales on credit. Such exemptions are not considered in this column.
2. Unless stated otherwise, the rate in this column applies if the recipient company holds at least 25 percent of the capital or the voting power of the paying company, as the case may be. Special conditions may apply.
3. A 10-percent holding is required.
4. The lower rate applies to interest from loans granted by banks.
5. A holding of 10 percent of voting rights or 25 percent of capital is required.
6. A 20-percent holding is required.
7. The lower rate applies to equipment rentals.
8. Treaty concluded by the former Yugoslavia.
9. Treaty concluded between Croatia and the former Serbia and Montenegro.
10. The rate applies if the Russian company owns at least 25 percent of the capital in the Croatian company and the value of the holding is at least USD 100,000.
11. Effective from 1 January 2010.

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