Zagreb International Review of Economics & Business, Special Conference Issue, pp. 113-135, 2008

ISSN 1331-5609; UDC: 33+65

Business Group Taxation In Croatia and the Implications of the EU Framework Adoption

Mihaela Grubišić

Ivan Čevizović

Abstract: The related companies' taxation has been a debatable issue for decades in the EU. Taxation policies in the EU countries have been tried to be reconciled to the advantage of as many member countries as possible in numerous tries. Although there has been a general trend of income tax rates' reduction in the last three decades, tax bases (and rates) still remain subject to national tax legislations. The greatest advance in direct taxation harmonisation has been achieved regarding the EU-headquartered multinational companies' activities that are doing business within the EU. Yet, the SME sector makes the majority of business activity in the EU and small- and medium-sized companies' networking is promulgated as a way of building up the competitiveness in the Single market. As a prospective EU member country, Croatia would have to adapt its taxation regulation according to the EU framework. Starting from the current related companies' taxation practices, this paper analyses the necessary changes in Croatian legislation and questions what degree of fiscal autonomy could be expected to remain regarding the related companies' taxation practices in Croatia after the EU joining.

Keywords: related companies' taxation, corporate income tax harmonisation, inter-corporate transactions, EU accession, Croatia

JEL Classification: H250

Introduction

Since the independence declaration of the Republic of Croatia in 1992, many business entities, formerly owned by the state have become privately owned. In line with the ownership transition phase, there has also been a consolidation phase leading to the (re)birth of business groups. However, the aim of this paper is neither to analyse the origin of business groups' formation in Croatia nor to investigate their longevity. It is

* Mihaela Grubišić is at The Institute of Economics, Zagreb, Croatia.
** Ivan Čevizović is at Faculty of Economics and Business, University of Zagreb, Zagreb, Croatia.

concerned with purely regulatory defined taxation approach which might have influenced the corporate management decisions to form a business group or help the regulatory bodies estimate the size of fiscal revenues coming from the various income taxes.

The taxation issue has been addressed in numerous papers and studies, especially from the stance of the double taxation problem which refers to the taxation in the source of income country and subsequent taxation in the destination of income country, i.e. parent company country. Even though double taxation often exists at both corporate and individual level, this paper deals only with the corporate taxation, i.e. the taxation of corporate income of business groups whatever its source might be.

According to the International Financial Reporting Standards (IFRS) a business group consists of at least two entities where one entity has more than 20% share in another one and thus qualifies for the equity/proportionate consolidation method of financial reporting. Business groups, in line with the IFRS practice, can be associated companies, joint ventures or subsidiaries. The only difference the Standards make is the level of control exacerbated through the ownership or voting rights of the parent in a related company. But, from the taxation point of view, a business group is a set of entities whose business results are consolidated on a group level. The letter approach derives from the Anglo-American legal practice which admits only the groups where one entity has a majority of ownership/voting rights in another one.

The concept of a tax group arose in the beginning of the XX century when it was argued that in case of market competition between a commercial entity, organised as a group of companies, and a commercial entity, organised as a single company, both organisational entities should be treated the same way for tax purposes (Lamb, 1995, p. 35). Still, until nowadays, a business group for accounting purposes is not treated equally as a business group for the purposes of taxation. The former is also known as an accounting group and it is often called business group while the letter is called the taxation group. Another difference is that taxation rules are mandatory while accounting policies, though also prescribed by the accounting standards and sometimes determined by the law, are to some extent subject to the choice of management. According to Hoogendoorn (1996), this fact is not surprising because accounting and taxation have two opposite goals - the first one is concerned with the wealth of shareholders while the letter one is concerned with paying as less taxes as possible.

The structure of the paper is as follows. Section 2 gives an overview of international business group taxation practices, while Section 3 offers the taxation practice review in Croatia. Section 4 deals with the European Union acquis regarding business group taxation practice, while Section 5 estimates the impact of the EU accession on business (group) taxation in Croatia. Last section concludes.

Overview of Business Group Taxation Practices in the EU Member States

Taxation in general deals with transferring a part of profits earned in one jurisdiction to the State budget of that jurisdiction. This can be reckoned as an off-balance sheet debt of profit-making entity to the country and its citizens that (in)directly enabled its profitable activities by means of legislative framework and infrastructure preconditions. The home country, i. e. the country of the parent company would like to tax the profits as much as the source-of-income country would. Due to differences in size of tax rates, profit shifting between related companies often occurs and it can take several forms, such as:

- companies locate their production – and therefore their profit – in low-tax jurisdictions
- companies manipulate with the pricing of cross-border intra-group transactions, what is particularly the case with the intangible assets whose price is much harder to determine
- companies shift their debts into the jurisdictions with lower interest rates. In most countries, interest payments are tax-deductible. Further, these payments are subject to low, often zero, withholding tax rates and benefit from an exemption or a tax credit system in the country of the company receiving the interest payment.

The sooner the tax jurisdictions are aware of profit shifting activities, the better their reaction. So, tens of bilateral double taxation avoidance agreements signed by the same contractual party are not a surprise. When it comes to business group income taxation and double taxation avoidance measures, several common issues, which would be elaborated in more detail in the following subsections, might arise:

- home taxation vs. income at source taxation
- separate entity vs. group taxation
- tax loss carry-forward or carry-back
- double taxation relief for inter-corporate dividends and royalties
- tax anti-avoidance measures, i.e. transfer pricing rules.

Home Taxation vs. Income at Source Taxation

The prevailing taxation principle worldwide is that countries tax income earned domestically, while home countries of parent companies tax worldwide income. Although it the first impression might be that the source-of-income country is

deprived for the part of tax revenues, especially if it lowers income tax rates to attract the foreign capital, it in fact, can always find the way to preserve its taxation revenues and prevent the double taxation. The trade-off between taxation revenues and foreign capital attraction depends primarily on application of two methods - the credit method and the exemption method. In addition, the expense deduction method sporadically applies.

In credit method the home country calculates worldwide income and taxes payable at the local tax rate. It then gives credit to the parent company for all taxes its related entities paid abroad. Practically it means that the total taxes payable are reduced by the nominal amount of taxes paid abroad. Tax credit can be recognised for the full amount of taxes paid abroad or it can be limited up to the parent company local tax rate. The justification for this method application is that no matter where businesses operate, they should pay the same tax. Also, tax holidays benefit the parent company country. This means that the tax allotted is totally neutral to capital export (CEN principle).

The expense deduction method, though similar to the credit method, reverses the calculation of taxes payable and tax credit. In this method worldwide income is calculated and taxes paid abroad are deducted before local tax rate is applied. The result is higher tax obligation in the parent country as compared to the tax obligation under the credit method.

The exemption method supports the equal treatment of all investors in one country. Before-tax income earned abroad is deducted in full from the worldwide income of the parent company in its home country. It means that the group members pay taxes only in the countries they earned their profit. The exemption method is grounded on the capital import neutrality principle (CIN). However, the autonomy of the source of income country is a threat for profit shifting between various tax jurisdictions which leads to tax revenues losses (usually in the home country) due to lower reported taxable income.

Table 1: Taxation allocation between source income country and home country

Type of method	Source country	Home country	Worldwide	Total
Expense deduction method				
Income	20	30	50	
Less deducted			6	
Taxable income			44	
Tax rate	30%	40%	40%	
Tax	6		17,6	23,6

Net income			26,4	26,4
Tax credit method (CEN)				
Income	20	30	50	
Tax rate	30%	40%	40%	
Tax	6		20	
Less tax credit			(6)	
Total tax paid	6		14	20
Net income				30
Income exemption method (CIN)				
Income	20	30	50	
Less exempted			20	
Taxable income			30	
Tax rate	30%	40%	40%	
Total tax paid	6		12	18
Net income	14		18	32

Source: Adopted according to Ashta, A., (2007), Double Taxation Avoidance: International and Dividends.

The choice of the method is dependent on the goals of the parent company country. The income exemption method is used by smaller countries with large foreign markets, while large countries prefer to use the tax credit method to prevent capital outflows. The confusing thing is that some countries use both CIN and CEN principle under different circumstances. According to Ashta (2007), exemption countries use income exemption method for taxing the income of active investors (profits, inter-corporate dividends), while they apply tax credits for passive income investors' taxation (portfolio dividends and interest, royalty payments). The same author points out that credit countries use tax credits for active investors' income taxation and income exemption method for inter-corporate dividends.

Separate Entity vs. Group Taxation

Most often the countries that recognise business groups allow the business results consolidation for tax purposes. Yet, the tax consolidation is in most tax jurisdictions optional and permissible for tax residents only, with a prevailing question of what share of ownership/voting rights one entity has to have in another one to qualify for tax consolidation. Usually, it is more than 50%, but often it is even more than 90%. The predominant concept of business group required for substantial group tax relief is de jure control, ranging from 75-100% that is actually almost complete control (Lamb, op. cit., p. 43). Traditionally, the countries that allow tax consolidation are Denmark, France, Germany, Luxembourg, the Netherlands, Spain and Portugal. The allowance of tax consolidation usually relates to the tax consolidation of domestic companies only, while the tax consolidation of both domestic and foreign subsidiaries is rare in positive European practice (Denmark).

Some countries allow certain business entities to choose to be taxed either at the group or at the separate level. But it is usually the case with small companies established as limited liability companies and/or limited liability partnerships. When taxation rules follow the accounting ones there are no temporary differences at all.[1]

Some experiences regarding the tax consolidation are illustrated in table 1.

Table 2: Fiscal consolidation in the EU Member States, 2006

Country	Tax consolidation allowed	Rules for fiscal consolidation / Special allowance
Austria	Yes	If holding is > 50%
Belgium	No	-
Cyprus	No	Group losses relief if holding is > 75%
Czech R.	No	-
Denmark	Yes	Only for 100% ownership share, extendable to foreign subsidiaries.
Estonia	No	-
Finland	Yes	If holding is > 90%
France	Yes	If holding is > 50%, extendable to foreign subsidiaries
Germany	Yes	For domestic companies only, if holding is > 50%
Greece	No	-

Hungary	No	-
Ireland	No	Group losses relief possible if holding > 75%
Italy	Yes	Both for domestic and worldwide companies if holding > 50%
Latvia	No	For domestic companies, EU-wide and taxation treaties' partners, group losses relief possible if holding > 90%
Lithuania	No	-
Luxembourg	Yes	If holding is > 95%
Malta	No	Group loss relief possible if holding is > 51%
The Netherlands	Yes	For holding > 95%, extendable to foreign companies under certain conditions.
Poland	Yes	If holding is > 95%
Portugal	Yes	If holding is > 90%
Slovakia	No	-
Slovenia	Yes	If holding is > 90%
Spain	Yes	If holding is > 75%
Sweden	Yes	If holding is > 90%
UK	No	Group loss relief possible if holding > 75%

Source: Adapted according to Nicodeme, 2006.

Tax Loss Carry-Forward or Carry-Back

There are wide differences in treating intra-group losses for taxation purposes within the EU which is a direct result of tax consolidation rules applied in the member states. Apart from tax loss carry-forward or rarely carry-back possibility, the group loss relief is existent in the UK and Ireland permitting a company to 'surrender' its loss to another entity within the same business group.[2] The proposal for a directive on the cross-border relief in the EU was issued in 1991 (COM (1990) 595) but it was never discussed by the European Council.

Double Taxation Relief for Inter-Corporate Dividends and Royalty Fees

Even though the classical system of taxation consisting of the taxation at the level of company and taxation at the shareholder level was internationally neutral, it distinguished between equity and loan financing. In the first case both corporate income and dividends are taxable, while interest is deductible from taxable income, making the loan financing a cheaper option. (Ashta, 2007). Due to the critics of double taxation, an integral systems of taxation emerged. The integration system of taxation has the advantage of source of financing neutrality because income is taxed only once, but it is not internationally neutral, especially as regards non-residents' taxation. For double taxation relief (integration system) to apply, most countries require a share ownership or voting rights threshold of 10-25% in domestically related company. The relief can be full or partial. Apart from this, there are a couple of ways to avoid double taxation of inter-corporate dividends. These are:

- Withholding tax = taxation at source = précompte mobiliar. The source-of-income country withholds taxes on dividends distributed, usually applying 5% to 25% rates.[3] The net dividend is then (fully or partially) freed of income tax in the parent company country.
- Tax credits = income exemption.
- Full exemptions of dividends paid. Only retained profits are taxed. It basically means that dividends distribution is encouraged and that taxes paid in the parent company country are lower. If there is no tax on dividends distributed in a parent country, the whole distributed income is tax-exempt.
- Split rate system or partial exemption of dividends paid. Dividends distributed are taxed at a lower rate than retained earnings (corporate income).
- Imputation credit = dividend franking credit = avoir fiscal. Dividend franking credit is firstly added to the dividends declared amount, then corporate tax rate is applied which is eventually reduced by the dividend franking credit. It generally means that the shareholder is firstly credited with full or partial corporate income tax amount, which is thereafter deducted from their tax liability.[4]

Interest and royalty fee taxation usually goes side-by-side. These payments are sometimes even more frequent than dividends, especially because they happen throughout the year. Like dividends, interest and royalty fee tax is paid only once – as revenue of the recipient in transactions between tax residents. Tax credit or withholding tax normally applies in cross-border transactions, unless the taxation is conducted according to bilateral double-taxation avoidance treaties. The treatment of

inter-corporate dividends, interest and royalty fees in the EU member countries is illustrated in table 3.

Table 3: Tax treatment of inter-corporate dividends, interest and royalty fees, and transfer pricing rules in the EU member states for tax resident and tax non-resident companies (without tax treaties provision and without P-S and I+R directives application)

EU member state	Residents				Non-residents			
	Withholding taxes			Thin-cap ratio	Withholding taxes (non-treaty countries)			Transfer pricing rules
	Dividends	Interest	Royalties		Dividends	Interest	Royalties	
Austria		25			25		20	OECD
Belgium	25				25	15		OECD
Cyprus	15	10					10	OECD
Czech Rep.				4:1	15	15	25	Yes
Denmark	28			4:1	28		30	OECD
Estonia		24	24		24		15	Yes
Finland	28		28		28		28	Yes
France		25		1,5:1	25	16	33,3	Yes
Germany	21,1	31,65		1,5:1	21,1		21,1	Yes
Greece		10				25	20	Yes
Hungary				3:1				OECD
Ireland	20				20	20	20	OECD
Italy		12,5		4:1	27	27	22,5	Yes
Latvia			5-15	4:1	10	5	5-15	Yes
Lithuania	15	0	15	4:1	15	10	10	OECD
Luxembourg					15			No
Malta		10						No
Netherlands	15			3:1	15			Yes

Poland	19			3:1	19	20	20	OECD
Portugal					20	20	15	Yes
Slovak Rep.		19				19	19	Yes
Slovenia	15	25	15		15			Yes
Spain				3:1	15	15	25	OECD
Sweden					30		0 (28)	OECD
UK						20	22	Yes

Source: Adapted according to Cnossen S., (2002), Coordinating Corporation Taxes in the European Union: Subsidiarity in Action and Deloitte International Tax and Business Guides.

Tax Relief on Group Reorganisation

This relief was more or less available in the EU member countries even before the adoption of Merger Directive that would be in more detail discussed in the next section. Although the Merger Directive deals with cross-border reorganisations in the Single market, some countries, like France, Germany, Ireland, the Netherlands, Portugal and the UK, allow the deferral of tax on capital gains arising on domestic intra-group transfers (Lamb, op. cit.).[5]

Some countries pay close attention to tax losses relief in case of business reorganisations. For instance, in Belgium losses may be carried forward indefinitely for tax purposes by the entity that has incurred the losses unless if control of company changes. In the letter case, to prevent the sale of loss-making companies, there is a thorough scrutiny if the change in control can be justified by legitimate financial and economic needs.[6]

Tax Anti-Avoidance Measures

The term ‘tax anti-avoidance measures’ usually encompasses transfer pricing rules and thin capitalisation rules. These are the two most often ways of tax evasion conducted by multinational companies.

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations from 1995 and The OECD Model Convention on Income and on Capital (MTC) from 2005, which serves as a model used by countries when negotiating bilateral tax agreements, are a paradigm for transfer pricing rules application for any tax jurisdiction dealing with such problems.[7] OECD rules are gradually gaining world-wide acceptance and are already adopted into legislation of

many European countries, as is shown in table 3. There is an extensive monitoring on transactional profit methods conducted by OECD that is a part of Transfer Pricing Guidelines application surveillance. Although the arm's length principle is a cornerstone of transfer pricing methods, there are some other methods applied, that are adopted in Croatian legislation as well.

Thin capitalisation rules are an attempt to restrict exaggerated transfer of income through inter-corporate borrowings, by limiting the maximum debt-to-capital ratio. But, these rules are more slowly finding their place in international taxation practice as compared to general transfer pricing rules.

The Business Group Taxation in Croatia

The corporate income tax rate is 20% in Croatia. Resident companies pay tax on worldwide income (CEN principle), with a credit for foreign tax paid. Non-resident companies pay tax only on Croatian-source income (CIN principle). There are no provisions on business group taxation, which means that each company, regardless of being a member of a business group, submits the tax documentation and fulfils tax obligations separately. However, for the purposes of transfer pricing rules' application, the related company is defined as a company where the representatives of a parent company either (in)directly participate in the Managing or Supervisory board or exercise its interest through ownership share. The percentage of ownership share is not defined in taxation regulation; therefore the definition from the Company Law, which states that the controlling ownership share is necessary for determining the relatedness between two companies, is applicable.[8] Still, tax-loss carry-forward rules apply only at the level of a single company for the next five years.

The tax base includes only operating expenditures for tax purposes, while temporary differences arising from deferred liabilities are not recognised.[9]

Dividends received by resident shareholders are exempt from profit tax, while there is no withholding tax on distributed income in the form of dividends to non-resident companies. For the reimbursement of interest and royalties to foreign parents, 15% interest and 15% royalty rate applies. However, the amount on tax payable on inter-corporate distributed income can be reduced by tax treaties.[10] Capital gains are subject to (20%) income tax.

Even though there are no special provisions on business restructurings' taxation, there is no real estate tax for the immovable assets transferred in business mergers or divestitures.

In determining if market prices in inter-corporate transactions were accounted (arm's length principle), five methods are allowed as of the beginning of 2005. These are Comparable Uncontrolled Price method (CUP), Cost Plus method (CP) and

Resale Price method (RP) as traditional transfer pricing methods, while Transactional Net Margin method (TNMM) and Profit Split method (PS) stand for non-traditional transfer pricing methods. All of these methods are a part of OECD transfer pricing rules. However, the practical usage of these methods as well as transfer pricing control exercise by tax authorities is debatable, because the relatedness between the companies is subject to tax authorities' concern only upon the demand of one of companies operating within a business group.

EU Directives Influencing Business Group Taxation

The direct taxation in the EU is, like all other regulations, enforced according to the Single Market principles and the acquis of the Treaty on European Union. This Single Market is based on the four basic freedoms, i.e. freedom of movement for goods, services, labour and capital. Generally, the entire EU policy-making has been tailored according to these four freedoms, ever since the Treaty of Rome was signed in 1957.

At the early stages of the EU legislation creation in the 1960s and 1970s, there were no attempts to harmonise direct corporate taxation. The idea of corporate income tax convergence necessity emerged as M&A activities strengthened, primarily within the scope of free movements of capital across the EU. The flow of tax harmonisation drafts and their adoption by the EC Commission is well described by Lamb (op. cit., p. 46-48).

The first laws concerning corporate tax harmonisation were passed in 1990, primarily due to large differences in taxation regimes and business forms in the EU member countries. The package of directives included Merger Directive, Parent-Subsidiary (P-S) Directive, Transfer Pricing Arbitration Convention and five more drafts. These directives were a step forward towards cross-border business activities encouragement. A parallel trend of corporate income tax rates reduction followed across the old-EU member states caused not only by the requirements of the EU market broadening but also by a favourable business environments in accelerating Asian economies. Some of the EU countries lowered the corporate income tax rates for more than 20 percentage points in the 20-25 year period. Austria, for instance, lowered its corporate income tax rate from 55% in the 1980ies to 25% in 2005, Finland did it from 59% to 26%, Ireland from 45% to 12,5% while the UK reduced it from 52% to 30%. Consequently, the EU-15 average tax rate dropped from 40,4% in the 1990 to 30,4% in 2005 (Nicodčme, 2006, p. 19).

The Code of Conduct for business taxation from 1998 was aimed to ban discriminatory corporate tax policies by member states. It prevents member countries from granting preferential tax regimes to only a subset of firms (typically,

multinational enterprises) without according the same tax treatment to all firms within its tax jurisdiction. However, this measure does not attempt to harmonise either tax bases or corporate tax rates, both of which had been proposed in the Ruding Report back in 1992.

The further progress emerged when the European Commission promulgated four proposals for corporate income tax harmonisation in 2001, namely:

- an EU corporate tax rate (with full harmonization of rates and bases)
- a compulsory harmonized method to compute the tax base
- the same harmonised method to compute tax bases, which would be optional (a Consolidated Common Tax Base) or
- the system of Home State Taxation in which all subsidiaries follow the same taxation rules as their parent company wherever they are located, while the source-of-income countries tax the income at their income tax rates. Most supporters find it an appropriate way of the SME sector taxation, as there is no need for SMEs to acquaint with the other countries' tax rules.[11]

These proposals target the reduction of profit shifting, which primarily happens within various tax jurisdictions where multinational companies operate. The introduction of a consolidated company tax base and formula apportionment has been still actively debated. However, the harmonisation of a tax base is very likely to some extant. The idea is that profit shifting could be reduced by consolidating the EU-wide profits of a multinational group applying a single tax base. The tax revenues are then allocated among the countries in which the group operates according to a pre-determined formula. Each EU member state would then apply its national tax rate to the share of the overall tax base that is allocated to it. This procedure closely follows the example of federal states with sub-national tax autonomy, such as the United States, Canada or Switzerland.

While the four proposals on income taxation still exist only for the purposes of discussion, some advances have been made regarding the related companies taxation within the EU. Still, broad-based direct taxation harmonisation is hardly to expect to happen because it does not have footing in the EC Treaty.[12]

With regard to multinational enterprises' transactions' taxation within the EU, two directives adopted in 1990 were changed in 2003 and 2005 and an entirely new directive for prevention of interest and royalty payments abuse was adopted in 2003. So, the supranational EU regulatory framework for related companies' taxation is as follows.

- Council Directive 2003/123/EC of 22 December 2003 amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (P-S Directive)
- Council Directive 2005/19/EC of 17 February 2005 amending Directive 90/434/EEC 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (Merger Directive).
- Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (I+R Directive).

The directives mentioned above apply only to the cross-border transactions between related companies within the territory of the EU. They do not cover the transactions of the EU enterprises with the companies outside the EU and they do not rely on the transactions conducted between related companies within one EU member state. Consequently, the EU member states keep the taxation freedom for national and EU-international transactions.

There are some shareholding caps for the afore-mentioned directives application. These are illustrated in table 4.

Table 4: Related companies' lowest shareholding thresholds for the EU taxation directives application

Implementation period	P-S Directive	Merger Directive	I+R Directive
Until 31 December 2006	20%	20%	25%
From 1 January 2007 - 31 December 2008	15%	15%	25%
From 1 January 2009 thereon	10%	10%	25%

The EU member states can change the criterion of certain holding in a subsidiary's capital by means of a tax treaty while at the same time having the option of not applying the directives if the uninterrupted holding period of a parent in a subsidiary is shorter than two years.

The objective of the P-S Directive is to exempt dividends and other profit distributions between subsidiary and parent companies from withholding taxes within the EU and to eliminate double taxation of such income at the level of the parent company. Provided that shareholding thresholds, as given in table 4 are fulfilled, the parent company state should:

- refrain from taxing distributed profits from the subsidiary or

- tax such profits while recognising the parent company the tax credit for taxes paid in the subsidiary's country of residence.

The P-S directive also applies when corporate groups are organised in chains of companies and profits are distributed through the chain of subsidiaries to the parent company. Each EU state can retain the option not to deduct any losses resulting from the distribution of profits of the subsidiary to the parent company. Management fees up to 5% of distributed profits can be deducted from the taxable profits of the parent company.

The main objective of the Merger Directive is that taxation of the income, profits and capital gains from business reorganisations should be deferred until a later disposal of the assets provided that the transferred assets and liabilities remain connected with the transferor. Although commonly known as Merger Directive, the term reorganisation, except for mergers, includes full and partial divisions, transfers of assets, exchanges of assets and transfer of the registered office from one member state to another one without liquidation or dissolution. The latter condition is applicable only for the transfer of registered office of enterprises registered as European Company (SE) and European Cooperative Society (SCE).[13] According to the Directive, 'where the assets transferred in a merger, a division, a partial division or a transfer of assets include a permanent establishment of the transferring company which is situated in a member state other than that of the transferring company, the member state of the transferring company should renounce any right to tax that permanent establishment. The member state of the transferring company may reinstate in the taxable profits of that company such losses of the permanent establishment as may previously have been set off against the taxable profits of the company in that state and which have not been recovered'. Thus, the member states taxing rights are safeguarded.

When it comes to assets transfer, only cash disbursed to the shareholders should not exceed 10% of nominal value of transaction. In other words, Merger Directive emphasises the importance of competitiveness build-up within the EU and treats favourably the investments into the new member states.[14] The Directive is in essence the continuation of the Commission Recommendation from 1994 on the transfer of small and medium-sized enterprises, which encouraged the Member States to take the necessary measures to facilitate the transfer of small- and medium-sized enterprises to ensure their survival and to safeguard the jobs that depend on them. This directive called on waiving taxation on at least part of the revenue from capital gains arising on the sale of assets of a business, providing tax incentives for the reinvestment of the profits made on the sale of a business in another enterprise not quoted on the stock exchange and reducing the taxation on the capital gain realised on the transfer of the shares to employees.

In line with provisions of I+R Directive, interest and royalty fees should be taxed only once at the EU territory. In general, interest and royalty payments should be exempt from any taxes in the country of transferor and taxed in the country of the recipient. But it does not hold if payments are treated as a concealed distribution of profit.

Transfer pricing is seriously tackled by the European Commission since the European Commission report from 2001 wherein it was estimated that medium-sized multinational enterprises spend approximately EUR 1 to EUR 2 million a year on complying with transfer pricing rules, while large multinational enterprises incur even higher expenditures ranging from EUR 4 up to EUR 5,5 million a year.[15] The European Commission established the Code of Conduct to standardize the documentation that companies must provide to tax authorities on their pricing of cross-border intra-group transactions in 2004 that favours the arm's length principle for transactions between related enterprises.[16] The EU transfer pricing documentation, (EU TPD), consists of two sets of standardised documents that a multinational enterprise should submit to tax authorities. They are: the master-file (a set of documentation containing common standardised information relevant for all EU group members) and country-specific files. The use of EU TPD is optional for multinational enterprises.

Transfer pricing will remain a widely discussed issue in the following years, especially since Huizinga and Leaven (2005) estimated that aggregate loss in taxes collected for European governments reach USD 2,7 billion a year due to substantial profit shifting activities.[17] Transfer Pricing Forum has been dealing with transfer pricing problems in the EU since 2002.

The Implications of Changing Business Taxation Framework on Doing Business in Croatia

The implications of changing business taxation framework have to be footed on the prevailing size of the majority of enterprises in Croatia. Likewise other EU member countries, the SME sector is dominant in Croatia. Over 99% of Croatian enterprises belong to the SME sector, as is shown in table 5.

It is evident from the table 5 data that the total net income realised by Croatian enterprises stood at 20,5 billion HRK (approximately 2,8 billion EUR) at the end of 2006. The largest enterprises participated with 11,9 billion HRK (58%) in aggregate net income, while the medium-sized and small enterprises achieved 3,1 billion HRK and 5,5 billion HRK, respectively. SMEs participated somewhat strongly in corporate income tax collected as compared to large enterprises. With regard to cross-border activities of Croatian enterprises, particularly the SMEs, there is no a

statistical indicator, and this fact is even complicated with the fact that there is no distinction between micro and small enterprises, as the letter would naturally be more internationally present.

Table 5: SME sector activity in Croatia, 2006, in million HRK

Description	Small	Medium	SMEs	Large	Total			
Number of enterprises	76.588	97.55%	1.480	1.89%	99.44%	441	0.56%	78.509
Number of employees	388.275	44.84%	172.345	19.90%	64.75%	305.263	35.25%	865.883
Total revenues	197.513	33.30%	115.571	19.48%	52.78%	280.056	47.22%	593.140
Total expenditures	189.631	33.48%	111.388	19.67%	53.15%	265.368	46.85%	566.387
Corporate income tax	2.415	38.78%	1.077	17.30%	56.08%	2.735	43.92%	6.227
After-tax income	11.194	35.97%	5.608	18.02%	53.99%	14.319	46.01%	31.121
After-tax loss	5.727	54.05%	2.501	23.61%	77.66%	2.367	22.34%	10.595
After-tax net income	5.467	26.63%	3.107	15.14%	41.77%	11.952	58.23%	20.526

Source: FINA, 2007.

According to the European Commission Recommendation the threshold of turnover or balance sheet assets for enterprises that qualify to be a part of the group of small, medium or micro enterprises increased, as is evident from table 6, congruent with the lessened thresholds of SME qualifiers adopted in the new Accounting Law in Croatia.[18] Needless to say, resident multinational enterprises are rare in Croatia.

Tax consolidation is not a mandatory option in the EU member states. Besides, the tax treatment of business group deviates significantly from the accounting group concept. As an accession country Croatia will have to adopt the directives regarding related companies income taxation and to enforce stricter control of transfer pricing. One argument in favour of stricter transfer pricing rules is that control of accounting and taxation results lies with the same institution – the tax authority. Yet, the question remains if the tax officials are capable of controlling related companies' transactions, especially when the subject of taxation are intangible assets whose comparables are difficult to find even in more developed countries. It is therefore expected that much attention in the EU would be dedicated to stricter transfer pricing regulation

especially when having in mind the e-business increase worldwide. Croatia would have to adapt its taxation legislation accordingly.

Table 6: SME sector definition in the EU and in Croatia

Enterprise category	Headcount in the EU and in Croatia	EU			Croatia		
		Turnover in EUR	or	Balance sheet total in EUR	Approx. turnover in EUR	or	Approx. balance sheet total in EUR
medium-sized	< 250	= 50 million	= 43 million	= 35,37 million	= 17.70 million		
small	< 50	= 10 million	= 10 million	= 8,85 million	= 4.,42 million		
micro	< 10	= 2 million	= 2 million	not defined	not defined		

* Approximate calculations of Croatian kuna (HRK) thresholds into EUR amounts conducted by applying 7,35 EURHRK rate
Source: SME definition in the EU, available at http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm, and Croatian Accounting Law.

The out-of-the-EU taxation regulation should be expected to remain within the national tax regulations and double taxation avoidance treaties. Apart from transfer pricing, direct tax harmonisation is not a feasible option in the near future, except for unique taxation of companies belonging to the SME sector and tax base harmonisation. The key supporting argument comes from the fact that the majority of business entities in each EU member state are from the SME sector, so the smallest resistance might be expected if parent company country tax base would be applied. The other important supporting argument favouring the presumption that direct tax harmonisation would neither be fast nor broad-based, is that there is no provision in the EU law for direct tax harmonisation. Additionally, the directives that regulate the issues that hampered the EU competitiveness growth at a large scale are already adopted.

The only argument in favour of direct taxation harmonisation is the threat of impinging any of the four freedoms of movement in the common market, which in most part remains neutralised after the multinational companies' transactions regulation. The point is that some part of related companies' transactions and their respective income always remains non-taxable, as it is impossible to follow the thousands of transactions, not only within related companies but within related companies' and their business partners that serve as a means of deliberate hiding of the part of profit on the basis of reciprocity.

Conclusion

The introduction of business group taxation in Croatian taxation system could become a serious subject in the accession process to the EU. However, the significant business group taxation implementation and monitoring problem would arise after the EU joining. Especially, the transfer pricing problem could become the hot issue in the next decade throughout the EU due to the large amount of tax revenues lost in cross-border tax evasion within the EU member states.

Even though there are continuous debates on direct taxation harmonisation, Croatia can be indifferent towards them as the most likely Home State Taxation or tax base harmonisation would not affect it to a large extent. One reason is that most Croatian companies belong to SMEs, which have limited cross-border activities. The other, more prevailing argument is that the Croatian corporate income tax base calculation is significantly synchronised with most EU countries' practices. The only area that Croatia lags behind the EU countries is inexistence of tax consolidation possibility for domestic related companies. However, most European countries permit tax consolidation only theoretically. Therefore, fiscal freedom would probably remain within the national taxation jurisdiction for domestic business groups and domestic enterprises in general in the foreseeable future. However, as taxation legislation of the EU converges with the OECD and vice versa, it would be interesting to follow both legislative frameworks in the years to come, as well as to monitor the new-EU countries experiences regarding the multinational enterprises' activities' monitoring for income taxation purposes.

NOTES

[1] Temporary differences stem from the difference between the accounting basis and the tax basis of the corporate income, i.e. deferred taxation. The main reasons of temporary differences are different accounting and tax treatment of depreciation, inventories, provisions, interest expenses, R&D costs and similar items.

[2] Interestingly, some EU member states offer indefinite tax loss carry-forward possibility, such as Austria, Belgium, Denmark, France, Ireland, Luxembourg, the Netherlands, Sweden and the UK, but most have restrictions in case of change of control (for details see Blažić, 2006, pp. 201-205).

[3] Withholding tax is often wrongly considered as an equivalent to the imputation tax (= advance tax = equalization tax = précompte) which is a mark for dividends paid in arrears.

[4] For various inter-corporate dividend taxation methods in the old-EU member states, see Blažić, 2006, p. 169.

[5] According to the same author, some EU member states, such as Luxembourg, the Netherlands, Portugal and Spain, also allow deferral of tax on unrealised intra-group trading profits in addition to classical consolidation rules.

[6] Deloitte International Tax and Business Guide - Belgium, June 2007, http://www.deloittewebguides.com/report_dl.asp?mode=pdf&issue_id=1862284571.

[7] Transfer Pricing Country Profiles of OECD countries are available at: http://www.oecd.org/document/25/0,3343,en_2649_33753_37837401_1_1_1_1,00.html.

[8] See Article 473 of the Croatian Company Law.

[9] The calculation of accounting income includes permanent as well as temporary differences.

[10] Croatia signed 45 bilateral double-taxation avoidance treaties. Most of them are agreements with the major trade partners, like the countries from former Yugoslavia and the EU member countries.

[11] See COM(2001) 582 final. About 99% of the EU enterprises belong to the SME sector. An EU Observatory survey on SMEs' activities is regularly conducted, with the last one completed in 2007 after carrying out more than 17 thousand European enterprises. Its results showed astonishingly low cross-border activity of the SMEs. For example, only 8% of the EU SMEs reported turnover from exports, while only 5% reported that they have subsidiaries or joint ventures abroad.

[12] The most closely related article of the EC Treaty on the issue of direct taxes harmonisation is given in the Article No 94 stating that "The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market".

[13] With the possibility of enterprises registration as SE and SCE, the business networking within the EU is facilitated. Only companies may hold shares in an SE, whose minimum capital must be 120.000 EUR. An SE is automatically equated to a public limited liability company in the member state where it has its head office and is subject to the tax laws of the country in which it is registered. Unlike SE, both physical persons and business entities can set up an SCE by subscribing at least 30.000 EUR of capital. Their liabilities are limited to the size of the subscribed capital. For more details see the Regulation (EC) No 2157/2001 on the Statute for a European Company (SE) and the Regulation (EC) No 1435/2003 on the Statute for a European Cooperative Society (SCE).

[14] The OECD approved of a mandate for the Working Group of business restructurings in 2007, following the steps of the Merger Directive.

[15] See European Commission, Company Taxation in the Internal Market, COM(2001) 582 final.

[16] The Code effectively implements the EU Arbitration Convention which was originally proposed in 1976 and signed in 1990. The follow-up of the Code of Conduct was the Code of Conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, issued in 2006.

[17] Information taken from Nicod?me G., 2006.

[18] See Official Gazzette of the RC, No 109/2007.

REFERENCES

Alesina, A., Perotti, R., (2004), The European Union: A Politially Incorrect View, Journal of Eonomic Perspectives, Vol. 18, no. 4, Fall, 27-48.

Ashta, A., (2007), Double Taxation Avoidance: International and Dividends, Burgundy School of Business (ESC Dijon), France – CEREN, working paper, February, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=940927#PaperDownload .

Ashta, A., (2006), The Parent Subsidiary Directive (90/435/EEC), Burgundy School of Business (ESC Dijon), France – CEREN, working paper, October, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=940967#PaperDownload.

Ashta, A., (2007), The Taxation of Mergers Directive (90/434/EEC) as Amended, ICFAI Journal of Mergers and Acquisitions, Vol. 4, no. 1, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=929392#PaperDownload.

Blažić, H., (2006), Usporedni porezni sustavi – Oporezivanje dohotka i dobiti, Ekonomski fakultet Sveučilišta u Rijeci, Rijeka, http://www.efri.hr/admin/dokumenti/H.Blazic_Usp_por_sustavi-knjiga.pdf.

Cnossen, S., (2002), Coordinating Corporation Taxes in the European Union: Subsidiarity in Action, University of Maastricht, working paper, http://www.cpb.nl/nl/activ/subsidiarity/papers/taxation/cnossen.pdf.

Cnossen, S., (2003), Coordinating Corporation Taxes in the European Union, University of Michigan, working paper, http://www.umich.edu/~iinet/euc/PDFs/2003%20Papers/Cnossen.PDF.

Code of conduct for business taxation tax measures covered, published within the conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997 concerning the taxation policy, Official Journal of the European Communities, C 2/5, 6.01.1998., http://ec.europa.eu/taxation_customs/resources/documents/COC_EN.pdf.

Code of conduct for the effective implementation of the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, Official Journal of the European Union, 2006/C 176/02, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:176:0008:0012:EN:PDF.

Code of Conduct for the effective implementation of the EU Arbitration Convention, 90/436/EEC of 23 July 1990, Commission of the European Communities, COM(2004) 297 final of 23 April 2004, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2004:0297:FIN:EN:PDF.

Commission Recommendation of 7 December 1994 on the transfer of small and medium-sized enterprises, text with EEA relevance, 94/1069/EC, Official Journal of the European Communities, L 385, 31/12/1994.

Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises, notified under document number C(2003) 1422, (2003/361/EC), Official Journal of the European Union, L 124, http://europa.eu/eur-lex/pri/en/oj/dat/2003/l_124/l_12420030520en00360041.pdf.

Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Towards an Internal Market without tax obstacles - A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities,

Commission of the European Communities, Brussels, 23.10.2001., COM(2001) 582 final, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2001:0582:FIN:EN:PDF.

Council Directive of 23 July 1990 on common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, 90/435/EEC, OJ L 225, consolidated text, http://eur-lex.europa.eu/LexUriServ/site/en/consleg/1990/L/01990L0434-20070101-en.pdf.

Council Directive 2005/19/EC of 17 February 2005 amending Directive 90/434/EEC 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (Merger Directive), Official Journal of the European Union, L 58, 4.03.2005., http://eur-lex.europa.eu/LexUriServ/site/en/oj/2005/l_058/l_05820050304en00190027.pdf.

Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (I+R Directive), Official Journal of the European Union, L 157, 26/06/2003 P, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0049:en:HTML.

Daly, M., (2006), WTO Rules on Direct Taxation, The World Economy, Vol. 29, Issue 5, 527-557.

Deloitte International Tax and Business Guides, available at: http://www.deloittetaxguides.com/index.asp?layout=countryAllDtt&rf=0

Eggert, W., Haufler, A., (2006), Company tax coordination cum tax rate competition in the European Union, University of Munich, Discussion paper 2006-11, March, http://epub.ub.uni-muenchen.de/archive/00000902/01/company.pdf.

FINA, (2007), Analiza financijskih rezultata poduzetnika Republike Hrvatske u 2006. godini.

Group Taxation in Belgium, France, Germany, Italy, Spain, the UK, and the US, (2003), Jones Day International Tax Briefing, http://www.jonesday.com/files/Publication/6f660ab8-97d0-4230-9c5b-71822ff023d9/Presentation/PublicationAttachment/dcd768bf-489c-4b58-8dbd-b510aaba5b69/Group%20Taxation_1.pdf.

Hoogendoorn, M. N., (1996), Accounting and taxation in Europe - A comparative overview, The European Accounting Review, No 5, Supplement, 783-794.

Issues related to group taxation, working document, (2006), Common Consolidated Corporate Tax Base Working Group (CCCTB WG), Brussels, May, http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCCTBWP035_consolidationFINAL_en.pdf.

Jančiev, Z., Supić, J., (2007), Porezni priručnik za trgovačka društva, Ministarstvo financija Republike Hrvatske – Porezna uprava, Zagreb, http://www.porezna-uprava.hr/contentData/PDF%20Datoteke/Brošure/TRGOVACKA%20DRUSTVA.PDF.

Lamb, M., (1995), When is group a group, Convergence of concepts of 'group' in European Union corporate tax, The European Accounting Review, Vol. 4, no.1, 33-78.

Nicodčme, G., (2006), Corporate Tax Competition and Coordination in the European Union: What Do We Know? Where Do We Stand?, MPRA (Munich Personal RePEc Archive), Paper No. 107, June, http://mpra.ub.uni-muenchen.de/107/1/MPRA_paper_107.pdf.

Tackling the corporation tax obstacles of small and medium-sized enterprises in the Internal Market – outline of a possible Home State Taxation pilot scheme […], Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Commission of the European Communities, COM(2005)702 final, Brussels, 23.12.2005., http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2005:0702:FIN:EN:PDF.

Zakon o porezu na dobit (Profit Tax Act), „Narodne novine‘ (Official Gazette of the RC), No. 177/04, 90/05, 57/06), http://regulations.porezna-uprava.hr/index_open.asp?idPropisa=1170&jid=1&file=The Profit Tax Act.

Zakon o trgovačkim društvima (Croatian Company Law), ‘Narodne novine‘ (Official Gazzette of the RC), No 113/93, 34/99, 52/00, 118/03, consolidated text, available in Croatian only, http://www.legalis.hr/downloads/zakon_o_trgovackim_drustvima.pdf.